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NAFTA: Twelve Years Later

[Editor's Note: There follows an edited transcript of the three-part joint program of the International Law and Practice Section and the Corporate Counsel Section of the New York State Bar Association (NYSBA) held on 25 January 2006 at the New York Marriott Marquis Hotel during the NYSBA's Annual Meeting.]

I. Introductory Remarks

STEVEN H. MOSENSON: Good morning. Welcome to the joint program of the Corporate Counsel Section and the International Law and Practice Section on "NAFTA: 12 Years Later," an overview of NAFTA.

My name is Steve Mosenson. I am chair of the Corporate Counsel Section of the New York State Bar Association (NYSBA). I would like to welcome you to the program and give a 15-second pitch for the Corporate Counsel Section. We are the voice and home of in-house counsel in the NYSBA; we have over 1,500 members. You need not be an in-house counsel to be a member of our section. We do have quite a few others: up to 30 percent of our members are from law firms and places other than inside corporations. But we are fairly unique in being a voice within the NYSBA advocating for in-house counsel.

We are engaged in a strategic plan this year for our members, and we are committed to providing services that may not be provided anywhere else in the association. So I just wanted to give a quick pitch for that. I hope those of you will consider joining our section, at least inquiring about some of the programs we have.

With that I'll turn this over to Bob Leo to do the substance of the program.

ROBERT J. LEO: Thank you. Welcome, everybody. I am Bob Leo, the chair, for about four more hours, of the International Law and Practice Section. I want to welcome you all, and especially the Corporate Counsel Section for agreeing to co-sponsor this program.

We have a great program. Before I turn it over, I'll give a commercial for the International Law and Practice Section. We have 2,000 members. We have about thirty-odd committees involved in all aspects of international law. We have over forty chapters in different countries around the world. A number of our chapter chairs are here today, from Stockholm, from Bolivia, from Argentina, and from London. We are very international, as you can tell.

Jack Zulack is here in the corner. He is the incoming chair. I'm going to thank Marco Blanco, the partner at Curtis Mallet here in New York who organized this program and will be your moderator and host. Without further ado, Mr. Blanco.

MARCO A. BLANCO: Good morning. Today's program is going to consist of three parts. The first panel is going to provide an overview of NAFTA, then and now. The second panel will provide an analysis of the Chapter 11 section of NAFTA, which provides for investor rights and investor-state arbitrations, and, finally, the last panel will provide a discussion of the current state of cross-border legal services under NAFTA.

For each panel we have a representative from Canada, Mexico and the United States.

II. Overview of NAFTA

A. Introduction

I am pleased to introduce to you the first panel, which will provide the overview of NAFTA. On the panel to my right is Milos Barutciski, a partner at Davies Ward Philips & Vineberg in the firm's Toronto office, where he practices international trade, investment and competition law. He regularly represents domestic and international clients in trade and investment matters involving NAFTA, anti-dumping, the WTO Agreements, countervailing duty and safeguard cases, foreign investment review, trade sanctions, foreign corrupt practices and international dispute settlement. Mr. Barutciski is chair of the International Affairs Committee of the Canadian Chamber of Commerce.

Next is Philip von Mehren, a partner in the international corporate department of Curtis, Mallet-Prevost, Colt & Mosle. His practice is focused on acquisitions and dispositions, often in a cross-border setting, for strategic financial buyers, including private equity and venture capital funds. He writes and lectures extensively on NAFTA. He is the author of "Cross Border Trade and Investment in Mexico: NAFTA's New Rules of the Game," published in the *American Journal of International Law*.

Next is Carlos Garcia Fernandez. By appointment of President Fox of Mexico, Carlos has been the head of the Federal Bureau of Regulatory Improvement since 1 April 2004. Although Mr. Fernandez began his career in the private sector in 1986, he switched to the public sector in 1993 as the Director of Foreign Matters of the Federal Bureau of Foreign Investment of the then Secretary of Commerce and Industrial Development. Then from 1994 to 2003, he served as the head of the Federal Foreign Investment Office of the Secretary of the Economy.

MR. VON MEHREN: Thank you very much, Marco.

We are going to try very hard to get a dialogue going amongst us and amongst the group that's assembled here. I'm going to start off with a very brief introduction to our topic, and then hand it off to Milos, who will then hand it off to Carlos.

The North American Free Trade Agreement (NAFTA) is really much more than a free trade agreement. And it's surprising that, twelve years after its date of implementation, most lawyers, even most international lawyers, don't really know that.

Obviously, NAFTA has had a tremendous effect on lowering tariff barriers among the three members, Canada, United States and Mexico. But it has also had an enormous effect on such diverse areas as government procurement, the investment sector, which we will hear more about in the second panel and we will touch on in this panel, cross-border services, financial services, and dispute settlement with respect to anti-dumping. All of the rules relating to these matters, when you look at them as a totality, require that a corporate lawyer or trade lawyer approach transactions that involve any of these three countries in a much more multi-disciplinary way than had previously been the case.

If you're an international deal lawyer, as I am, you have to be always on the lookout for situations in which substantive rules and NAFTA may be able to help your client. In fact, in the mid-90s I was involved in situations where, although there had been an enormous change in Mexico's legal system as a result of the passage of NAFTA, there were a few areas concerning which Mexico's laws did not satisfy commitments under NAFTA. In those areas, after careful discussions with Mexican regulators, we were able essentially to open up sectors of the Mexican economy that otherwise would not have been able to be opened up.

The next point that I think is very important when you approach NAFTA and attempt to gain an understanding of it is that it was built on the U.S.-Canada Free Trade Agreement, which had been passed earlier, in the mid-80s. But what NAFTA really did was basically to commit Mexico to implement a completely new and radically neo-liberal development program. And for Mexico, the proof is in the pudding. Because one can look at virtually any aspect of international trade and investment law in the Mexican legal system and view the enormous fundamental changes that have occurred in the legal system.

All that having been said, what are the results? We are going to touch upon this a little more as we go through the program. But I think it's very clear, both in terms of investment flows and trade, that NAFTA has been part of a process by which regional integration has increased tremendously. All of those aggregate numbers are up among the three economies.

What are the threats to NAFTA? Essentially, the threats to NAFTA, I think, are mostly of a political nature. We are going to talk about a few bumps in the road in a minute, but essentially the only real threat to NAFTA, I believe, in the short run would be if Mexico veers radically to the left, which I think is a possibility but not a probability. An abandonment by the Mexican administration of NAFTA, I think, would have a significant effect on Mexico's development path and obviously have a very significant effect on investment flows and trade.

Based on that introduction, I think we want to continue on with Milos's points, and then we will hopefully elicit questions from you in the audience. Thank you.

MILOS BARUTCISKI: Thank you, Philip. What we had thought about in part when we discussed amongst the three of us earlier how we could try to do something a little more creative than the more traditional talking head presentation. What I'm going to talk about, as Philip pointed out, is how the impact and benefits of NAFTA have been more or less evident. There is plenty of material provided that will give you the numbers on the impact of NAFTA: what it has done between trade and investment between the U.S. and Canada. I want to highlight that point, trade and investment, and their conjunction.

We have had for decades an enormous volume of trade going back and forth between Canada and United States—I won't speak so much for Mexico for the moment—and an enormous volume of investment flowing between the two countries. I think it is a really a microcosm of what's happening to trade globally. Today, in the 21st century, trade isn't what it may have been six or seven decades ago or five decades ago when the GATT was signed, where in most instances manufacturers in Canada and United States or wherever would pack their goods, see them crated and loaded onto a boat, and wave goodbye to them as they went to distant ports.

Today investment follows and in some cases leads trade, for a simple reason: products are not just fungible widgets. That is especially so with the migration of trade toward products of value, which require greater service after sales, and so on. It means you have to have your feet on the ground in the country of destination for your export, which has further fueled the cross-border investment among the three countries. So the benefits and the positive impact over the past decade or twelve years of NAFTA are to be seen there.

What I want to reflect on is that, now that we have had twelve years of successful NAFTA, what we are seeing today and have been seeing for a number of years is a creaking institution. It is starting to groan under some of the pressure it has been put under by the parties, but as importantly, from the lack of attention to this very important feature from three governments. Without being too nationalistic, I have the sense that the lack of attention is probably most noticeable in the United States although I don't think I can absolve the Canadian government of that either. We see the same issues in Canada in terms of attention. The last election, just two days ago, is a perfect example. NAFTA and international affairs more generally simply did not even register as a blip on the radar screen, despite the fact that every party agrees that half of our economy is dependent on international trade.

Now, the creaking or groaning, where is it coming from? Let's start with some basic features of the agreement. First, there is the Secretariat. The agreement was set up to make the Secretariat an administrative post; it is not like the Secretariat of the European Commission. But administrative processes are important. Dispute settlement doesn't work on its own: you need a court registrar. Just to pick an example, NAFTA Chapter 19 panels, six or seven years ago, were basically taking about three hundred days. And NAFTA itself says—it is not a mandatory target—it should be approximately three hundred fifteen days. Today they are taking over two years. It takes longer to go through a Chapter 19 process on average (for example, to review an anti-dumping/PVD case) than it would previously have taken the Court of International Trade in the U.S., which is what the NAFTA process was intended to replace.

You ask yourself: why is that occurring? Well, it comes back to the administrative infrastructure of NAFTA. There is insufficient investment in both managing and maintaining the Secretariat. The U.S. Secretariat is a shoestring operation without question. But we have other neglected institutions in NAFTA: for example, the Free Trade Commission, which is supposed to hold a meeting of the three trade ministers once a year. The Commission does go through the perfunctory meeting, but it has never evolved beyond a one-day, one-morning affair of three ministers and a handful of their senior colleagues. So we failed to build on the original concept behind NAFTA.

The third point, before I pass it on, I think underscores what I've just said, and that is that NAFTA isn't just a set of rules fixed in a point in time. Almost every chapter of NAFTA contemplates and introduces a mechanism to deepen or further integration and rules to ease and facilitate ever-increasing access to each other's markets. I can go through areas like sanitary and phytosanitary (SPS) standards, a really exciting topic. What is it about? It is about mad cow disease. We had several billion dollars' worth of trade between the two countries tied up for several years because of this—it's not the only reason: it's not the one or two cows in Alberta or the two cows in the U.S. But the SPS working group, which is there in the SPS chapter of NAFTA, has barely met in a decade. We should have anticipated these kinds of issues. That's one issue.

The same thing applies to the area of standards, basic technical standards. Corporate counsel who work for manufacturing firms know what I'm talking about when you talk about standards. For example, one thing that Canada and U.S. have done in a few instances—as you've done with Europe—is mutual recognition agreements. I've yet to hear one corporate counsel tell me that, in the manufacturing context, there's anything wrong about an MRA where it exists. But there aren't enough of them.

Another example is the temporary entry of business personnel and professionals. Again, the working group dealing with that is practically dormant. And on and on and on. There's been incremental work on rules of origin. But what if we were, not so much to ease up, but to streamline the rules of origin in NAFTA, which are contained in Chapter 4? I think the biggest failure has been the failure to invest in the institutional infrastructure over time that would recognize, underscoring the point that Philip made, that NAFTA isn't just a set of rules. It was meant to establish the beginnings of an institution that would evolve over time: not an economic union, like the EU, let alone a political union, but an institution that has life.

Now I turn the floor over to Carlos.

CARLOS GARCIA FERNANDEZ: Thank you Philip; thank you Milos. Good morning, everyone. I would like to thank the chair, people of both the Corporate Counsel Section and the International Law and Practice Section, in particular, the chairs who still occupy their posts for a few remaining minutes, the incoming chairs, and my friends from Curtis, Mallet-Prevost, Marco and Philip, and all the friends from the firm, for this invitation.

I would like to continue the exercise that has been started by both Philip and Milos.

My intention is to reflect on two basic items: the significance of NAFTA and future challenges for Mexico, similar to how both Milos and Philip have presented the matter.

On the significance of NAFTA for Mexico, the entry into force of NAFTA and Mexico's establishment of a broad network of free trade agreements and bilateral investment treaties have fostered the growth of trade and foreign direct investment in my country. As Philip and Milos said, this is a part of NAFTA, from the Mexican perspective, but NAFTA cannot be reduced to just trade and investment. From the Mexican perspective, it meant a change of mentality in order to realize that the world needed rules of the game. Both Canadian and American investors need rules of the game in order to promote their investment projects and to foster trade with Mexico. Consequently, an important leap has been achieved in terms of competitiveness and size of the economy.

The figures in relation to imports, exports and trade volume reached an aggregate trade volume of US $434 billion by the year 2005. If we move to foreign direct investment, there has been a tremendous impact of NAFTA on foreign investment coming into Mexico. Pre-NAFTA it averaged about US $3.7 billion a year. In the post-NAFTA era, we are reaching nearly US $17 billion a year on an average basis. According to figures from the United Nations

Conference on Development (UNCD) for last year, Great Britain got US $219 billion in foreign direct investment in 2004; the U.S. on an inward basis got $106 billion; and China came in third place with $60 billion. Then came France, Hong Kong, Russia and Mexico. Mexico at US $17 billion led in Latin America, in comparison with Brazil and Chile. So Mexico comes in seventh place on a worldwide basis after Great Britain, U.S., China, France, Hong Kong and Russia. That's on foreign direct investment.

I share the views of Milos and Philip in that, in my view, despite the evident success of NAFTA for the Mexican economy, some issues need to be addressed in order to move forward. The key question is how we can move forward. The three partnered countries, the people of the three countries, can move forward and solidify the bonds among Mexico, the U.S. and Canada with regard to security, immigration, and harmonious and balanced development. This will involve strengthening NAFTA institutions, as Milos rightly put forward, and the mechanisms established by NAFTA, including the dispute settlement mechanisms. We will listen carefully to the views of our friends who will later touch upon these subjects. Another issue is how, from the North American perspective, to deal with the competition from Asia.

An additional challenge is security. In that regard, the Security and Prosperity Partnership of North America was created in March 2005. We need to secure North America from external threats, and we need to respond to and prevent threats within North America. And we need to promote growth, competitiveness and quality of life.

It might be the right time to analyze the feasibility of climbing up the ladder of integration. To open our minds and think about moving from a free trade zone or customs union or economic community. We do not necessarily have to think of going up this ladder in a single exercise and, with a single decision, expect to reach full integration. We can take one small step at a time. As they say, Rome was not built in a day. But why not challenge our minds in connection with future integration, so that we can only talk about more than just goods or services and foreign direct investment. We can try to keep moving since NAFTA is, as Philip said, much more than a free trade and investment agreement.

After twelve years of successful NAFTA, some institutions need to be refined, and some institutions need to be developed. We have to give more life into NAFTA's structures.

So being twelve years old—and I conclude with this idea—NAFTA is an adolescent. And adolescents need to be developed; they need to continue evolving, growing. But they don't need walls; they don't need to be dormant. Thank you.

MR. BARUTCISKI: I just want to follow through with a couple of things that Carlos referred to. Carlos may be a little more optimistic about the evolution of NAFTA than I am. He called NAFTA an adolescent. Having three younger children, I would think of it more as beginning elementary school. Yes, we are not a toddler anymore, but we really haven't learned to read or write yet.

I want to make a couple of things clear. There's a cottage industry in my country to blame the Bush administration for its stand on a host of trade issues, and a lot of that criticism is deserved. This is not their problem. This issue that I was talking about, the starving of NAFTA as an institution and the failure to capture its potential and to feed this potential, is something that predates that U.S. administration. At least the current administration has the very legitimate excuse that it has been preoccupied with some very significant issues since 2001. The previous administration didn't have that excuse; yet it allowed the institution to wither just as gradually as the present administration has.

So this is not a partisan issue. This is a failure of the political systems in not just the United States, but also in Canada; the same issue occurs in Canada. Although trade policy people, like myself, were cognizant of the issue, there wasn't the same push by our government—successive governments, both conservative and liberal—or by our business community even to push that. People kind of took the low-hanging fruit of the implementation of NAFTA and said, "Wow, that's great." So that's really my first point.

The second point—and Carlos put it among the challenges—is the impact of globalization and emerging economies outside of North America: we all know China. But it is not just China, others include Brazil and India, etc., etc. We have within NAFTA something that is unique. We have within NAFTA a grouping of three countries within a free-trade area, where tariffs have been completely eliminated between Canada and the United States for some years now and very close to being eliminated in a couple of years between Mexico and the rest of us. And what do we have within those three countries that would allow the continental economy to compete effectively with the rest of the world? We have the economic engine that is the United States. We have part of it in central Canada, which is an integral part of that economy: the auto industry and a number of other manufacturing industries, but we also have resource and energy assets in Canada that are significant. I think anybody will admit that is significant, especially in today's climate. And thirdly, we have something that no other developed economy has: We have access within a duty-free zone to a pool of educated but low-cost labor. Now, if that isn't the recipe from a trade and economic policy perspective for injecting greater competitiveness into the North American economy, I really fail to see how you could write up a better one.

But we are failing to take advantage of that. That is the key. It's not just that we haven't allowed NAFTA to grow and evolve because it is a good thing from a trade policy perspective. My point is that the failure to allow NAFTA to grow and evolve and invest in its ongoing development is going to threaten our ability as North Americans and North American economies to compete more effectively with a much bigger and more powerful world out there than we faced twelve years ago when we signed NAFTA.

MR. VON MEHREN: And one of the things so surprising is that the division of labor that you essentially described among Mexico, Canada and United States, was, I think, a sort of economic principle behind the formation of NAFTA. When you go back twelve years ago and look at the global economy, China wasn't really in anybody's mind at the time.

One of the things that I think has been tough on Mexico, although in the long run it may be very beneficial, is that the economic activities that NAFTA, in this division of labor, envisioned for Mexico have to some extent been taken by the Chinese. You have these stories where Chinese manufacturers of television screens are sending them by overnight mail into Memphis every day. Television screens were one of the things that everybody thought Mexico was going to be very much involved in. But even though in the short run that may be less beneficial than what we had hoped for Mexico, in the long run, if Mexico can meet the challenge of China and show that it has a more value-added, more educated, more efficient labor force than the Chinese, I think it can be a tremendous benefit for Mexico.

MR. FERNANDEZ: I agree with what Philip has said. We constantly ask ourselves in Mexico—not only the Mexican government but also the private sector—is how we can compete with China, and not only with China, but, as Milos has said, with other countries in Central and South America, in central and east Asia. We are convinced, at least that's my conviction, that we need to do that on a two-tiered basis.

On the one hand there is the rule of law. NAFTA has helped tremendously to strengthen the rule of law, from an institutional perspective, in Mexico. So we have the rules of the game there, and we are determined—at least my generation is determined—to abide by the rules of the game, at both the domestic and international levels.

On the other hand, there is the question of logistics: we have to become a logistics hub if Mexico wants to attract further investments. Going from $17 billion to reach the US $60 billion that China got in the year 2004, we need to make Mexico a logistics hub in which your clients will have first-world services in logistics, telecommunications, maritime transport, railroad transport, cargo transport, etc., etc. In addition to that, we must incorporate highly developed technology and well-trained and skilled labor into the manufacturing of goods and rendering of services. In other words, I am absolutely convinced that it wouldn't be the right strategy for Mexico to try to compete with China in terms of low-cost labor. I don't want that type of standard of living for the people of Mexico. We want to improve the standard of living for every single Mexican. Therefore, we have to invest in education. We have to better train our people. We have to put high tech in the processes for the manufacturing of goods and the rendering of services. In order to do that we have to strengthen and develop the institutional dimension of NAFTA.

Finally, NAFTA is about goods, services and investments. What about people? I just put forward that question, because vis-à-vis the free trade agreement that was evolved after 1957 by the Europeans, they encompassed not only goods, services and investments, but also people. Thank you.

MR. VON MEHREN: We now have time for some questions.

AUDIENCE MEMBER: In your opinion, what impact do security issues in Mexico have on limitations with NAFTA? I know Mexico City is on a high-risk travel alert from the U.S. government. Do you think that has impacted NAFTA?

MR. FERNANDEZ: It's a difficult question to be answered on a black-and-white basis. I think that we have to pay serious and decisive attention to this matter of security. We need internal security and external security in order to improve standards with our partners in North America.

MR. VON MEHREN: If I could just add to that. I think the security issue in Mexico really parallels the whole emergence of the rule of law in Mexico. You can't expect a society, any society, to go through as profound a change as Mexico has already done over the last fifteen or twenty years, and to complete every aspect of that transformation.

I think the present administration has really tried to attack some of the basic problems relating to personal security, and I think that whoever is in the next administration will have to continue that process.

AUDIENCE MEMBER: Sir, for any one of you that has an answer, one of the things that enhances economic growth obviously is the portability of labor. And it is difficult for Mexican labor to go lawfully where Mexican labor is needed, primarily in the United States. That doesn't seem like a great idea as far as the portability of labor is concerned. Do any of you have an idea in regard to the current administration or any administration as to what can be done to enhance the portability of labor to go cross borders, either way, where it is needed, without law enforcement and all kinds of restrictions that diminish economic growth?

MR. FERNANDEZ: That's another difficult one. I would stop there.

MR. BARUTCISKI: I'll take the Hail Mary pass. We actually talked about this a week ago amongst the three of us, actually more between Carlos and me on this one.

NAFTA itself doesn't deal with the issue. But it is an economic reality. I attended an ABA meeting three or four months ago, and there was a speaker talking about the demographic issues facing all of our countries.

Although Canada and the U.S. aren't in as bad a shape as Europe, we are facing the same challenges in terms of demographics and our need for labor. You think it is just a U.S. problem of having a need for labor from the outside, and the obvious place is Mexico because it is right there. We have that in Canada as well. We have a large number—not nearly as many as the U.S.—of Mexicans traveling to Canada for seasonal and other work. We see that as a positive thing.

The main issue is to start by building incrementally on what we have. What we have in NAFTA that doesn't address the broader labor issue but starts looking at it is a mechanism to deal with and facilitate business travel and temporary entry for professionals. And we've let that chapter wither. For example, the approach of both of our governments, in particular the U.S. government, vis-à-vis NAFTA visas for Mexican professionals and Mexican business people has been pathetic. As between each other, Canada and the U.S., I make the same comment. It's not nearly as bad as with Mexico, but also not particularly great.

In NAFTA, we have a laboratory, an institution we can use to experiment and develop mechanisms and, as important, build some of the links among our respective immigration and security bureaucracies. Because that is a critical and necessary part of the issue, and we are letting that wither. I think that's where we have to start looking.

With regard to the point made earlier about having to invest in the institution, NAFTA is full of institutions that hold enormous potential to grow into something more without thinking radical thoughts like political union or anything like that. Nobody in the United States would even dream of that at the present time. It has been mooted in Canada from time to time. But we don't have to go there. There are many things we can do in the present institution, not by rule changes or by changes to the treaty, but just by investing the time to sit down with officials and talk about this kind of thing. If we can begin by facilitating temporary entry at the business and professional level, we might start developing models. As we ratchet further down in the skill level that's required to qualify for professional entry under a NAFTA chapter, we can start building templates for how we might address the issue of larger volume and less skilled labor.

I'd like to clarify my point about the synergies of NAFTA and what the three countries bring to the table in light of what Carlos has spoken about. I wasn't trying to say, "Open the borders to cheap labor, but don't give the folks coming in citizenship or residence." That's not what I'm talking about. I'm talking about what each country brings to the table today, and that allows both Mexico and Canada and the United States to exploit our own advantages by pulling together these assets, and that's the key.

So the answer isn't in NAFTA today, but the institutional framework to develop an answer is there.

MR. FERNANDEZ: With NAFTA, we laid the foundations, but we have to keep going. We have the institutional framework, but we must keep building the project. The project is a huge building, and therefore the foundations must be very solid in my opinion. Although the foundations are a pre-condition, they are not sufficient in themselves for an evolving and dynamic relationship among the three countries. In NAFTA's institutional framework, we must move forward and try to find positive and creative solutions to the challenges and problems we are confronted with for the three countries to keep moving in a competitive manner. Thank you.

MR. VON MEHREN: I would like to ask Mr. Fernandez a question, and I hope that it is not too political a question. Because you are talking about people and the standard of living, and, if I understand correctly, you're talking about a balance between exporting labor and not cheapening it so that the standard of living in your country suffers. But I'm thinking, how do you envision this in your country? If you take an area in Mexico, how can we use this model when really you can't blame people for going to Chicago to provide cheap labor because look at the standard of living in some of those areas in Mexico. When you say the standard of living in Mexico should not suffer, how do you envision that working?

MR. FERNANDEZ: Thank you. I think that we have to address this subject from two different perspectives, one of which is an internal one. We Mexicans have to respond and be responsible for the well being of our own people. That is our main responsibility. And the government, as President Fox has done, must keep moving ahead by creating the proper conditions for investing in people, for training and educating people, and for creating the business climate needed for others to do business in Mexico.

Secondly, I will say that, in light of the institutions that NAFTA has, there is the possibility that things will evolve by our addressing some of these matters not only from the Mexican perspective as a Mexican problem but as a reality affecting the entire area.

To sum up, we Mexicans have to continue doing our own internal work. In addition, we have to continue the dialogue with our Canadian and American partners in order to strengthen the institutions and to make NAFTA not only the foundation but a solid building that encompasses and gives protection to every single human being in the whole region.

AUDIENCE MEMBER: That's a noble sentiment, but I think it is not an issue for Mexico alone. The U.S. and Canada, I think, need to refocus on what they are all about as governments for their people. They are supposedly democratic. Ford is laying off 30,000 people. I think a lot of them would like to move to Mexico to work in a plant down there where they will be paid less, but it will be warmer. There are a lot of social dynamic issues lurking under the surface. The same issues that have drawn the Europeans into the European Union, into that political perspective. American and Canadian businesspeople and most wealthy Mexican investors want to ignore that stuff. So how is this going to come to the fore? Because the majority of people need to support this effort. And if they are not going to, you're going to see continuing sputtering along of NAFTA as it is without any further improvement.

Do you have any ideas on this, gentlemen?

MR. BARUTCISKI: Yes, I think we all have thoughts on this. I certainly do think about these issues. I mean this has been a policy discussion, not a law discussion, but it's been a policy discussion based on a legal instrument that, I think, does have promise to address some of these issues. That's really what I was trying to get at. NAFTA doesn't deal with the kind of issues we are talking about. Let me use Marxist terminology. Let's think back to our poli-sci days when we were undergraduates and reading that goofy stuff about factors of production and stuff. I forget the idioms that were used. But NAFTA is about removing barriers to mobility of different factors of production, and it is doing that incrementally with respect to all of them but not entirely. It is starting to do that incrementally with respect to mobility of labor at the professional and technical level. It's a small step, but it is a start, and I think that's the reality that we have to start addressing within NAFTA. We have the institution: that was really my fundamental point here. I'm a big fan of incrementalism. I don't think you have to have revolutions to achieve progress. Sometimes they might be useful. You guys have done it. We have done it the other way. We have had pretty nice progress, thank you very much, for a couple of hundred of years, and we haven't had revolutions. As one of our prime ministers used to say, never do anything by halves if you can do it by quarters. But if you're moving forward, don't complain.

MR. FERNANDEZ: And I would just like to say that, based on the institutional framework of NAFTA, we have to open up more efficient communication devices (and thereby foster dialogue) among the governments, our offices and society at large. Next week I will go to the OECD to address another audience about the Mexican experience with the public/private dialogue needed to build the rules of the game in Mexico.

MR. BLANCO: Thank you very much.

III. NAFTA Chapter 11: Investor Rights and Investor-State Arbitrations

MR. BLANCO: Our second panel will discuss Chapter 11 of NAFTA, which is the only provision of NAFTA granting rights of action to private parties.

To discuss this panel I am pleased to present Cecilia Azar. She is a consultant of the ABA/USAID Mediation Project in Mexico and Professor of ADR and International Commercial Arbitration at ITAM, UNAM and other academic and non-academic forums. Prior to that, from 1998 through 2000, she served as Secretary General of the Arbitration Center of Mexico.

Next to her is Catherine Amirfar. She is an associate in the New York office of Debevoise & Plimpton LLP, where her practice is focused on international dispute resolution. She has extensive experience in public and international law and arbitration. Recently she served as part of a team representing Mexico in the International Court of Justice in *Avena and Mexican Nationals (Mexico v. United States of America)* concerning violations of the Vienna Convention on Consular Relations.

Next is John Terry. John is a partner of the Toronto office of Torys LLP. He practices business and public law litigation with a focus on international trade and arbitration. John has been counsel on a number of NAFTA Chapter 11 cases on both the investor and government sides, including a successful action by the U.S. corporation S.D. Meyers Inc. against the Government of Canada, and a recently-heard claim by UPS against the Government of Canada. So I am going to pass the microphone to John.

JOHN TERRY: Thanks, Marco.

In this panel, I will go first, Catherine second, Cecelia third. We are shifting to an area in which NAFTA, which may be lacking in protecting the mobility of labor, is not necessarily lacking in investor protections. I'm going to start by explaining how Chapter 11 works and what its key provisions are. Then we are going to move to some of the thornier issues that have come up in the last decade or so of jurisprudence on this section.

To start with, in terms of the background of Chapter 11, it is of course the only provision pursuant to which NAFTA, or the WTO for that matter, provides a private right of action to parties. It sort of snuck in there to a large extent. I don't think many people were focused on this provision when the big debates were going on about whether or not NAFTA should be ratified in Mexico, the United States and Canada. Its legacy really goes back to a series of bilateral investment treaties that have been negotiated since the mid part of the century, typically by developed countries looking to protect their investors who are investing in developing countries. There is some jurisprudence around these treaties, but not much up until the point at which NAFTA was adopted in 1994.

The thing that was unique about NAFTA and that drew a lot of attention to this whole area, from critics, commentators and also practitioners, was that it was the first bilateral investment treaty that allowed for challenges between developed countries, that is, between Canada and the U.S. We found quite quickly that lawyers on both sides of the borders were getting creative and pushing the boundaries of the treaty further than they have ever done so in other cases.

Under Chapter 11 of NAFTA there are three primary guarantees that you can call an "investor bill of rights." First are nondiscrimination provisions. The primary one is what we call national treatment under NAFTA. You have to make sure that you're giving the same protection to a U.S. investor's firm in Canada as we are to Canadian companies that are in like circumstances. That national treatment provision picks up on some of the language that's been there since 1949 in the GATT, dealing with financial treatment. The other nondiscrimination treatment, again like the GATT, is a "most favored nation" provision, pursuant to which we can't give U.S. investors in Canada worse treatment than accorded an investor from the United Kingdom. Those provisions come with a whole history under the GATT: there is a lot of GATT jurisprudence. So there's a bit of a history and context within the broader international trade treaties to interpret these provisions. Here of course they apply specifically to investment, which is something we don't have under the WTO treaties, and they provide a private right of action.

The second guarantee is with respect to treatment in accordance with what Article 1105 calls "fair and equitable treatment and full protection and security." That is a provision that I'll talk about a little bit later. That's been quite an interesting provision, and it has generated probably some of the most controversy and most interesting jurisprudence under NAFTA. Because it is not focused on discrimination but on the actual treatment that's been given in a particular instance to a particular company, it is somewhat similar to the basic issue of fair process or justice under administrative or public law.

The third provision is one that prevents expropriation without compensation. I note at the outset it's quite interesting when you're advising companies in this respect, because I may be in a situation where I can say, if there's a particular concern about Canadian government legislation and the effect it is going to have on companies, a U.S. corporation may have better legal remedies than a Canadian corporation. There may be nothing a Canadian corporation can do under Canadian law or under NAFTA, because NAFTA of course is there to protect investors in other countries, not in Canada. The same would apply in the U.S. context: a Canadian corporation or one whose shareholders are Canadian could have a remedy under NAFTA against the U.S. government that a U.S. corporation would not have.

The nondiscrimination provision I spoke about briefly enjoins both de facto and de jure discrimination. Even if policies are not aimed at discriminating against a foreign company, they are subject to the provisions calling for most-favored-nation treatment or national treatment. The most-favored-nation provision can serve as a basis on which you can try and achieve through NAFTA what isn't directly available under NAFTA for a particular corporation. The way this works is as follows. Assume, for example, under NAFTA we in Canada have said to a corporation that we will grant it a right of fair and equitable treatment. Assume further that we have also entered into a bilateral investment treaty with another country, let's say France, where we have agreed to provide not only fair and equitable treatment but specific protections in certain administrative proceedings. The corporation can then, as a U.S. party, claim that Canada has already violated the most-favored-nation treatment because Canada is giving more protection under the bilateral investment treaty to France than to the corporation under NAFTA. There have been several cases in this area that have basically allowed parties not only to get the protection that NAFTA grants them but to basically ratchet that up to get protection that is given by a NAFTA party to other countries.

As I noted before, NAFTA provides for "fair and equitable treatment and full protection and security" in accordance with international law. And this provision has been focused on egregious conduct, such as failures to enforce the law. There have been attempts under NAFTA jurisprudence to push this further. There have been some cases—the case of *Pope & Talbot, Inc. v. Government of Canada* notably, in which the NAFTA tribunal adopted as a standard what looked like a standard of basic administrative fairness standard, such that, if you weren't granted treatment meeting such standard, you would have a right under NAFTA.

Some of you may be familiar with the decision in *Loewen Group, Inc. v. U.S.*, which might be used to attack a U.S. court decision. The *Loewen Group* decision involved a jury trial in Mississippi against a Canadian defendant in which very inflammatory language was used to get a massive punitive damages award. There is a provision under the Mississippi law that required the defendant to post a large bond for an appeal, and the defendant effectively was not able to do that, so the award stood. The Loewen Group then challenged it under NAFTA, bringing a claim seeking damages under Chapter 11. In June 2003, the NAFTA tribunal, for various technical and jurisdictional reasons, dismissed the Loewen claims. Although Loewen was unsuccessful, the tribunal indicated that the facts before it would otherwise have warranted a finding that justice had been denied and that there therefore had been a violation of the fair and equitable treatment standard.

There have been a couple of other cases under NAFTA that have challenged court decisions. This raises some interesting issues about the role of international tribunals in not quite reviewing but certainly crafting remedies that result from a review of decisions in the national courts of Canada, the U.S. and Mexico.

Another important NAFTA provision is that which proscribes expropriation without compensation, reflecting international law principles regarding expropriation. Expropriation must be for a public purpose on a nondiscriminatory basis, in accordance with due process, and upon payment of compensation. NAFTA Chapter 11 provides that the compensation must be the equivalent of fair market value.

The controversial *Methanex* case dealt with environmental regulation in California. The case was brought by Methanex Corporation, a Canadian firm and producer of methanol, which is a component in MTBE, used as an octane enhancer in unleaded gasoline. The international arbitration was brought against the U.S. after California banned the use of MTBEs, with Methanex arguing that the ban was an expropriation. The tribunal found that a general nondiscriminatory regulation that has an expropriating effect does not constitute an expropriation. This is actually a standard that is narrower and tougher to meet than may be the case in some instances of Canadian expropriation law. *Methanex* was the case that was used to scare people into saying we should move away completely from Chapter 11.

Beginning in about 2000 there was a backlash when people started to realize what was happening with respect to Chapter 11. There were a few cases brought in Canada that dealt with environmental legislation: a case dealing with the use of ethanol as an additive in gasoline, which was successfully brought and settled against the Canadian government, and a case that dealt with restrictions on the cross-border movement of PCBs. People, particularly environmentalists and those involved in the *Methanex* case, saw NAFTA as a Trojan horse that could be used to attack bona fide legislation.

An aspect contributing to this is that the process is consistent with the way commercial arbitration is generally conducted: the parties adopted confidential procedures; and they choose members of the arbitral tribunal by seeking out experts with experience in arbitration. This is a process that outsiders might not consider transparent at all. This is highlighted by a comment that appeared on 11 March 2001 in the *New York Times*:

> Their meetings are secret. Their members are generally unknown. The decisions they reach need not be fully disclosed.
>
> Yet the way a small group of international tribunals handles disputes between investors and foreign governments has led to national laws being revoked, justice systems questioned and environmental regulations challenged. And it is all in the name of protecting the rights of foreign investors under [NAFTA.]

As Catherine and Cecelia will discuss, a number of court actions have been brought in each of the three countries challenging the authority of Chapter 11 tribunals. A constitutional challenge brought in Canada was dismissed. Essentially it was brought without a factual context. And the court at the first level dismissed it as not being "ripe" for adjudication. But you're now starting to get this pressure within states themselves to bring challenges to Chapter 11 and with a particular concern that the parties, in agreeing to arbitration under Chapter 11, have done so in a way that doesn't conform to a constitutional framework. In Canada the challenge has been based on particular provisions in the constitution that allow the state and the federal government to establish particular courts, and the argument is essentially that the Canadian Constitution does not allow the federal government to establish courts (i.e., Chapter 11 tribunals) that can review the Canadian legislation the way the NAFTA tribunals have done.

If you look more closely, however, the concerns are hugely exaggerated. In my view, if you look at the reality, Chapter 11 has not been the bogeyman that various critics have thought it would be. There have been just under forty cases filed since 1994, and there has been a relatively even amount in each state. In the early days more claims were brought against Canada and Mexico, and then, in the past five or six years, more claims have been brought against the U.S. Only five of these were won by investors. The total amount of claims in these cases is in the billions, but an actual amount of only about $19 million has thus far been awarded. So typically there are bits and pieces where investors will succeed, but the damages awarded are low. And particularly these tribunals have not been awarding lost profits in a generous way.

One of the earlier cases, the *Metalclad* case, involved a claim against Mexico for effectively expropriating property that was going to be used for a particular waste disposal facility there. There had been a massive lost-profits claim, but all that was awarded in that case was the amount of money that had been put into the investment.

Within the tribunal system, there isn't a rule of precedent whereby the tribunals are bound by each other's decision. But there's a lot of respect paid to other decisions. There have been one or two tribunals that made pronouncements that are pro-investor, but in general the tribunals have taken a relatively balanced tone in reviewing these issues. Of the twelve cases pending, many of them deal with the same subject matter, which is basically claims arising from a dispute between Canada and the U.S., and many of these claims are very creative ones that I would think in the end are not likely to prevail. It just hasn't been the gold rush or the huge flood of investor cases that many critics have complained would occur.

What's also happened in terms of NAFTA is that transparency has really shaken up the whole industry and the jurisprudence of international commercial arbitration. Because materials from the cases have been put on public Web sites. There's been a lot of pressure to do everything transparently. In the *UPS v. Canada* case, the hearing actually had a live video feed. There have been amicus parties allowed to make submissions in a number of cases, including *Methanex*. They have all been interesting developments, and they have responded to the public concern with respect to Chapter 11. As a result of that, they have led to a significant reform in the way in which a number of these cases are dealt with, not only in NAFTA but in other bilateral investment treaties around the world.

Just another historical note: I was reading about a speech given by Elihu Root, who was Secretary of State under Teddy Roosevelt and president of the American Society of International Law. His speech was quite fascinating because it concerned when it is legitimate for international arbitrations to be reviewing decisions of international courts. At that time many of the cases he was looking at involved ships. He made the point of how, in twelve cases, matters decided by the U.S. Supreme Court had been subsequently submitted to international tribunals because of a subsequent denial of justice. Six of those cases reached opposite results.

It will be interesting to hear Catherine, who is going to talk about the U.S. debate around these issues and to see whether any of those sentiments are reflected in the way the U.S. deals with these issues of Chapter 11 tribunals and their legitimacy under U.S. law today.

In summary, the power of NAFTA Chapter 11 claims should not be exaggerated. In my experience, Chapter 11 claims can be very effective deterrents for governments in that they know that laws may be vulnerable to Chapter 11 attacks. There are significant cost consequences. In the *Methanex* case, the losing party was hit with costs. So, Chapter 11 arbitrations have to be used with care.

Another point relates to corporate counsel. We often get situations in which Canadian, U.S. or other companies find that they have an investment issue abroad for which they don't have a remedy. That can be for various reasons: because the courts in that country cannot be trusted or because they haven't made an appropriate provision in their contract to go to arbitration. If that is the case, in many cases the bilateral investment treaty, not NAFTA, can provide remedies. But it is very useful to make sure that you're structuring your transaction so the company entering into the agreement is sitting in the best possible jurisdiction to take advantage of the bilateral investment treaty. Thus, if you have a UK case, and the UK has a treaty with South Africa, you'll want to make sure you get the appropriate protection for your investment in South Africa and should consider using a UK subsidiary in entering into the contract.

With that, I will pass now to my fellow panelists to continue with the discussion.

CATHERINE M. AMIRFAR: Thank you, John, and good morning.

I would like to thank the New York State Bar Association, in particular Marco Blanco and Philip von Mehren, for the invitation to speak today. I consider it a privilege to address this group this morning.

My task today is to address the current state of NAFTA's Chapter 11 provisions, that is, twelve years later. In particular I'm going to be focusing on the U.S. perspective.

Now, I don't think it is an exaggeration to say that Chapter 11 is really the most often criticized provision of NAFTA. It has proven to be a lightning rod really for anti-NAFTA and anti-globalization efforts. What I would like to do this morning is present a few of the issues that have caused some of the concerns and to essentially describe what the twelve years have taught us with respect to these issues.

I'm going to be focusing on five matters. The first is domestic court rulings at risk. The second is the premise that NAFTA actually affords greater rights for foreign investors over, say, U.S. investors. The third is the notion that private tribunals are ultimate adjudicators for what could be characterized as public disputes. The fourth involves issues relating to the transparency of NAFTA proceedings. The fifth is the lack of appellate procedures provided in Chapter 11 and the implications of that.

So first, we have domestic court rulings at risk. This concern is really about the fact that foreign investors can effectively challenge domestic judicial decisions through NAFTA Chapter 11.

Now, John has already gone through a little bit of what has become the infamous *Loewen* case. What I'll discuss here is really what I think is the specter of *Loewen*, not what actually happened in the *Loewen* case, but the implication of the *Loewen* case.

Loewen was a case in a proceeding brought by a Canadian funeral home that got hit with a $500 million damage award in Mississippi. Now, during the course of these proceedings there were, shall we say, anti-Canadian statements made during the proceedings. So the arbitration was brought under Chapter 11, really challenging the damage award itself and the lack of procedure and process associated with that award.

In 2001 the tribunal issued an interim decision, and this is the decision that really got a lot of attention at the time. It rejected the U.S. government's arguments that the case should be dismissed because there was no "government agency," that in effect it was a dispute between two private parties. In rejecting this, the tribunal said that foreign investor rights under NAFTA may indeed extend to the civil court context. That begged the question: If that's the case, it would seem to indicate there were no limits on the types of court actions that could be challenged under NAFTA.

So that was the reaction, and it continues today. Just to give you a sample of what was going on within the United States as a result of the *Loewen* decision: The Conference of Chief Justices from U.S. state courts, who were obviously clearly receptive to the fact that a Mississippi state court decision had been brought under review, passed a resolution and urged the Bush Administration to negotiate and approve "provisions in trade agreements that recognize and support the sovereignty of state judicial systems and enforcement and finality of state court judgments." Similarly, the U.S. Conference of Mayors urged that orders of United States courts should not be challenged before international tribunal proceedings under Chapter 11.

What is the reality? The *Loewen* decision was handed down in June 2003. I would characterize it as schizophrenic. The panel was clearly exercised over the treatment of Mr. Loewen in the Mississippi courts, in terms of both the bias and discrimination that seemed to be evident in the arguments presented in that case. The tribunal however found, and I quote: "We find nothing in NAFTA to justify the exercise by this Tribunal of an appellate function parallel to that which belongs to the courts of the host nation." (From Paragraph 242 of the tribunal's award.) Ultimately the tribunal denied Mr. Loewen relief, but there was a door left open. The tribunal noted that, "[i]n the last resort, a failure by that nation to provide adequate means of remedy may amount to an international wrong but only in the last resort." (From Paragraph 242 of the tribunal's award.) It is a very small door and a door that has not been used. That is the message with respect to this.

What is the specter of *Loewen*? Have the fears associated with what *Loewen* does with Chapter 11 actually materialized? I think the answer is no. I think that largely NAFTA tribunals have disavowed any appellate competency over domestic courts. I will note that, in terms of the constitutional implications, while the U.S. Supreme Court has not taken this issue on directly, there was in last term a case by the name of *Medellin v. Dretke* that involved the ability to enforce a decision of the International Court of Justice. I was involved in this case. For various procedural reasons certiorari in that case was dismissed by the Supreme Court, but we are back there again this term in the consolidated cases of *Sanchez-Llamas* and *Bustillo*, which present the same issue. Is there domestic enforceability? Are U.S. courts bound by decisions of the International Court of Justice, which is essentially an international adjudicatory body set up by treaty?

Now the implications of these cases for NAFTA Chapter 11 I think could be great. But we will have to wait and see how the Supreme Court deals with them. There is an argument under U.S. law that making a decision of an international adjudication binding on U.S. courts would be a violation of the provisions of Article 3 of the U.S. Constitution. I don't think that that's a very persuasive argument myself, because I think it would undermine essentially the entire arbitration regime we have in place. But it remains to be seen whether the United States Supreme Court takes that up. We should have some type of resolution on the issue by the end of this year.

Is there a question?

AUDIENCE MEMBER: I just wondered how *Loewen* turned out on appeal in the Mississippi courts?

MS. AMIRFAR: You know, I believe the appeal was denied. In fact, there was no appeal, because there was a requirement of a 125-percent bond that Mr. Loewen was required to post. He couldn't come up with that kind of money, so essentially one of his arguments before the tribunal was that his process, his rights to process were violated because he was denied the ability to appeal.

MR. BARUTCISKI: Let me put *Loewen* into perspective. This was a $5 million state antitrust claim over a contract dispute. It was an absurd process and a hearing that just defies the imagination for anybody looking at it from outside the U.S. at least. You may be more comfortable with some of the things that go on in some state and federal courts; the rest of the world looks at it and shakes its head. It ended up in a $500-million punitive damage award. Loewen was a public company in the United States and Canada. To pay the bond to appeal this ridiculous award would have triggered every banking covenant that Loewen had and brought the company to bankruptcy. So they settled it for a structured settlement of $175 million, which ultimately brought the company to bankruptcy.

So to put it into perspective, it wasn't just a bunch of stupid things that happened in the trial. It was a bunch of stupid things that happened at trial, followed by the judge giving the jury instructions as to what the plaintiff was asking for; then, the jury comes back and asks, "Can we give more?" and the judge says, "Of course." Then the company is brought to its knees and basically becomes insolvent as a result of this ludicrous process.

We talk about a denial of justice, but this isn't just about a plaintiff who didn't get the result it liked. The outcome just defies logic; it was a denial of justice by any standard. And I think the tribunal essentially said that, but it was an evidentiary issue.

MS. AMIRFAR: That's right. The tribunal was extremely exercised over what occurred. And here we have an example of how exercised the Canadian community was as a result of the *Loewen* decision. The record is replete with anti-Canadian sentiments, which I will not get into here today.

MR. TERRY: One point which relates to the appeal issue is that it actually ended up being an important factor in the case. Because one of the reasons the tribunal didn't grant an award to Loewen was that Loewen had not exercised its appeal rights all the way up. Loewen should have posted that bond so it could exercise its appeal rights.

One of the problems in NAFTA and a lot of other bilateral investment treaties is that you don't have to exhaust your local remedies. In the old days you had to exhaust your local remedies; then under NAFTA there's a three-year time limit. What you have to do is to decide whether or not you're going to bring your case before you've exhausted local remedies; there is no requirement to exhaust them. What *Loewen* says is we are not going to find a denial of justice unless you go all the way up looking for review.

AUDIENCE MEMBER: This was a funeral home roll-up, wasn't it? It started with a purchase agreement. Was there an arbitration clause in that agreement?

AUDIENCE MEMBER: Can you repeat the question?

MS. AMIRFAR: Of course. Was there an arbitration clause in the agreement that gave rise to the original action in Mississippi? I'm unsure of that. I don't think so. It certainly was not an issue in the course of proceedings in Mississippi.

Any other questions with respect to *Loewen*?

AUDIENCE MEMBER: I don't understand: the U.S. is a party to the statute establishing the International Court of Justice, so what basis does the U.S. have to deny the implementation of international law decided by the International Court of Justice (ICJ)?

MS. AMIRFAR: That's an excellent question, and that is the question that's going before the U.S. Supreme Court in March. We just submitted briefs. I'll tell you, based on the *Medellin* case and the briefs in that case, the United States's position is that the Vienna Convention that gives rise to the substantive rights at issue is not self-executing in a way that confers a private right of action to individuals proceeding in United States's courts, and that the interpretation of the Vienna Convention set forth by the ICJ was actually incorrect. And further, even though by the optional protocol the United States agreed to abide by the decision of the ICJ, that doesn't translate into the inability of the United States Supreme Court to take a different stance than the ICJ in interpreting that treaty. In our constitutional regime the treaty is interpreted by the highest court in the land, the U.S. Supreme Court, and does not need to refer to any tribunal in doing so.

Our argument is very much in line with what you said: A treaty is a treaty, a bargain is a bargain. The United States acceded to abide by the decisions in having to submit to that dispute resolution; they are now bound by the result. It is as simple as that. That is the issue the Supreme Court has taken up which will go forward in March.

AUDIENCE MEMBER: Let me just follow up with an implication of the question this gentleman just asked here. If you do have an arbitration clause in your contract, going to Stockholm or someplace, are you then going to be able to attack that arbitration under NAFTA, or will you be precluded because you've chosen your sole remedy of arbitration in Stockholm?

MS. AMIRFAR: You would not be able to attack that under the provisions of NAFTA.

AUDIENCE MEMBER: So that's your choice, you either have NAFTA or you have arbitration?

MS. AMIRFAR: I don't think it is as stark as one or the other. It's not the way that your choices would come to you. You don't waive one by choosing the other.

AUDIENCE MEMBER: That's what I meant. Have you waived your rights to a NAFTA arbitration by choosing arbitration in Stockholm or any other place?

MS. AMIRFAR: No.

MS. AMIRFAR: Let me move to the second issue with respect to Chapter 11, and that is the notion that John touched upon, that foreign investors would have greater rights. In this context I'm focusing on expropriation. The definition is broader under NAFTA. Under U.S. law it is generally only real property that is involved, and other generalized economic interests are not eligible. Under NAFTA, that's simply not the case. Market access and market share are considered investments entitled to protection under Chapter 11.

The second notion is the lesser degree of impact required for an action to constitute a taking under NAFTA versus other law, and, coupled with that, the fact that foreign investors (and not domestic investors) may collect for regulatory takings. The U.S. case, *Lucas v. South Carolina*, states that mere diminution is insufficient. In contrast to that, the tribunal in the *Metalclad* case stated that expropriation under NAFTA includes covert or incidental interference with the use of property that has the effect of depriving the owners in whole or significant part of the use or reasonably-to-be-expected economic benefit of property. Now, that is somewhat broader than the requirements for a taking under U.S. law. I'm not going to go through all of these, but there was concern about this within the United States political community, i.e., that U.S. investors are somehow less protected than foreign investors, particularly under the principles of takings and due process law under the U.S. Constitution.

Now, largely as a result of the public debate over Chapter 11 and other provisions, the U.S. Congress directed in the Trade Act of 2002 that investment protection provisions of trade agreements have to comply with certain stated objectives. The Trade Act lists as one of the objectives that you must ensure that foreign investors are not accorded greater substantive rights with respect to investment protection than are United States investors in the United States. This is particularly so with respect to expropriation and compensation for expropriation.

Then we have the related notion of private tribunals dealing with public disputes. Again, the basic structure of NAFTA gives private parties the right to challenge national policies that burden their ability to do business freely. Of course that has an impact on the policies of the member states. The concern is that this constitutes a threat of investor-state challenges that chill the development of public-interest policies. The opponents typically cite to the case John mentioned, which is *Ethyl Corp. v. Canada*, in which the Canadian government reversed a ban of MMT, a gasoline additive, as a result of a Chapter 11 proceeding brought by an MMT manufacturer. So again it is this notion that they are at the mercy of investors. It sets up an incentive for the states to pay the polluter and undermines the precautionary principles as well. If there is a dearth of scientific information or uncertainty, the government must err on the side of protecting the public. Well, if the government errs on the side of protecting the public, it is also vulnerable to challenges under Chapter 11.

The commentary, and I'm going through this very quickly, but the commentary is essentially addressing that concern. You have the national association of counties, the national league of cities, and members of the Senate concerned about the threat of Chapter 11 arbitrations that might result in preemption and nullification of governmental laws and regulation.

So what happened? A dozen years after NAFTA became effective and despite a great deal of this, only one NAFTA tribunal has found a violation of Article 1110 for regulatory activity. That occurred in 2001, the *Metalclad* case, which found an indirect taking. It appears that *Metalclad* is a singularity in that respect. While several other tribunals have considered Article 1120 claims in the context of an alleged indirect expropriation, including partial takings, no tribunal has found in favor of such a complaint.

One example I want to set forth is *S.D. Myers, Inc. v. Canada*, which found that, since Canada's interference with claimant's business was temporary, it did not violate Article 1110. That actually mirrors similar provisions in U.S. law.

Another thing to note is the ripple effect of the NAFTA discussion in respect of the Chilean Free Trade Agreement. New language was added there that makes it more difficult for foreign investors to succeed in a regulatory expropriation claim, particularly if the regulatory action has any environmental or public health nexus.

I'm actually going to wrap this up because I know Cecelia will be addressing transparency. Let me say though, the Chapter 11 process has become more transparent and timely. I add just a quick note on the lack of appellate procedure. Only under limited circumstances may the award of an arbitration panel be brought to domestic courts for review, and review is limited to issues under the New York Convention (i.e., only corruption, fraud, misconduct by panelists, procedural irregularity or arbitrators having exceeded their authority to award). To date there have been only three challenges to arbitration, all in the Canadian courts. Because reviews are already taking place in different courts and potentially different standards of review are likely to occur in still other courts of the member states, a more consistent review is desirable.

The Chilean and Singapore free trade agreements reflect a policy of establishing some sort of appellate review of arbitral awards. So my conclusion I think is that the lessons from NAFTA are likely to have significant implications not only for other free trade agreements as they are negotiated but also for the entire bilateral-investment-treaty regime as it is put forth by the U.S. government.

Thank you.

CECILIA AZAR: I would like to thank the New York State Bar Association and especially Marco for inviting me to this meeting.

I would like to start by giving a very general overview of the evolution of investment regulations in Mexico. First, as part of our domestic law before 1973 we had constitutional restrictions, and of course the Calvo Clause. We can summarize by saying that the regulation of foreign investment was rigid. The Latin American states perceived foreign investment as a loss of sovereignty, as a threat of foreign control over their economies.

After 1973, the first investment law entered into force: a law to promote Mexican investment and to regulate foreign investment. In 1993 we made a very important reform of this law, and, in preparation of the enactment of NAFTA, a new law was enacted relating to foreign investment; its mission was to favor national development. What are the main characteristics of this new law in Mexico? Number one, foreigners are no longer forbidden to own real estate in Mexico, and foreign investors are, for example, now able to obtain mining and water concessions, participate at any level of ownership percentage in Mexican companies, buy assets, participate in new economic fields, open and manage new establishments. These are just a few examples.

Gradually the foreign investment law has led to an increase in the level of foreign participation in the following areas: satellite communication; railroads; financial associations; the stock exchange; and international passenger land transport, to name a few examples.

There are still some restricted areas. Some of them are pretty obvious; some others have been discussed and debated, like the oil and hydrocarbon industry and electrical utilities.

Now from an international law perspective: as you may know, Mexico became a member of GATT in 1986 and a member in the WTO in 1995. In addition, Mexico has been negotiating a significant number of bilateral investment treaties and several free trade agreements that include an equivalent of NAFTA Chapter 11 or similar provisions.

Let us move on to the Chapter 11 objectives. If we were to review the general objectives of Chapter 11—and I think we must take a little risk here—the objectives of Chapter 11 are to depoliticize investor state disputes, create a reliable investment arena, establish a mechanism that guarantees international reciprocity, and, as you can see from Article 1115, provide for a dispute resolution system that guarantees equal treatment to investors of party states, due process and impartial constitutional and decision-making bodies.

This last provision is particularly important for Mexico because it comports with the requirements of Mexican law. I'm talking here about the law relating to the conclusion of treaties and the dispute resolution mechanism that Mexico must follow in an international treaty.

In general, this is a particularly important chapter of NAFTA for Mexico. We must remember that the dispute resolution mechanism set forth in Chapter 11 was negotiated on these terms because of Mexico. I quote from the U.S.'s NAFTA Statement of Administrative Action: "The NAFTA provides a historic investor-state dispute settlement mechanism, so that individual U.S. companies no longer face an unbalanced environment in an investment dispute with the Mexican government but can seek arbitration outside Mexico by an independent body."

Let us turn to some interesting aspects of Chapter 11 and their relevance for Mexico. First, it contains broad definitions. For example, "expropriation" is defined as a measure "tantamount to nationalization or expropriation." I think these broad definitions increase the chance of disagreements.

Second, a dispute arising from an "act of authority" is usually a non-arbitrable matter. According to Mexican law, an expropriation or act by the Mexican state is an arbitrable matter. So, Mexico is facing the duty to arbitrate with domestic investors.

Third, the local judiciary has the last word regarding the arbitral situs. In the *Metalclad* case the local judiciary has the last word in a sense.

Fourth, a different method is required for calculating compensation.

Fifth, transparency versus confidentiality: here we have some important questions. For example, is our Chapter 11 case confidential in the way that private commercial arbitration is? Or must states give public access to case information?

I think the main concern around Chapter 11 could be summed up in the observation that private arbitrators decide questions that have a direct effect on the economic interests of both the investor and the host country.

I would like to talk a little bit about this debate between transparency and confidentiality. First of all, we must know that the arbitral tribunal proceedings in Chapter 11 cases are not necessarily made public from the outset because disputes are settled in accordance with the arbitration rules chosen by the investor. For Mexico it would be the rules of the International Centre for Settlement of Investment Disputes (ICSID) because we are not party to the Washington Convention or the UNCITRAL arbitration rules. In the case of UNCITRAL, the commencement of an arbitration of a dispute handled under the UNCITRAL rules is not made public unless one of the parties makes it public. Tribunals established under the UNCITRAL rules have generally stipulated what kind of information must be considered confidential and what may be made public by one of the parties. The commencement of the proceedings is made public through the channels available to ICSID. What must be made public is the notice of intent, the notice of arbitration, the statement of claim and the statement of defense.

Most proceedings initiated under Chapter 11 have been published on an Internet site called "NAFTAclaims.com." Although it is the most complete source of these proceedings, it does not constitute an official source.

In July 2001 the Free Trade Commission issued an opinion on the subject of transparency in the context of Chapter 11 dispute settlement procedure. The commission has specified that "nothing in the agreement imposes an obligation of confidentiality" and "nothing prevents the parties from delivering documents submitted to the Tribunal or issued by them, subject to the specific rules governing the proceedings."

I think the interpretation of the Free Trade Commission doesn't provide the required certainty. The interpretation limits the possibility of giving public access to the arbitral proceedings to the provisions of the applicable arbitration rules.

One should also analyze and consider the impact of media intervention in these kinds of cases. Is the case really confidential? As you can see, there are an astonishing number of Web sites and press releases on the *Metalclad* case, not always with accurate information.

Some very general conclusions follow. First, the main effect of Chapter 11 for Mexico has been direct foreign investment: from the time of its enactment through June 2003, Mexico has received $136 billion in direct foreign investment.

Second, Chapter 11 has been the catalyst for important domestic legal reforms. For example, we included the UNCITRAL model law into the Mexican Commerce Code. Chapter 11 also has contributed to the development of arbitration in the country.

There are significant challenges for Mexico in participating in arbitrations against private entities.

In conclusion, some main challenges for Mexico: In the political arena, debates over sovereignty need to be overcome in order for more areas (e.g., energy) for foreign investment to be opened. For local authorities, the main challenge is the need for them to understand the scope of international commitments and to be aware of the consequences of their actions in order to avoid any potential violations of Section A of Chapter 11. For the judiciary, it must become aware of the scope of its review: they do not have to analyze the merits of the dispute. And that's something pretty difficult for Mexican judges to understand. Finally, arbitrators need to become aware of the impact of Chapter 11 awards in the domestic and international arenas.

A very general question that has been asked frequently is: Why hasn't Mexico ratified the Washington Convention? I'm going to give you the answer that the Mexican NAFTA representative gave me some time ago. He told me, "What for, Cecelia?" And the reason he gave was that the Convention does not provide for any investment regulatory framework as Chapter 11 or the bilateral investment treaty does. However, the Mexican government is now currently seriously considering ratification of the Convention.

NAFTA's substantive standards of investor protection require interpretation, and that interpretation needs to be applied by state courts. That can only be feasible as long as the United States, Canada and Mexico continue to support the Chapter 11 dispute resolution mechanism.

I think arbitration promotes respect for implicit bargains between investor and host countries.

Arbitration assures neutrality, especially in connection with deciding the appropriate compensation for nationalized assets. It provides a forum that is more neutral than the host country's courts, both politically and procedurally.

Finally, even if this mechanism was included because of Mexico's participation in the treaty, I believe and am optimistic, like Carlos, that it currently offers benefits to all three nations.

MR. BLANCO: Thank you very much.

IV. Cross-Border Legal Services Under NAFTA

MR. BLANCO: Our final panel today will discuss cross-border legal services in North America.

I am pleased to introduce the following panelists. To my right is Manuel Campos Galvan. He is a partner of the firm Lex Corp Abogados. Manuel advises Mexican clients in all aspects of Mexican investments, cross-border, tourist developments, manufacturing and trade, business law, financial projects, cross-border leasing. He has represented issuers, underwriters and municipal and state financing projects in Mexico and throughout Latin America. Manuel acts as the Chair of the Task Force on International Legal Services of the Association of the Bar of the City of New York.

We also have Lorna Counsell. She is an associate in the Ottawa office of the Canadian firm of Fraser, Milner, Casgrain. Her practice focuses on government relations and international law. Lorna has acted for The Law Society of Upper Canada on federal regulatory matters since 2001 and been involved with their discussions with the government of Canada on the trade of legal services as it pertains to the GATT negotiation.

Next to Lorna is Steven Krane, whom we all know. He is a partner in the litigation/dispute resolution department of Proskauer Rose in New York City, concentrating on legal ethics, sports law and alternative dispute resolution. He's been involved with New York State Bar Association activities for many years and served as President from 2001 to 2002. He is Chairman of the Committee of International Law Practice Section of the New York State Bar Association Special Committee on Cross Border Legal Practice since its creation in 2004.

I will pass it over to Steven first.

STEVEN KRANE: We now turn from Chapter 11 to Chapter 12 of the NAFTA, as we talk about cross-border trade and services.

This morning as I was listening to the other presentations, I think one of the themes has been that NAFTA held great promise but that much of its potential has been unrealized. And my view is that that applies to legal services, as well as to the rest of the various subjects that are addressed by the treaty. By itself the NAFTA did very little of significance with respect to legal services; perhaps foreign legal consultant reciprocity has become more entrenched as a result of the treaty. That's a very small contribution in terms of the overall market for legal services cross-border. But essentially, what NAFTA did was to establish a framework through which there could be negotiations among the members of NAFTA for the liberalization of restrictions on cross-border practice.

Now, this has not happened. Why is that? Because none of the fifty-seven regulatory bodies in the United States are signatories! The fact is that there are fifty-seven separate attorney regulatory bodies in the United States, and they all go in their own different directions. They are all, for lack of a better word because there is no better word, protectionist when it comes to regulating the legal profession. Strong feelings abound, even within the United States, as to whether lawyers from one state should be allowed to come in even temporarily to another state to practice law, to provide legal services to their own clients, who they are perfectly capable and lawfully representing in their home state. The fact that you might have to go to a meeting in another state, and fly into New York or go to California if you're a New York lawyer and conduct a negotiation or a deposition or an arbitration, that has somehow become a major issue among the bars of the United States. The American Bar Association thought it was so significant they created a commission and came up with a model rule to allow multi-jurisdictional practice—temporary multi-jurisdictional practice—and that rule has now been adopted by twenty-five or twenty-six states, one of which is not New York. Even though the New York State Bar Association approved said rules and recommended that the Appellate Divisions adopt said rules, in June of 2003, we sit here in January of 2006 without said rules having been spoken about in an official way.

I think as we go through the rest of the program we will talk more about why that is and what might be happening.

So my role: for those of you who were in London in a chilly room on a Saturday morning in October, you remember my remarks on the GATT negotiations and how they were totally unlikely to result in any movement of any kind or have any meaning for lawyers in terms of the liberalization of restrictions on cross-border legal services. I find myself being the designated wet blanket when it comes to the effect any of these treaties have on the day-to-day practice of law. There are some ways that we can possibly maneuver around them or perhaps—although I think it is unlikely—use them to liberalize cross-border practice, but so far the GATS and the NAFTA have been failures not because of any intrinsic problems within themselves but because of the structural problems that mostly we in the United States have in terms of how we regulate ourselves. Not that we are not still trying!

The Committee on Cross Border Legal Practice spearheads the effort of the New York State Bar Association to negotiate some sort of liberalization—so far unsuccessfully—with the European Union, but with a little more success with the Law Society of Upper Canada although there are some contingencies there that have been stalled for a few months.

In any event, that's my dour introduction to this program. I know my co-panelists have different views, so let me turn over the microphone to Lorna, who will speak next.

LORNA J. COUNSELL: Hi, everyone. I've been working for a number of years with the Law Society of Upper Canada on their discussions with New York State and with the government of Canada on the GATS negotiations. So I'm coming at this purely from an Ontario perspective and not from the perspective of Quebec or any other province.

Steve and I had a brief discussion earlier, and he said, "You folks in Ontario must be really irritated that nothing has happened with New York, and it just seems to go on and on and on, and nothing is ever realized." And I said that I didn't think it was that bad, and that's because we are down here doing business all the time, and Ontario lawyers have either decided to just take the New York bar, or firms are arranging themselves in such a way that business can be conducted. Having said that, I believe that, in the last round of meetings this fall, Ontario is more hopeful than ever that there will be an extension of the Model MJP Rule essentially for transactional work, so that attorneys can be down here and not have to have taken a bar.

But we know that that's not going to happen for at least a number of months, maybe a year or more in Canada, even if it is to happen soon for other states, which we anticipate it will. But for Ontario it probably won't happen until next year.

In the meantime firms are taking any number of approaches to do business. I guess in spite of NAFTA and in spite of GATT, things are working. So we share that view.

With respect to the GATT specifically, Canada expressed its real concern this past fall, in June of this past year, I believe, that the process was not working at all. Canada is at the moment trying to promote new ways of collective dealings as opposed to one-on-one work that's been done to date. So I'm going to turn it over to Manuel, and then we are going to get into a bit of a debate about all of this.

MANUEL CAMPOS GALVAN: Thank you. Well, as Steve and Lorna have mentioned, there are individual attempts at negotiations with bar associations, including the Mexican bar. Probably one of the biggest stumbling blocks is the federal system. Basically, any agreement resolving the matter would give access to the whole country. So has the Model Rule, which was never enacted and has not been fully implemented, restricted trade and the cross-border provision of legal services? I don't think so. We have been actively working on both sides. There are a number of U.S. firms that have a significant presence in Mexico, and that is because such a large framework was enacted in anticipation of NAFTA.

What is that framework today? Well, basically you as a foreigner can practice as long as you have a license. There is a provision for a foreign legal consultant. Although it has not been specifically regulated, there is the basis for the regulatory authority (i.e., the Ministry of Education) to grant you a foreign legal consultant license in consultation with the Mexican bar. In order for you to be licensed and able to practice, there are courses of study. The one that has always existed consists of basically doing the full course of study within a Mexican accredited university, or you can have your studies validated, which was recently enacted in 2000. And then specific rules were established even more recently with respect to lawyers.

What is going to happen with WTO? Well, Mexico has not made a formal proposal. There has been a recommendation from the Mexican bar. That recommendation, in very sketchy terms, is going to be based on a model that has already been subjected to a number of interpretation questions among different parties.

And at this point I think that's what the current situation would be. So I guess we turn it back to Steven.

MR. KRANE: Okay. A little more detail probably is warranted on what's been going on in terms of the New York State Bar Association's efforts to move things along relating to cross-border matters.

I will first start with our efforts over the last few years with respect to Mexico. That concludes my presentation on those efforts!

There have been some fundamental disagreements over, first of all, whom we should be talking to within Mexico, as well as a history that pre-dates my involvement in this. I'm neutral in this process. I do not have an international practice of my own. My firm does not have an office in Canada or in Mexico. So I think I fell into this as the dispassionate professional diplomat of the Bar Association for handling this thing and also because I find it interesting. It's fun, and it takes the regulation of lawyers to the international level.

In terms of Canada, we have had some exploratory discussions with the Law Society of Upper Canada and Ontario over the course of the last two years or so that culminated in a two-day meeting in Toronto in September. At that meeting we really got down to nuts and bolts with the Law Society, which is of course the regulatory body for lawyers. They say New York lawyers can come into Ontario and practice. That's it. They don't need to go to anybody else, as long as they have authority under the implementing legislation that grants them the power to regulate the practice of law, which they do. If they say we can come in, we can come in. So they are the last word on this.

The New York State Bar Association, as everybody in this room knows, is a voluntary bar association, the largest statewide bar association in the United States, as the tagline goes. And what we say is all well and good, but we still have to sell it to our regulatory body, which happens to be the Appellate Division in New York—talk about a fractionalized nation, we are a fractionalized state. We have to convince the four departments of the Appellate Division that they should agree, because they are actually the ones that regulate lawyers. Blame the Constitution of 1984, but they are the ones who actually regulate the lawyers in New York State. So we have to go to them and get them to bless this, or to the Court of Appeals, which arguably has the supervening authority under Section 53 of the Judiciary Law. But there are political issues between the Court of Appeals and the Appellate Division that require everybody to be involved in this process. It means involvement of the Administrative Board, where you have the Chief Judge, the four presiding judges of the Appellate Division and the Chief Administrative Judge sitting in a room talking about all this stuff. So that is our target audience.

As I mentioned earlier, we had recommended two-and-a-half years ago that New York adopt rules allowing lawyers from other states to practice law temporarily in New York. As long as they don't hang out a shingle in New York or hold themselves out as New York lawyers, you can come in and do whatever it is you do and practice law in New York State, as long as you go home eventually. So don't overstay your welcome. That has been a tough sell, even with respect to across-state-lines lawyers in New York.

The concept that the ABA had was that we are not going to have federal legislation on this—heaven forbid we should have the feds breathing down our necks, although there are those who would support that. Most bar associations and the American Bar Association oppose federalization of the practice of law. But if you had a network of rules, if every state adopted a rule along the lines of the Model Rule on Multijurisdictional Practice adopted by the ABA, you would have in effect a network of rules that allows lawyers to go from one state to the other temporarily.

New York had some reluctance to adopt the MJP rule with respect to other states: there is a concern about lawyers from New Jersey, Pennsylvania and Vermont coming in and poaching clients. The question was, why should we do this, what's in it for New York lawyers? And it has taken a fair amount of convincing to get at least the powers-that-be to examine this issue once again. As of a few months ago, the word on the street was it was dead, and it was about to be rejected. It's now not quite dead, to quote Monty Python and the Holy Grail; it might recover. And hopefully there's going to be some movement.

Now, why do I go into this whole thing? Because the predicate for our discussions with the Ontario officials was that once the MJP rules were adopted in New York, state to state, we would then seek to expand them to non-U.S. entities, so that lawyers from those parts of the world could also come into New York temporarily and practice without having to fear being prosecuted for the unauthorized practice of law. So that was really the basis for our discussions with the Law Society of Upper Canada.

Now, if we don't have the rules state to state, we don't have the predicate for any kind of discussion with Ontario, and so that's really where we are at this point. We are in limbo, hoping to take the next step and hoping to move forward. But at this point I think it's hard to predict which way the MJP situation is going to resolve itself in New York. If we don't get MJP rules, we might as well pack up and not further explore any kind of discussions with any other territory. Because if there's a reluctance to allow Pennsylvania lawyers to come into New York temporarily to practice, what are we going to do with those people from Ontario? And then the Mexicans will come in, and for all you know, we'll have people from Argentina and Paraguay and then Costa Rica and England, all these strange lands where people speak different tongues coming into New York, and then there'll be mass hysteria. New York, the center of commerce for the world, but, when it comes to lawyer regulation, we are as protectionist as they come. That's an unfortunate state of affairs that hopefully through persuasion will be able to be reversed.

So do we really even care is probably the question we should be asking at this point. Do we care about the NAFTA? Do we care about the GATS negotiations? Is this even something that we should be pursuing at all? Are we in a situation where the status quo is better off left alone? Lorna?

MS. COUNSELL: Well, we do care in Ontario. We need the markets here. We need to be involved in transactions. That's why we are sitting on the edge of our chairs waiting to see what is going to happen with extending the rule within the U.S. and then subsequently to Ontario. But I think the feeling at the Law Society in Canada is that there's never been a real problem between New York and Ontario. The problem is with other jurisdictions. So the Law Society has been very pleased with their own discussions with the New York State bar, but they have been frustrated to no end with the fact that there hasn't been any progress with other jurisdictions. And as a result nothing can happen with them.

So that's why I say Ontario firms and practitioners have found other means to do the work. If the rule is extended, as we hope it will be next year, then it will make it much, much easier to be involved in transactions here and go back and forth, and more firms will do business. That is inevitable. And that's happening anyway, but it would be much more so if the rule were extended.

The Law Society of Ontario is protectionist as well. I think that's just the nature of the profession. But they are nowhere near as protectionist as the New York State bar, and that's for sure.

MR. KRANE: Hear, hear.

MS. COUNSELL: I think no one is.

MR. KRANE: Well, Florida, New Jersey, France, and California. We have some friends in the protectionist ranks.

MS. COUNSELL: I mean the real push is from lawyers in Toronto, who are doing business here anyway, and upstate New York lawyers who are wanting to cross the border on a very regular basis. So that's where the push is coming from on each side. I think we are at a point where the decision is imminent, and then, we hope, it will be extended to Ontario in the next few months.

MR. KRANE: Interestingly, I met last month with representatives of the four Departments of the Appellate Division. There's an Inter-Departmental Committee on the Ethics Rules and Code of Professional Responsibility. That committee convened in early December, and they invited me to speak on the Multijurisdictional Practice Rules. One of the questions was—it wasn't really a question—but I got the sense that the rules were being viewed as primarily for the benefit of downstate lawyers, more specifically Manhattan lawyers, even more specifically large-firm Manhattan lawyers, and the question was, why should the regulators from upstate care about this. That is when I played the Canadian card. And I said, well, they care about it because they are looking to expand their opportunities outside the country, specifically in Ontario and Quebec. In fact, I mentioned we have been in discussions with Ontario, and there is tremendous interest on both sides of the border in liberalizing the restrictions, so that it's quite possible, it's most likely that if you adopt this, the next step would be to expand it slightly, like a little bubble, beyond the U.S. borders. There was actually some "oh, that's interesting" responses on the part of the upstate representatives, who said, "Oh, I didn't realize that this was something that lawyers throughout the state actually might care about." So I think the seed has been planted, and there is a glimmer of receptivity that, since the possibility of cross-border practice in Canada seemed to be a favorable factor in selling the rules domestically, there might be receptivity down the line for expansion into Canada.

Now, all this raises some questions where we get back into the GATS and whether or not you have problems if, for example, you say New York will allow Ontario lawyers to come in. Now you've got some most-favored-nation problems, some potential issues under Article 5 of the GATS. It is not entirely clear, and there is some disagreement even within our own committee, as to whether NAFTA, if it applies, takes you out of the most-favored-nation requirements of the GATS because the GATS is not entirely clear as to what sorts of free trade agreements it exempts from most-favored-nation status. And that's something that would need to be analyzed before any rules are adopted.

What we have also been talking about with respect to the discussions with Ontario is how to limit the application of any expansion. You cannot have an agreement between New York and Ontario; you are not contracting parties. So you talk in terms of a conscious parallelism, where you agree that both jurisdictions will adopt rules that mirror one another's at or about the same time. And that's how you get around not being able to have some state-provincial contact and all the rules that would go along with an agreement of that sort, which is extremely complicated.

You also have the problem of reciprocity, which is a no-no under the GATS. So how do you go about putting in or building into any rule you adopt the concept of reciprocity? Can you even do it, or do you just do it and wait to see if anybody challenges it, if someone wants to mount a challenge? So these are the kind of issues that we have been discussing, and there have been really very, very productive discussions that have moved farther than conversations we have had with any other bar group outside the U.S. But again, it's all conditioned on our taking care of things at home before we cross international borders.

AUDIENCE MEMBER: Could you just give your wet-blanket view of how the licensing of foreign legal consultants under our Court of Appeals rules relates to the MJP issue?

MR. KRANE: The foreign legal consultant rule: for those of you keeping score at home, New York was the first state to adopt legal consultant rules. We don't actually call them foreign legal consultants in New York. And New York's rule is almost verbatim the same as the ABA model rule, so we are really at the forefront with that rule.

There are really only about five hundred legal consultants in New York State by the way, so it's been successful to an extent. People have taken advantage of it, but it hasn't exactly opened the floodgates when you consider there are 170,000 registered lawyers in New York State and only five hundred legal consultants. That really operates in a different sort of stratum actually. There is an ABA Task Force on Foreign Legal Consultants that is trying to harmonize the Model Multijurisdictional Practice Rule with the Model Rule on the Licensing of Foreign Legal Consultants from a national standpoint. There is a question as to the extent to which foreign legal consultants in State A can avail themselves of the Multijurisdictional Practice Rule in State B, or whether they can avail themselves only of the Legal Consultant Rules in State B. So there is an interplay there, but they really operate as two very different systems, state by state. Of the states that have adopted legal consultant licensing rules, there are broad variations as to what legal consultants can do. The ABA adopts its model rule, but it's just that; it doesn't have any force of law. The ABA can't impose its rule on anybody. As the CCBE continues to remind us in our discussions with them, not even the ABA can bind the country, so why should they just talk to New York?

You have therefore this different regulatory scheme even within the U.S. as to what legal consultants can do, and in some states they can do more things than in others. It is really another layer in the patchwork quilt of regulation that has some interplay with the multijurisdictional practice rules but exists independently.

MS. COUNSELL: I just want to tell you briefly how it is going to impact Ontario. At the moment in Ontario, foreign legal consultants (FLCs) can do pretty much anything except appear in court, but you need to have a real residence in Ontario. The MJP rule will change that, so it is going to change the practice quite significantly if it is extended because FLCs right now can practice. In Ontario right now there are about eighty FLCs, and the main requirement that will be different under the MJP rule is the real residency. So it will be different.

AUDIENCE MEMBER: I just thought I'd recount an experience which I had in Ontario a few years ago where the lack of clarity in these jurisdictional rules caused me some difficulty. I represented a foreign bank making a letter of credit and trade facility in a project finance transaction to a Canadian entity, which was a joint venture of a very well-respected Canadian company. We negotiated the deal partly in the United States, and then we eventually went up and closed in Canada. As sometimes happens on these things, the equity is sold and they were all very unhappy with the resultant loss of their investment. They commenced a proceeding against my firm seeking a review of the legal fees that I charged after it was all over—the fees were paid for by the other side—on the basis that they weren't even my clients'. Of course my own clients didn't object to these things, but since I stepped into Ontario I was somehow subject to jurisdiction for purposes of the legal fee review. Of course I then had to hire Canadian counsel, separate from my own Canadian counsel, because they advised me that there was a conflict, and they couldn't represent me on this. Then of course there was an issue as to whether or not the syndicate would pay for this separate Canadian counsel representing me. Needless to say, I would pause to ever go back into Ontario.

AUDIENCE MEMBER: I think the discussion would benefit a little bit if we also looked at the other side of this equation. The reason why we want to do these things is in large part due to the type of transaction that Larry was just describing. It's not that lawyers get this great idea that they would love to be able to go to Canada every now and then and practice law. It's because the client has legal business there, and they are most likely asking you to help them with that business. That's the real driving force behind it all.

MS. COUNSELL: And that's precisely the rationale behind extending the MJP rule.

MR. KRANE: Jim is absolutely right. The problem in terms of selling this whole thing statewide is that the majority of lawyers in New York State never practice outside New York. And a good number of them never go outside their home county or judicial district to practice. Most of the lawyers in New York have a very localized legal practice. And for them, what does this mean? Why do they care? Why should the regulators care when most of their constituency have no interest in leaving the state to do anything, and there is the risk that interlopers from outside of the state may come in and take away their business? That's the concern. That's where the protectionist concerns come from. And that's what we, the organized bar, all of you out there, have to try to counteract in your public statements and discussions with the regulators, wherever they may be.

AUDIENCE MEMBER: I have a law degree from Oxford and although I'm American and came back, New York is very liberal and allows a lot of people with foreign credentials to take the bar exam. I cannot take the bar exam even in New Jersey, because they don't recognize my credentials. I can't take the bar exam in thirty-six other jurisdictions in this country, even though I've been a member of the New York bar for several years.

New York is liberal with Canada. If you have a common law degree from a Canadian university, you can take the bar exam here. I wonder, number one, can New York lawyers take the bar exam in Canada just with their American degrees? I don't think they can. I know there was a 1974 ruling—that may have changed—that only citizens of Canada, not even landed immigrants, can take the Ontario bar exam.

So when you say we should make it liberal, I think you should be able to take a bar exam in every jurisdiction. But just to be admitted, I think that's another thing. And again, in Canada, can a New York lawyer take the bar exam in any Canadian province just on the basis that he's admitted in New York?

MS. COUNSELL: No. Point well taken.

AUDIENCE MEMBER: So we allow you to take the bar exam here, but you in Ontario don't let lawyers take the bar exam there.

AUDIENCE MEMBER: It is an educational issue. I think you have to take certain courses.

AUDIENCE MEMBER: And you can only sit for the bar in New York if you have a common law background. I'm an American with a French law degree, and I had to do an LLM.

AUDIENCE MEMBER: Yes, but in New Jersey you can never take the bar. Never.

AUDIENCE MEMBER: It used to be infinitely worse. For instance, if you had two residences, you could not take two bar exams. I had to wait to take the bar exam in my second state. Now, my question to you is, in that case, obviously somebody had standing to go and sue. Is there anyone associated with this problem who would have standing to go and sue?

MR. KRANE: Well, why not? If someone is denied the right to take the bar exam.

AUDIENCE MEMBER: Yes, it wouldn't be the Ontario citizen.

MR. KRANE: It would be the Ontario citizen.

AUDIENCE MEMBER: On the basis of what? Because I can't get the advice? But I can: it could be an advisor.

MR. KRANE: It is not something that I thought about, but I think there would be somebody who would be in a position to challenge the regulation if they were so disposed.

AUDIENCE MEMBER: Well, that's what's needed.

MR. KRANE: That could be one avenue to force the issue, yes.

AUDIENCE MEMBER: Mr. Krane, I made a comment before about the incompatibility between the most-favored-nation status and the GATT and the relationship to that and NAFTA. There is an exception in GATT for economic organizations and integration that is part of GATT itself—

MR. KRANE: That's what I was referring to, but with Article 5, once you get into that, it's not a slam-dunk argument that NAFTA falls within that exception, because it is fuzzy language, as you might expect in any sort of international treaty. But it is something that we would need to analyze. It may well be that there is an exception from MFN treatment that comes out of that article, but it's not apparent on its face that NAFTA applies to professional services.

AUDIENCE MEMBER: I have a question for Mr. Campos Galvan. You've fallen silent because of all this interest in New York and Ontario. Has the Mexican bar made any contacts and efforts to work with the Louisiana bar, the Puerto Rico bar and the Quebec bar to come up with a civil law multijurisdictional agreement or ways of recognizing qualifications?

MR. GALVAN: Not that I'm aware of. And principally, it would be because the Mexican bar really does not have an economic interest in jurisdictions such as Louisiana or Puerto Rico. It would be mostly California, Texas, New York, and New Mexico.

NAFTA at Twelve Years: An Overview

By Bryan Elwood, Philip von Mehren and Milos Barutciski

I. Introduction

The North American Free Trade Agreement (NAFTA), which became effective on 1 January 1994, links Canada, the United States and Mexico into a free trade area. The treaty has resulted in a variety of significant institutional changes among the three states in regard to foreign trade between them.

For example, NAFTA immediately eliminated duties on one-half of all U.S. and Canadian goods shipped to Mexico and is gradually phasing out other tariffs over a period of about fourteen years. Moreover, import restrictions are being removed from a variety of product categories, including motor vehicles and automotive parts, computers, textiles, and agriculture. Customs duties between the United States and Canada were eliminated in 1998 pursuant to a ten-year phase-out program under the U.S./Canada Free Trade Agreement, which was the precursor to NAFTA.

NAFTA also implemented a variety of other measures, including the following:

- Simplification and synchronization of rules of origin and customs procedures among the three countries.
- Provisions regarding intellectual property rights (such as patents, copyrights, and trademarks).
- Introduction by Mexico of a public procurement bid challenge procedure at the federal level.
- Removal of restrictions on investment among the three countries.

In addition, NAFTA includes a variety of provisions for dispute resolutions, but it does not create a set of supranational governmental or judicial bodies. Among the provisions addressing dispute resolution are the following:

- Chapter 11, regarding resolution of investment disputes between foreign investors and host governments;
- Chapter 14, regarding disputes over the provision of financial services;
- Chapter 19, regarding review of antidumping and countervailing duty determinations by specially appointed ad hoc panels as an alternative to judicial proceedings in the domestic courts of one of the three countries; and
- Chapter 20, regarding inter-governmental disputes over the interpretation and application of NAFTA generally.

Moreover, NAFTA provides for the establishment of working groups in almost every NAFTA chapter, which can also address potential disputes among the three states. Finally, the worker and environmental protection provisions added as side-agreements to NAFTA established trilateral labor and environmental commissions that can address disputes.

II. The Impact of NAFTA

Comparative statistics from 1993 to 2006 reflect the very substantial impact NAFTA has had on the trade relations among the three countries. There has been enormous growth in North American trade, going from U.S. $306 billion in 1993 to U.S. $772 billion in 2005,[1] or roughly U.S. $2.1 billion in trade each day. Among the benefits the three countries have enjoyed from the implementation of NAFTA are the following.

A. Mexico

Mexico has benefited from NAFTA. Since the adoption of NAFTA, Mexico's exports to the United States and Canada quadrupled, reaching U.S. $183 billion in 2005,[2] with a positive trade balance of U.S. $57.1 billion in 2005.[3] The Mexican economy was the fifteenth largest in the world[4] in 1998, but the tenth largest in 2004.[5] Mexico's annual per capita income also rose significantly, from U.S. $5,940 in 1990,[6] prior to NAFTA, to U.S. $9,640 in 2004.[7]

A good bit of this improvement can be attributed to trade. During the NAFTA years around thirty percent of Mexico's GDP has come from trade.[8] Indeed, over twenty percent of Mexico's jobs are generated by exports,[9] which rose from U.S. $51 billion in 1993,[10] prior to the adoption of NAFTA, to U.S. $188 billion in 2004,[11] of which U.S. $167.8 billion are to NAFTA countries.[12] Jobs created by exports in Mexico pay on average thirty-seven percent more than non-export related jobs.[13]

B. Canada

Likewise, Canada has benefited from both the 1989 Canada-U.S. Free Trade Agreement (FTA) and the 1994 NAFTA. From the time of implementation of the FTA to today Canada-U.S. trade has more than tripled. Under NAFTA, between 1994 and 2004, two-way trade grew at an average of almost six percent annually. In 2004, bilateral trade reached U.S. $680 billion, equivalent to U.S. $1.8 billion worth of goods and services crossing the border every single day.[14] Trade represents 36.5% of Canada's GDP.[15]

By delivering secure access to the robust U.S. market, NAFTA contributed to the growing prosperity in Canada. The steady economic growth since 1993 has allowed the government of Canada to reduce taxes while eliminating the federal deficit.

Today, one-quarter of all Canadian labor is linked to international trade with jobs that pay up to thirty-five percent higher than those not linked to international trade.[16]

C. USA

The United States has also benefited from NAFTA. U.S. exports to Canada and Mexico grew one hundred twenty-five percent between 1993 (U.S. $147.7 billion) and 2005 (U.S. $331.3 billion).[17] These exports represent over thirty-six percent of all U.S. exports.[18] Overall trade represents 12.7% of the country's GDP. Part of the reason for the increase in U.S. exports is that NAFTA reduced Mexican tariffs to almost zero for U.S. goods from its average level of ten percent in 1994. Today, more than eighty-five percent of U.S. goods enter Mexico duty-free, and by 2008 all tariffs should be eliminated.[19]

In the energy sector, NAFTA helped secure access to Canadian oil supplies. U.S. agriculture also benefited under NAFTA. In 2005, Canada and Mexico purchased over U.S. $18 billion worth of U.S. agricultural products, or 29.6 percent of total U.S. agricultural exports in 2004, up from 20.8 percent in 1993.[20] And U.S. manufacturing output and jobs have also showed healthy signs of strong growth since NAFTA took effect. Between 1994 and 2004 total manufacturing output rose forty-one percent, compared to thirty-four percent in the preceding ten years.[21] By 2001 NAFTA had added a net half million U.S. manufacturing jobs.[22]

D. Foreign Direct Investment

Cross-border investment has also increased since the implementation of NAFTA. Between 1994 and 2005 Foreign Direct Investment (FDI) flowed to Mexico at an average of U.S. $15 billion per year, reaching U.S. $172 billion in March of 2006, of which U.S. $113 billion came from NAFTA investors.[23]

Canadian investment into Mexico reached U.S. $5 billion, twenty times what it was in 1990.[24] More noticeable is the volume of Canadian FDI to the United States, which grew by more than three hundred percent between 1990 and 2003 to U.S. $198 billion, while U.S. investment in Canada increased one hundred fifty percent during the same period, to a record U.S. $215 billion.[25]

III. The Current Status of NAFTA

NAFTA is still fundamentally sound, although there have been some speed bumps. Among those speed bumps are the following.

A. Security

Since 11 September 2001, balancing open borders and security has been a key priority for the NAFTA partners. Immediately after 11 September, the U.S. administration decreed the immediate shutting down of all land, air, and sea borders, thereby provoking millions of dollars in losses, *per hour*, to Canadian manufacturers and retailers, as well as the closure of eleven plants in Canada.[26] Cargo trucks that previously took only minutes to cross the U.S.-Canadian border suddenly took many hours, with similar delays at the U.S.-Mexican border.

But the "Smart Borders" accord with Canada and the "Border Partnership Action Plan" with Mexico were quickly crafted because of extensive interagency ties that already existed between the governments, in large measure as a result of the interaction among the three states created by NAFTA.[27]

B. Chapter 11

Chapter 11 of NAFTA provides procedures for regulating investor/state disputes. The jurisprudence in regard to Chapter 11 controversies has largely dispelled the radical claims made in early years that those investor/state provisions in Chapter 11 created an unreasonable burden on the ability of the various governments to regulate the public interest. Nevertheless, in the past decade, about forty cases have been filed, and it has been argued that the threat of investor suits has led to a certain "regulatory chill," inhibiting the governments of the NAFTA partners from adopting appropriate legislation in the public interest. Among the controversial cases were the following.

- SD Myers was awarded Can. $6 million in damages plus interest and costs after a NAFTA panel found that Canada had violated its investment obligations in regard to a ban on exports of waste PCBs that SD Myers wished to dispose of at its facility in the U.S.
- Methanex, a Canadian corporation, filed a U.S. $970 million suit against the United States, claiming that a Californian ban on MTBE, a substance that had found its way into many wells in the state, was harmful to the corporation's sales of methanol.
- Metalclad, an American corporation, was awarded U.S. $16.5 million in damages from Mexico after local and state governments passed regulations banning a toxic waste facility *after* construction of the facility was completed.

But a close examination of the cases shows that only a handful of investor claims have been successful. The decisions in *SD Myers* and *Metalclad* suggest that the investors were injured as a result of egregious governmental conduct. By contrast, the Methanex claim was dismissed in its entirety in 2005.[28]

C. Softwood Lumber

The softwood lumber dispute between the United States and Canada has become a perennial phenomenon, although one can wonder if things really would have turned out differently had there not been a NAFTA.

The dispute centered on stumpage fees, that is, the amounts charged by the Canadian government to companies that harvest timber on public land in Canada. The United States sees Canadian stumpage fees as being de facto subsidies, and a coalition of U.S. lumber producers want Canada to follow the American system in regard to harvesting lumber on public lands and auction off timber rights at market prices.[29]

As is to be expected, Canada objected to having its system of administering public lands dictated by U.S. industry. As it is, ninety percent of Canada's softwood lumber exports go to the United States, so the impact on the Canadian lumber industry was great when, in May of 2002, the United States imposed duties of twenty-seven percent on Canadian softwood lumber, arguing that Canada unfairly subsidized producers of spruce, pine, and fir timber.

On 31 August 2004 a NAFTA Chapter 19 panel made a final decision which favored the Canadian lumber producers because it determined that no injury had been caused by either dumping or subsidies.[30] That was a crucial finding, since a finding of injury is required before any subsidy or dumping duties can be imposed.

However, the United States did not comply with the panel's decision to end the duty, and the U.S. domestic industry filed a NAFTA appeal through an "Extraordinary Challenge Committee" convened under NAFTA Chapter 19. On 10 August 2005 that Committee also ruled in favor of Canada. The United States did not budge and Canada eventually initiated proceedings in U.S. courts, arguing that NAFTA has been incorporated into U.S. law and it must be obeyed as a matter of U.S. law.[31]

As of 27 April 2006, when the two governments tentatively settled the dispute (subject to legal "scrubbing" of the terms of the settlement) the United States still had not abided by any of the rulings, arguing that the rulings do not apply to their most recent decisions. Also, a WTO panel, in a separate case, decided that injury did occur, although the arguments presented in the NAFTA case were not the same as those presented in the WTO case.

The sensitivity of this dispute should not be underestimated. On 6 October 2005, the then Canadian Prime Minister Paul Martin observed that the integrity of NAFTA was being compromised because of the U.S. decision to ignore the ruling of the NAFTA Chapter 19 panel, and Mexico publicly supported the Canadians, even as Mexico pursues its own grievance over a long-running sugar trade dispute with the United States. Although the Martin government was defeated in the January election, the new government led by Conservative Prime Minister Stephen Harper also made it clear that the dispute was a top Canadian priority and that Canada would work "to ensure that the [United States] respects its NAFTA obligations."[32]

D. Frailties and Weaknesses of Chapter 19

Chapter 19 contemplates a system of *ad hoc* bi-national panels of trade experts (lawyers, academics, consultants, etc.)[33] who decide an individual case and then disband, with panelists returning to their own endeavors in their own countries. This was intended as a possible solution to the perceived excessive deference that national courts had to their own antidumping agencies, and experience in the early years suggested that Chapter 19 panels were indeed prepared to undertake more probing reviews of administrative decisions by national agencies, without turning the process into a *de novo* hearing on the merits.

However, it has proved increasingly difficult to appoint swiftly trade experts due to increasing conflicts. Furthermore, panelist compensation is considered poor. Panelists are paid a relatively modest U.S. $600 a day, and are provided with only limited financial assistance for research, despite voluminous case materials. The NAFTA governments' failure to select panelists from the roster, and institutional foot-dragging in the management of the Chapter 19 process, have led to growing delays.

As a consequence, in recent years, cases have rarely been able to meet the 315-day target to issue a final decision. Chapter 19 panels reviewing U.S. decisions now routinely take longer than the U.S. Court of International Trade (USCIT). The result has been that the perceived advantages of the Chapter 19 process are being increasingly eroded.

Frustration with the Chapter 19 system exists on both sides, in terms of opponents and proponents alike. Opponents of the system criticize inconsistent panel decisions due in part to the lack of an appellate process. The Extraordinary Challenge Committee only addresses cases for significant process violations and failure to meet the domestic standard of review. Other critics have objected to the potential bias of *ad hoc* panelists, who may be trade attorneys practicing before the very same national administrating authorities they are judging.

In addition, constitutional questions have been raised regarding the jurisdiction of Chapter 19 panels. U.S. critics argue that the selection of NAFTA panelists violates the appointments clause of the Constitution. The softwood lumber industry in the United States has recently challenged the constitutionality of the process in the federal appellate courts,[34] although two prior challenges were unsuccessful.

IV. Emerging Challenges

Globalization and trade liberalization have led to increasing competition from outside the free trade area created by NAFTA. The emergence of China, in particular, as well as India, Brazil, and other emerging economies, has led to a major realignment of global trading patterns. Indeed, China's competitive advantage can dwarf the advantages of duty-free trade within the free trade area of NAFTA, as is indicated by the fact that in recent years China's trade with the United States has developed much more rapidly than Mexico's, and China will likely pass Mexico as the second most important U.S. trading partner in 2006.[35] Moreover, the United States has in recent years appeared to give preference to the quick results that can come from negotiating bilateral free trade agreements rather than relying solely on the slow and complicated process of achieving a consensual agreement among many nations in the context of larger regional trade agreements.

These developments throw up a number of issues which the NAFTA partners must address in the future, including the following:

- How can the NAFTA parties align their own economies to take advantage of the opportunities of emerging markets like China?
- Does the trend toward negotiating bilateral or small regional FTAs outside NAFTA threaten the integrity of NAFTA?
- Is NAFTA supple enough to deal with continuing security concerns, or do we need to consider different approaches?
- Can NAFTA deal effectively with economic shocks from phenomena like BSE and SARS?
- Is there a backlash against FTAs that will affect NAFTA modernization?

Indeed, this last point is becoming especially acute, for there is a growing belief in some sectors of society that economic development via free trade agreements does not work because it does not help to distribute wealth evenly between rich and poor. Along these lines, Latin American politics are notably shifting to the left. In almost all recent continental elections the center left candidates have been selected: Brazil, Uruguay, Venezuela, Bolivia and Chile. In Mexico, where elections were held in July of 2006, the leftist contender, Andres Manuel Lopez, still contested the apparent results of the election even after the final announcement of the results in favor of his opponent. He had been ambiguous regarding his position on NAFTA and there was talk that changes in Mexico's macroeconomic policy, including requests to modify NAFTA, could have taken place if the left had won the election.

V. Going Forward

Nevertheless, more progress is possible on issues like rules of origin, temporary entry of professional and business personnel, harmonization of technical standards, and institutional integration, each of which is discussed below.

A. Rules of Origin

It is apparent that welfare gains associated with a free trade zone are not being realized. Economic welfare costs continue to be around 1.5% to 2.3% of GDP.[36]

The administrative goal among the NAFTA states was to complete negotiations by 1 May 2006 on the Track III round of reducing "rules of origin" costs which is estimated could expand duty free treatment through rules of origin liberalization for at least U.S. $30 billion in trilateral trade by 2007,[37] but the Security and Prosperity Partnership of North America, responsible for carrying out the negotiations, has not succeeded in providing results. The NAFTA Working Group on Rules of Origin, however, has been active in further liberalizing NAFTA rules of origin.

B. Temporary Entry of Professional and Business Personnel

For the first ten years of NAFTA, the number of U.S. visas for Mexican professional workers was set at 5,500, not including any accompanying immediate family members. However, the new procedures for Mexicans to obtain NAFTA professional visas have been simplified, and beginning in January 2004 the number of Mexicans who may obtain visas to work as professionals in the United States (on TN2 visas) became unlimited. At the same time, the liberalizing trend of recent developments is potentially threatened by the implementation of the United States's Western Hemisphere Travel Initiative (WHTI), which is going to require U.S. citizens, as well as Canadians, to produce a passport or similar document to enter the United States. The percentage of U.S. citizens who hold passports is very low by international standards and there is concern in some quarters in all three NAFTA countries that the WHTI will cause a significant trade and investment impediment.

C. Streamlining of Regulatory Processes and Mutual Recognition

There is a need for the NAFTA parties to promote greater compatibility in autos and auto part regulations, and in standards and conformity assessment, while at the same time ensuring safety and environmental protection. Nevertheless, progress has been made.

There has been some harmonization of sanitary standards and industrial restructuring in North American livestock markets. For example, North American pastures and feedlots now include animals that have lived in more than one NAFTA country, and hog production in Canada and the U.S. has become highly integrated, with Canada shipping rising numbers of feeder pigs to the U.S. for finishing (the last stage of production) and slaughter. Similarly, Mexico is a net exporter of cattle to the United States, and this trade consists primarily of feeder calves.

D. Better Institutional Integration Among the Three Nations

An important topic is the matter of what is to become of NAFTA. Consideration should be given to enlarging the role of the Free Trade Commission and the NAFTA Secretariat under the provisions of Articles 2001 and 2002 of NAFTA. Arguably, this could be done without the need for any change in treaty wording. The Commission could decide to give the Secretariat a single, central location and the beginnings of a unified office and structure in terms of day-to-day operations.

Moreover, the NAFTA partners should consider creating a permanent NAFTA panel system, building on the present NAFTA structure under Chapter 19, but adding jurisdiction over disputes arising under Chapters 14, 20, and possibly 11.

So far, the working groups for each Chapter have been useful in resolving small disputes at their inception, before they become problems. However, the working groups could do more to propose and seek to carry out a reasonable modernization of NAFTA.

Finally, the NAFTA Secretariat sections are underfunded, particularly the U.S. section, which has the most cases and the smallest budget. The NAFTA parties should consider increasing the budgeting for the Secretariat.

Indeed, there are some indications that the United States and Canada are willing to move to greater integration in certain areas. In December 2002, for example, the United States and Canada announced that their military troops would operate indistinctly on both sides of the border should a threat to either be detected.[38]

The key issue is whether the NAFTA partners can move beyond a free trade area to a convergence on external tariffs or even a customs union. A more modest proposal going forward would be the creation of a potential "NAFTA-plus" arrangement, which would be limited to additional trade and investment measures, but with the hope that that development might lead to a full-fledged customs union with a common external tariff structure at a later date.

Indeed, the existential question for NAFTA is whether it will survive if it just stands still, considering all the changes in the global market that are taking place throughout the world.

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The Residency Obligation Under the Canadian IRPA: Four Years Later

By Sergio R. Karas

I. Introduction

The Canadian *Immigration and Refugee Protection Act ("IRPA")*[1] states in section 28 that a permanent resident must, with respect to every five-year period, be physically present in Canada for a total of seven hundred thirty days, unless he or she is outside Canada and fits into one of the exemptions specifically provided for in the legislation.

The physical presence requirement and the objective standard set out in section 28 of the *IRPA* represent a change from the previous provisions set out in the *Immigration Act*,[2] which was in force until 28 June 2002. While the previous legislation emphasized a permanent resident's intention to abandon Canada as his or her place of residency, the current provisions provide an objective test. But as the case law developed in the last four years shows, a subjective element is still present in the evaluation of the resident's conduct, and it comes into play before a person can be stripped of permanent resident status.

The current legislation introduces, for the first time, two new elements: the application of humanitarian and compassionate grounds relating to a permanent resident; and the consideration of the best interests of a child affected by the parent's loss of status, both of which must be taken into account prior to a final determination that a person has lost permanent residency in Canada. Surprisingly, there have been relatively few cases dealing with section 28 of the *IRPA,* and most of the decisions rendered seem to be strongly tied to the facts of each case.

II. Discussion

A. Text of Section 28 of the IRPA

Section 28 of the *IRPA* states as follows:

(1) A permanent resident must comply with a residency obligation with respect to every five-year period.

(2) The following provisions govern the residency obligation under subsection (1):

(a) a permanent resident complies with the residency obligation with respect to a five-year period if, on each of a total of at least 730 days in that five-year period, they are

(i) physically present in Canada,

(ii) outside Canada accompanying a Canadian citizen who is their spouse or common-law partner or, in the case of a child, their parent,

(iii) outside Canada employed on a full-time basis by a Canadian business or in the federal public administration or the public service of a province,

(iv) outside Canada accompanying a permanent resident who is their spouse or common-law partner or, in the case of a child, their parent and who is employed on a full-time basis by a Canadian business or in the federal public administration or the public service of a province, or

(v) referred to in regulations providing for other means of compliance;

(b) it is sufficient for a permanent resident to demonstrate at examination

(i) if they have been a permanent resident for less than five years, that they will be able to meet the residency obligation in respect of the five-year period immediately after they became a permanent resident;

(ii) if they have been a permanent resident for five years or more, that they have met the residency obligation in respect of the five-year period immediately before the examination; and

(c) a determination by an officer that humanitarian and compassionate considerations relating to a permanent resident, taking into account the best interests of a child directly affected by the determination, justify the retention of permanent resident status overcomes any breach of the residency obligation prior to the determination.

B. Cases Containing Section 28

1. *Kuan*

In *Kuan v. Canada (Minister of Citizenship and Immigration),*[3] Kuan became a permanent resident, returning to Taiwan with his family within five days of landing in Canada. While in Taiwan, he applied for returning resident permits on two occasions, as it was then possible to do, but was refused both times. Upon returning to Canada four years after landing, he was ordered removed on the basis that he had failed to comply with the residency obligation set out in section 28 of the *IRPA.* His appeal to the Immigration Appeal Division ("IAD") failed. In a lengthy decision, the IAD held that under the previous *Immigration Act,* permanent residents could justify extended physical absences by establishing that they did not have the requisite intention to abandon Canada as their place of permanent residence during the relevant period, but that opportunity no longer exists under the *IRPA,* which provides for a mathematical calculation of a permanent resident's obligation of physical presence in Canada.

More importantly, in canvassing the possible existence of humanitarian and compassionate grounds, the IAD attempted to develop a test to examine the circumstances of each case, and noted that appropriate considerations in such evaluation included the appellant's initial and continuing degree of establishment in Canada; reasons for departure from Canada; reasons for continued or lengthy stay abroad; ties to Canada; whether reasonable attempts to return to Canada were made at the first opportunity; and, generally, whether unique or special circumstances were present that may have prevented the appellant from returning. In that case, the IAD noted that Mr. Kuan returned to Taiwan to continue working in order to qualify for a Taiwanese pension, but also remained in Taiwan to work and study after qualifying for such pension, and he failed to demonstrate the existence of sufficient humanitarian and compassionate considerations to warrant special relief. The IAD also considered the best interests of the child, but held that they would not be affected negatively by the removal, since they resided in Canada with their mother, who had not lost permanent resident status.

2. *Kroupa*

The IAD reached a similar conclusion in *Kroupa v. Canada (Minister of Citizenship and Immigration).*[4] In that case, the appellants were citizens of the United States. The husband and wife couple became permanent residents in 1985 when the husband was employed in Canada. They returned to the United States in 1987 in order to look after a mentally ill daughter, and the husband remained employed by a U.S. company in Portland, Oregon. He visited Canada once or twice per month to assist his employer's Canadian subsidiary. Upon returning to Canada for a visit in 2002, they were issued removal orders on the basis that they had lost their permanent resident status. Their appeal to the IAD was dismissed.

The appellant argued that he could avail himself of the exemption provided in section 28(a)(iii), as being employed on a full time basis by a Canadian business. The IAD held that the residency obligation set out in section 28 of the *IRPA* had not been met and specifically rejected the husband's argument, noting that Mr. Kroupa remained employed by a U.S. company and that he only provided services periodically on behalf of his U.S. employer's parent company to their Canadian subsidiary, thus not falling within the scope of the said exemption. Despite the IAD's acknowledgment that the primary reason for the couple's return to the United States was to look after their mentally ill daughter, who was now an adult, the IAD noted that Mr. Kroupa continued to enjoy a comfortable professional life in the United States and his services to the Canadian corporation were only marginal and temporary in nature. Therefore, the IAD rejected his position that he could retain his permanent residence in Canada, and also held that there were insufficient humanitarian and compassionate considerations, since the couple's mentally ill daughter was already an adult and also lived in the United States.

3. *Wong*

In *Wong v. Canada (Minister of Citizenship and Immigration),*[5] the IAD reached a different conclusion. The appellant became a permanent resident in 1997, but returned to Hong Kong within one month after his arrival in Canada. He re-entered Canada in 2002 and was ordered removed on the basis that he had failed to comply with the residency obligation set out in the *IRPA.* The appellant did not contest his absence, but asked the IAD for discretionary relief. The IAD allowed the appeal and reiterated that the case law which had developed in the area of discretionary relief in sponsorship and removal appeals under the previous *Immigration Act* continued to be relevant under the *IRPA,* and that the appropriate considerations for such relief included those set out in *Kuan.*[6]

In this case, the appellant had terminated his employment in Hong Kong prior to coming to Canada and returned there to dispose of his home and arrange his affairs, planning his relocation to Canada, which was complicated by the ongoing care of his elderly father, who was diagnosed with cancer shortly after he returned to Hong Kong. Since the appellant was his father's primary caregiver until his father's death in September 2001, and even though he did not return to Canada immediately as he wished to observe the traditional mourning period, the appellant met the onus of demonstrating the existence of sufficient humanitarian and compassionate considerations to warrant granting special relief in light of all the circumstances of the case.

4. *Thompson*

The consideration of special circumstances can also extend to those in existence prior to a resident leaving Canada. In *Thompson v. Canada (Minister of Citizenship and Immigration)*,[7] the IAD considered an appeal brought by a permanent resident who had left Canada to give birth to a child. Ms. Thompson had become a permanent resident at age 14 in 1975, and had an affair with a Canadian citizen. In 1988, she returned to Trinidad to give birth to her child. However, the father of the child obtained a custody order in Trinidad allowing him to bring the child back to Canada. A year later, Ms. Thompson came to Canada to be near her child, but a departure order was made against her after it was determined that she had failed to meet her residency obligation. The IAD allowed her appeal, taking into account the best interests of the child.

In considering the existence of humanitarian and compassionate considerations, the IAD noted that the appellant had lived a productive and law-abiding life in Canada before returning to Trinidad because of her pregnancy, and accepted her evidence that she only returned there in order to avail herself of the support of her close family members. The IAD accepted her evidence that she had made several attempts to rekindle her relationship with the Canadian father of the child and that she was hopeful to resolve that situation. The IAD noted that the child was doing very well in school in Canada and had re-established her bond with the appellant, and therefore the child could be affected negatively if the appellant was forced to return to Trinidad.

5. *Angeles*

A number of different arguments were advanced in *Angeles v. Canada (Minister of Citizenship and Immigration)*.[8] In that case, the appellant was an airline employee, a citizen of the Philippines and a permanent resident of Canada for several years. However, during the relevant five-year period for the calculation of his residency obligation, the appellant had only spent three hundred sixty days in Canada. He was ordered removed for failure to meet his residency obligation. The IAD dismissed his appeal, and he pursued a judicial review application at the Federal Court.

In his judicial review application, the appellant impugned the IAD's decision to dismiss his appeal, advancing three distinct arguments to attack the IAD decision: first, he argued that he was deprived of the assistance of an interpreter; second, he contended that the IAD breached the principles of fundamental justice by failing to ensure that he was properly represented by competent counsel; and third, he argued that the immigration officer who made an adverse determination concerning his permanent resident status was obligated to consider humanitarian and compassionate grounds prior to making such determination.

The court rejected all of the arguments advanced by the appellant. The court noted that a standard of patent unreasonableness is to be applied in reviewing IAD decisions and that, based on the evidence on the record, the court was satisfied that the IAD had properly examined the relevant matters. The court agreed that the factors set out in *Kuan* concerning an individual's intention throughout the periods of extended absence from Canada are relevant factors to be considered in the assessment of discretionary relief, and that, since the appellant had not demonstrated a clear intention to establish himself in Canada while maintaining his domicile on a permanent basis in the Philippines with his wife and children whom he never attempted to sponsor, such relief could not be granted. The court noted that the appellant's intention "to perhaps settle in Canada at some point in the future in the hope of improving his family's standard of living"[9] was not sufficient to warrant special relief.

With respect to the appellant's argument that the immigration officer who made the initial determination of loss of status was obligated to consider humanitarian and compassionate grounds, the court held that he was not obligated to do so unless the appellant advanced those arguments. Having failed to do so, the appellant had not discharged the onus that fell upon him, and therefore the immigration officer had no obligation to explore them. This aspect of the decision confirms that it is the obligation of the person concerned to advance all humanitarian and compassionate considerations at the earliest possible opportunity.

One interesting aspect of *Angeles* is how the court dealt with the appellant's argument that the IAD was obligated to ensure that he had the assistance of competent counsel. In the case, the appellant had designated his sister to be his legal representative. The court determined that the appellant had been given every opportunity to secure legal counsel and that, having designated his sister to act as his representative, he was responsible for that choice, notwithstanding the fact that it was apparent from the record that she had difficulty understanding and meeting the procedural requirements of the hearing at the IAD, and although her request for a postponement to allow for the proper production of documents was denied. The court noted that there was no evidence that the appellant or his representative ever indicated to the IAD that they had concerns about the retention of competent counsel, and the court cited with approval the decision in *Huynh v. Canada (Minister of Employment and Immigration)*,[10] where it was held:

> That the applicant's story was not told or did not come out clearly may have been a fault of counsel or it may have been that the applicant did not properly brief counsel. As I understand the circumstances, counsel was freely chosen by the appli-

> cant. If counsel did not adequately represent his client, that is a matter between client and counsel.[11]

The court dismissed the appellant's contention of lack of competent counsel and held that the IAD had no obligation to intervene regarding his choice of representative. The court's decision concerning this issue should serve as a warning sign to the public to consider carefully the competency of their representatives before engaging them in legal matters. It must be noted that this case was heard by the IAD prior to the amendments to the *IRPA* requiring that only licensed representatives may appear before immigration tribunals, but given the lack of appropriate education and training standards for non-lawyers, a similar result could ensue if an appellant attempts to argue that counsel was not competent: Such a line of argument appears to have been foreclosed by the courts.

6. *Lello*

The consideration of humanitarian and compassionate grounds also arose in *Lello v. Canada (Minister of Citizenship and Immigration).*[12] In that case, the appellant came from England to live in Canada in the 1960s with her husband and had a Canadian-born daughter. She returned to England, but came back to Canada in the 1970s with her second husband for a short time. She returned again to Canada after the end of her second marriage, but went back to England in 1983 to care for her ill parents. In 2003, the appellant decided to settle in Canada, where her daughter and her grandson were living, believing that she was still a permanent resident. The visa officer refused to waive her residency requirements on humanitarian and compassionate grounds, and determined that she was in breach of her residency obligation.

At the IAD, the appellant argued unsuccessfully that humanitarian and compassionate considerations existed based on the testimony of her daughter that she would have to seek social assistance to support herself and her son if the appellant was directed to leave Canada. The IAD interpreted that statement as a threat and dismissed the appeal. The Federal Court held that the IAD had applied the wrong test in its consideration of humanitarian and compassionate grounds, and that the IAD should have asked whether the daughter was able to sponsor the appellant and, if not, her failure to maintain the required number of days of physical presence in Canada should have been waived. Although the decision in this case was positive, it must be cautioned that the factual context appears to be very narrow in scope.

III. Conclusion

Having regard to the case law developed in the four years since the *IRPA* came into force, it is apparent that, while section 28 of the *IRPA* provides an objective test for determining whether a permanent resident has maintained his or her obligation to reside in Canada, the consideration of humanitarian and compassionate grounds continues to be a relevant factor that must be canvassed carefully before a permanent resident can be held to be in breach of the residency obligation. However, the onus rests with the applicant to ensure that all facts and arguments are presented at the earliest possible opportunity. The skilful presentation of humanitarian and compassionate considerations is crucial in the success of a challenge to a decision that a person is no longer a permanent resident of Canada.

Endnotes

1. S.C. 2001, c.27.
2. R.S.C. 1985, C.12 Section 24.
3. 34 Imm. L.R. (3d) 269 (IAD).
4. 34 Imm. L.R. (3d) 55 (IAD).
5. 35 Imm. L.R. (3d) 320 (IAD).
6. See text accompanying note 3 *supra*.
7. 35 Imm. L.R. (3d) 308 (IAD).
8. 2004 F.C. 1257; 38 Imm. L.R. (3d) 308 (Fed.Ct. T.D.).
9. *Id.*
10. (1993) 65 F.T.R. 11 (Fed.Ct. T.D.).
11. (1993) 21 Imm. L.R. (2nd) 18 (Fed.Ct. T.D.).
12. 45 Imm. L.R. (3d) 95 (IAD).

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Estate and Income Tax Planning for the Transatlantic Family

Hypothetical Fact Pattern

Editor's Note: This issue of the Practicum *contains in the following three articles a detailed discussion of estate and income tax planning for the transatlantic family from the vantage point of three jurisdictions: New York, Germany and France. The fact pattern that forms the common basis of the discussion in the three articles is set forth below.*

Alexander K. Gordon, aged 52, is a citizen of the United Kingdom, and his wife, Claudia Gordon née Stern, aged 47, is a citizen of Germany, and they have been domiciled in Harrison, New York, since 1986, when they moved to the United States from France. They have been permanent residents of the United States (i.e.,"green card" holders) since 1987. The Gordons have two children, Marcus Gordon, aged 16, and Cecilia Gordon, aged 14, both of whom were born in New York and are United States citizens and currently attend boarding school in Connecticut. Mr. and Mrs. Gordon were married in France in 1984, where they were both residing and working at the time.

Currently Mr. Gordon is the chief executive officer of Kramer Technologies, Inc. ("KTI"), a publicly traded corporation involved in the manufacture of electronic monitoring devices for hospital patients, particularly for victims of heart attacks and strokes. KTI is headquartered in Dobbs Ferry, New York. Mrs. Gordon is a certified public accountant and a former partner of a large accounting firm in New York City. She retired from this position in 2003 in order to become more involved with her family's publishing business in London, England, known as PL Publishers, Ltd. ("PLP"). This company was formed by her grandfather (on her mother's side), Patrick Lott, in 1933 and is currently owned by Mrs. Gordon and her brother, Pierre Stern. Mr. Stern is the chief executive officer and president of PLP, resides in London, and runs the day-to-day operations of the company. Mrs. Gordon is a board member and the treasurer of PLP and is very involved in the management of the company, notwithstanding her domicile in the United States. She travels to London at least four times a year for a week at a time to deal with business matters.

The Gordons' assets consist of the following (in U.S. dollars):

- — A residence in Harrison, New York, owned by them as tenants-by-the-entirety, with a value of $1.8 million and no mortgage.
- — A vacation home on Marco Island, Florida, in Mr. Gordon's name, with a value of $1 million and a $300,000 mortgage.
- — A small two-bedroom apartment in London in Mrs. Gordon's name, with a value of $750,000.
- — Two brokerage accounts at a brokerage firm in New York City, one in each of their names and each with a value of approximately $1.5 million.
- — Mrs. Gordon's 50% interest in PLP. The entire company was valued at $20 million approximately three years ago for purposes of determining its value for a possible sale to an outsider.
- — Mr. Gordon's 401(k)/pension plan with KTI, which currently holds approximately $1.5 million.
- — Mrs. Gordon's individual retirement account (IRA) with a current balance of $300,000, most of which was rolled over from her pension plan at her former accounting firm.
- — A group life insurance policy on Mr. Gordon's life with a face amount of $1 million.

Mr. Gordon has decided to resign from his position as CEO of KTI as of 31 December 2005, in order to take a position as the CEO of a new start-up pharmaceutical company in Europe. The Gordons will sell their home in Harrison and purchase a smaller home in the country, about 30 miles from the city where the new company will be located, for approximately $1 million. They will retain their homes in Marco Island and London. Their children will continue to attend boarding school in Connecticut but will spend all of their vacations in the new home in Europe. Mrs. Gordon will continue to assist Mr. Stern with the running of the family business in London.

The authors of the following three articles were asked to assume that the Gordons had come to them for pre-emigration/immigration estate and tax planning. Each of the authors from France and Germany was instructed to assume that the start-up company of which Mr. Gordon will be the CEO was located in his country and that the new residence of the Gordons would be located in that country; and these two authors were asked to provide pre-immigration estate and tax-planning advice to the Gordons based on this. The author from New York was asked to provide advice to the Gordons that deals with expatriation taxation and planning and general estate planning that would take into account their move oversees.

Estate and Income Tax Planning for the Transatlantic Family

The U.S./New York Perspective—Expatriation, Domicile, and Probate

By Glenn G. Fox

I. Expatriation Tax Issues

A. Overview

Since the Gordons have been lawful permanent residents of the U.S. (i.e., green card holders) for at least 8 of the preceding 15 years before moving to Europe, they will be considered "long-term residents" under Section 877(e)(2) of the Internal Revenue Code of 1986, as amended (the "Code") (hereinafter referred to as "long-term U.S. tax residents"). As such, the Gordons will have to contend with the U.S. expatriation tax on their income, gifts, and estates, should they decide to relinquish their green cards or if they do not waive the benefits of the tax treaty between the country to which they are moving and the U.S.[1] In such a case the Gordons would be considered "expatriates" under Code Section 877.

The U.S. expatriation tax rules provide an alternative method of taxation that is generally applicable to U.S. citizens who renounce their U.S. citizenship and to long-term U.S. residents who terminate their U.S. residency. (As discussed above, the Gordons are considered long-term U.S. tax residents). The operative expatriation tax rules are contained in Sections 877, 2107, and 2501 of the Code. The American Jobs Creation Act of 2004[2] (the "Jobs Act"), signed into law on October 22, 2004, made some key changes to the existing tax expatriation rules.

B. Individuals Subject to the Alternative Method of Taxation

A former U.S. citizen or a long-term U.S. resident is subject to the alternative method of taxation under Code Section 877 for a period of ten years if (i) his or her average annual net income tax liability for the five years preceding expatriation exceeds $124,000,[3] (ii) his or her net worth is $2 million or more on the date of expatriation, or (iii) he or she fails to certify under penalties of perjury that he or she complied with all of his or her U.S. tax obligations for the five preceding years or fails to provide evidence of such compliance if requested by the Secretary of the Treasury.[4] These tests are now used to determine conclusively whether the expatriating individual is subject to the alternative method of taxation. The individual's motivation for expatriation is no longer relevant.

C. Exceptions to Treatment as an Expatriate

Once an individual terminates his or her U.S. residency or renounces his or her citizenship, he or she can avoid the application of the alternative regime in one of two ways.

First, an expatriating individual will avoid being taxed under Code Section 877 if he or she falls below the $2 million net worth and $124,000 U.S. income tax liability thresholds and certifies that he or she has complied with all his or her U.S. tax obligations for the five-year period preceding his or her expatriation and provides evidence thereof (if requested).

Second, even if an expatriate meets at least one of the monetary thresholds, he or she can avoid the application of the alternative tax regime if he or she falls into one of two very narrowly defined categories of individuals under Code Section 877(c). A former U.S. citizen can avoid the application of the alternative tax regime if he or she (i) was born a U.S. citizen and a citizen of another country and remained a citizen of that other country and (ii) had no "substantial contacts" with the U.S. A person will be deemed as having no "substantial contacts" with the U.S. if he or she was never a resident of the U.S.,[5] never held a U.S. passport, and was not present in the U.S. for more than 30 days during any calendar year in the ten-year period preceding his or her loss of U.S. citizenship.[6] Alternatively, a former U.S. citizen can avoid the application of the alternative tax regime if (i) he or she was born a U.S. citizen, (ii) neither of his or her parents was a U.S. citizen at the time of his or her birth, (iii) he or she lost his or her U.S. citizenship before reaching 18 ½ years of age, and (iv) he or she was not present in the U.S. for more than 30 days during any calendar year in the ten-year period preceding the loss of citizenship.[7] In the case of either exception, the expatriate must certify under penalties of perjury that he or she has complied with all of his or her U.S. tax obligations for the five-year period preceding his or her expatriation.

If an expatriate can satisfy one of these exceptions, he or she will be taxed by the U.S. as a nonresident alien and will be able to benefit from any applicable U.S. bilateral income tax treaty.

There are no similar exceptions currently available to expatriating long-term U.S. residents. Consequently, all expatriating long-term U.S. residents who meet the net worth or tax liability test, or fail to certify compliance with all U.S. tax obligations in the five years preceding expatriation, such as the Gordons, will be subject to the alternative method of taxation for a period of ten years.

D. Former U.S. Citizens and Long-Term U.S. Residents Subject to Full U.S. Taxation

A former U.S. citizen's or long-term U.S. tax resident's presence in the U.S. for more than 30 days in any given calendar year during the ten-year period following expatriation will cause the alternative method of taxation to no longer apply to him or her.[8] Instead, the former U.S. citizen or long-term U.S. tax resident will be subject to full U.S. taxation on all of his or her worldwide income, regardless of the source and the nature of such income.[9] Therefore, if the Gordons wish to avoid being fully subject to U.S. taxation during the ten-year period after the move to Europe, they should avoid coming to the U.S. for vacations (on Marco Island, for example) or otherwise for more than 30 days per year.

However, up to 30 days spent in the U.S. for employment purposes can be excluded by a former U.S. citizen or long-term U.S. tax resident if he or she falls within one of two narrowly defined categories of individuals. First, a former U.S. citizen or long-term U.S. tax resident can exclude up to 30 days spent in the U.S. for employment purposes if he or she becomes a citizen or resident of a country in which he or she, his or her spouse or either of his or her parents was born, provided that the former U.S. citizen or long-term U.S. tax resident is fully liable for income tax in that country. Second, a former U.S. citizen or long-term U.S. tax resident can exclude up to 30 days spent in the U.S. for employment purposes if he or she was present in the U.S. for no more than 30 days during each year in the ten-year period ending on the date of citizenship or residency relinquishment.[10] Since the Gordons' employment will be in Europe, this 30-day exception will not apply to them.

E. The Alternative Method of Taxation

1. U.S. Income Taxation

If no exception is available to the expatriate, the alternative method of income taxation will apply. The former U.S. citizen or long-term U.S. resident will be subject to U.S. income tax on his or her U.S.-source income at the rates generally applicable to U.S. persons rather than at the rates applicable to other nonresident aliens.[11] For this purpose, the range of income items treated as U.S.-source is more expansive than the range of items generally considered U.S.-source income. The following items of gross income will be treated as U.S.-source income with respect to an expatriate: (i) gains on the sale or exchange of property (other than stock or obligations) located in the U.S.; (ii) gains on the sale or exchange of U.S. stock or debt obligation of a U.S. person, the U.S. or a state; and (iii) income or gain derived from a controlled foreign corporation if the expatriate owned, directly, indirectly, or constructively, at any time during the two-year period ending on the date of expatriation, more than 50 percent of the total combined voting power or total value of the stock of the corporation, provided that such income or gain does not exceed the earnings and profits attributable to the stock that were earned or accumulated before the expatriation and during periods that the stock ownership requirements were met.[12]

Former U.S. citizens and long-term U.S. residents subject to the alternative method of taxation are also taxed on exchanges of specific types of property.[13] Generally, an expatriate who exchanges property that produces U.S.-source income for property that produces foreign-source income in an exchange that would otherwise not result in the recognition of income must, nevertheless, recognize as U.S.-source income any gain calculated as if the property exchanged was sold for its fair market value. The individual will receive a stepped-up basis in the exchanged property. Examples of such transactions are the removal of tangible personal property from the U.S. with an aggregate fair market value in excess of $250,000 and the contribution of property to a foreign trust.[14] These recognition provisions will not apply if the expatriate enters into an agreement with the Secretary of the Treasury which provides that any income or gain derived from the property that is acquired in the exchange during the ten-year period after expatriation shall be treated as from sources within the U.S.[15] Therefore, if the Gordons own significant tangible personal property that they plan to move to Europe, they should consider entering into such an agreement.

In addition, under Code Section 121(e), if an expatriate sells his or her principal residence, he or she will be prohibited from availing himself or herself of the exclusion from gain under Code Section 121 (which generally excludes $250,000 of gain if the taxpayer is single and $500,000 if the taxpayer is married and he or she has lived in the residence as his or her principal residence for two of the past five years before selling it). Since the Gordons will be selling their Harrison, New York, home they should be made aware of their inability to take advantage of this rule if they become expatriates.

Finally, income or gain from property contributed to a foreign corporation by a former U.S. citizen or long-term U.S. resident during the 15-year period commencing five years prior to expatriation is treated as U.S.-source and the expatriate is taxed on such income or gain as though he or she owned such property directly.[16]

On the other hand, former U.S. citizens subject to the alternative method of taxation are not subject to U.S. income tax on their foreign-source income and deductions are allowed only to the extent they are connected with the gross income that is subject to expatriate taxation, except that no capital loss carryover is allowed.

2. U.S. Estate Taxation

Taxation pursuant to the alternative method also has certain U.S. estate tax consequences. The property of a former U.S. citizen or long-term U.S. resident decedent who relinquished his or her U.S. citizenship or terminated his or her U.S. residency within the ten-year period immediately preceding his or her death is subject to U.S. estate tax in the same manner as that of a nonresident alien who never resided in the U.S., with one exception.[17] In addition to including U.S. situs property, which is generally the only property of a nonresident alien subject to the U.S. estate tax,[18] the gross estate of a former U.S. citizen or long-term U.S. resident also includes a percentage of the fair market value of the stock of any foreign corporation in which he or she owned, directly or indirectly, at the time of his or her death 10 percent or more of the total combined voting power of all classes of stock and in which he or she is considered to have owned (through attribution) 50 percent or more of either the total combined voting power of all classes of stock entitled to vote or of the total value of the stock of the corporation.[19] In such a case, the decedent's estate includes that portion of the fair market value of the stock that the fair market value of any asset owned by that corporation and situated in the U.S. bears to the total fair market value of all assets owned by the foreign corporation.[20] It is irrelevant whether the stock of the foreign corporation is situated inside or outside the U.S. A limited foreign tax credit is available for foreign taxes paid to a foreign country with respect to property that is subject to U.S. tax by operation of this rule.

3. U.S. Gift Taxation

Similarly, taxation pursuant to the alternative method has certain U.S. gift tax consequences. Nonresident aliens are generally not subject to U.S. gift tax on the transfer by gift of intangible property, e.g., stock.[21] However, a former U.S. citizen or long-term U.S. resident subject to the alternative method of taxation is subject to U.S. gift tax on the transfer by gift of any property, including intangible property.[22] The gift tax imposed on the transfer of intangible property under this rule can be credited with the amount of gift tax that was paid to a foreign country with respect to that gift. In addition, U.S. gift tax will apply on a gift of stock of a foreign corporation made by a former U.S. citizen or long-term U.S. resident during the ten-year period following expatriation if the expatriate, at the time of making the gift, owned, directly or indirectly, 10 percent or more of the total combined voting power of all classes of stock entitled to vote and in which he or she is considered to have owned (through attribution) 50 percent or more of either the total combined voting power of all classes of stock entitled to vote or of the total value of the stock of the corporation.[23] If the gift is taxable under these tests, the taxable gift includes that portion of the fair market value of the stock transferred which the fair market value of any asset owned by that corporation and situated in the U.S. bears to the total fair market value of all assets owned by the foreign corporation. Again, it is irrelevant whether the stock is situated inside or outside the U.S.

F. Tax Rules for Determining Citizenship and Residency Termination

Pursuant to revised Code Section 7701(n), a U.S. citizen or long-term U.S. resident who otherwise performs an act of expatriation will retain his or her U.S. status for U.S. federal income tax purposes until he or she gives notice to the Secretary of State or to the Secretary of Homeland Security of the act of expatriation and provides a statement in accordance with Code Section 6039G. This new section abandons the use of immigration-based residency rules and instead requires the use of tax-based rules for determining a U.S. citizen's or long-term U.S. resident's tax status. At present, the precise method required to be used for giving notice of the termination of U.S. residency or of the renunciation of U.S. citizenship is unclear.

G. Procedural Rules

U.S. citizens and long-term U.S. residents subject to Code Section 877 must file annual returns for each of the ten years during which the alternative method applies, even if no U.S. federal income tax is due for any of those years.

In addition, expatriating U.S. citizens and long-term residents, even if they are not subject to Code Section 877, must file an expatriation statement using Internal Revenue Service (IRS) Form 8854. U.S. citizens and long term residents who are not subject to Code Section 877 must file Form 8854 only once so as to notify the IRS of their intention to terminate U.S. tax residency. This form serves as the initial and annual expatriation information statement for U.S. tax purposes and is also considered sufficient notice to the Secretary of State or the Secretary of Homeland Security of the act of expatriation. The termination of residency and the renunciation of citizenship for immigration purposes carry separate filing obligations. The penalty for failure to file a statement under Section 6039G is $10,000, unless the expatriate can show that the failure is due to reasonable cause and not to willful neglect.

II. Determining Domicile of Non-U.S. Citizens for Estate Tax and Gift Tax Purposes

A. Generally

The Gordons will only be subject to estate tax as nonresident aliens, and to the alternative estate tax regime for expatriates, if they are considered non-domiciliaries of the U.S. for estate tax purposes. If they move to Europe, but are still considered domiciliaries of the U.S. for estate tax purposes, they will continue to be subject to U.S. estate tax and gift tax on their worldwide property. Therefore, it is important for the Gordons to understand the estate and gift tax domicile rules and how they differ from the income tax rules.

Under U.S. estate and gift tax law, an alien is considered a U.S. resident for estate and gift tax purposes if he or she is domiciled in the U.S. at the time of his or her death or at the time of a gift. If an alien enters the U.S. for even a brief period of time, with no definite present intention of later leaving the U.S., he or she is deemed to be domiciled in the U.S. and, therefore, is considered a U.S. resident for estate and gift tax purposes.[24] Thus, an alien may be considered a nonresident alien for estate and gift tax purposes and a U.S. resident for income tax purposes, since the estate tax residency test is the more subjective domicile test just described, while the income tax residency test is met if the alien satisfies an objective day count test or holds a green card.

As mentioned above, the determination of domicile for estate and gift tax purposes is a factual issue that focuses on the following factors, among others:

1. The length of time spent in the U.S. and abroad and the amount of travel to and from the U.S. and between other countries.
2. The value and size of the alien's homes and whether he or she owned or rented them. (If the home owned abroad is worth substantially more than the home owned in the U.S., this could be an indication that the alien was not domiciled in the U.S. If the alien owned a home abroad and only rented a residence in the U.S., this could also be an indication that he or she was not domiciled in the U.S., since renting a residence in the U.S. may show intent to eventually leave. Conversely, if the alien owns a home in the U.S. and rented a home abroad, this might be an indication of intent to remain in the U.S. indefinitely (resulting in a determination that the decedent was domiciled in the U.S.). Nevertheless, under certain circumstances renting a residence in the U.S. may also indicate intent to stay (resulting in a determination that the decedent was domiciled in the U.S.), particularly if the alien rented in the U.S. for a long period of time.)
3. The locations of houses and other residences, since a house in a vacation area is less of an indication to remain indefinitely than in other areas.
4. The situs of valuable or meaningful tangible personal property (cars, jewelry, furniture, artwork, clothing, etc).
5. The location where the alien's close friends and family are situated.
6. The locales in which the alien has religious and social affiliations or in which he partakes in civic affairs.
7. The locales in which the alien's business interests are situated.
8. The status of the alien's visa.
9. The places where the alien states that he or she resides in legal documents, such as deeds, wills, trusts, letters, etc., or in verbal communications.
10. Whether the alien spends time in a locale due to poor health, for pleasure, to avoid political problems in another country, etc.
11. The jurisdiction in which the alien is registered to vote.
12. The jurisdiction that issued the alien's driver's license.
13. Income-tax filing status (although income-tax filing status and income-tax residency status do not necessarily determine that an alien is a resident for estate and gift tax purposes, the chances are significantly greater that an alien will be considered a U.S. resident for estate tax purposes if he is a U.S. resident for income tax purposes).

No one factor is determinative of whether an alien is domiciled in the U.S. for estate tax purposes. In each case all of the facts and circumstances are examined.

In the Gordons' case, they will sell their current principal residence in Harrison, New York, and purchase a new principal residence in Europe, where they will live most of the year (particularly if they relinquish their green cards and want to avoid being subject to worldwide U.S. income tax). Presumably, if they settle in either the United Kingdom or Germany, the spouse who is a citizen of that country will register to vote there and both of the Gordons will obtain driver's licenses in those countries. It is also likely that they will join a house of worship in the country in which they settle and establish club and social affiliations in that country. They will most likely move all of their tangible personal property to Europe (although they should be wary of the deemed-gain recognition rules under the expatriation tax provisions, discussed above) and, of course, they will be employed in Europe, rather than in the U.S. All of these factors point towards a finding that they have relinquished their domicile in the U.S. and established it in Europe.

Some of the factors that may, however, weigh against a change of domicile from the U.S. to Europe are that the Gordons' children will remain in the U.S., Mr. Gordon will retain his vacation home on Marco Island, Florida, and the Gordons may maintain some investment assets in New York. However, since the home is only a vacation home and the Gordons will spend very little time there, this does not seem to be a significant factor. In addition, the Gordons should probably try to move as much of their investment assets out of the U.S. as possible, to avoid a domicile question and problems with disposing of the assets upon death (see Part II.B below). Their children's presence in the U.S. would, then, be the one remaining factor, and this would be outweighed by the other factors set forth above. Therefore, it seems from the facts that the Gordons would be considered non-domiciliaries for estate and gift tax purposes. Therefore, they would just have to contend with additional estate and gift tax issues (above those with which the ordinary non-resident alien would have to contend) during the ten-year expatriation period, as discussed above in Parts I.E.2 and 3 above.

B. Impact of Estate and Gift Tax Treaties on Domicile

1. Introduction

As discussed in Part II.A above, it is unlikely that the Gordons will be considered domiciliaries of the U.S. for estate and gift tax purposes when they move to Europe. In the event that the IRS takes the position that they are still U.S. domiciliaries under U.S. law, it is important to understand whether they will, nevertheless, be considered domiciliaries of the country in which they will reside under the estate and gift tax treaty between the U.S. and that country.

2. Estate Tax Treaty Between Germany and the United States

Under the Estate and Gift Tax Treaty Between Germany and the U.S.[25] (the "German Estate Tax Treaty"), a person is deemed to be domiciled in the U.S. if he or she is a resident or citizen of the U.S., and he or she is deemed to be domiciled in Germany if he or she has his or her domicile or habitual abode in Germany, or if he or she is deemed, for other reasons, to be subject to unlimited tax liability for the purposes of the German inheritance and gift tax.

If the individual is deemed to be domiciled in both countries under the above rules, the German Estate Tax Treaty "tie-breaker" provisions will apply. Under these rules, the individual who has dual domicile will be deemed to be domiciled in the country where he or she has a permanent home, or if he or she has a permanent home in both countries or neither country, in the country where his or her personal and economic relations are the closest ("center of vital interests"). If it cannot be determined where his or her center of vital interests is the closest, he or she will be deemed to be domiciled in the country in which he or she has a habitual abode and if he or she has habitual abodes in both countries or neither country, he or she will be deemed to be domiciled in the country of which he or she is a citizen. If the individual was a citizen of both countries or neither country, the competent authorities of the two countries agree on the country where he or she resided.

Notwithstanding the general tie-breaker rules, if an individual, at the time of his or her death or at the time of making a gift was a citizen of one country and not a citizen of the other country and, under the respective laws of each jurisdiction, is deemed to be domiciled in both countries, but the individual has not been domiciled in the country of which he or she is not a citizen for more than ten years, he or she will be deemed to be domiciled in the country of which he or she was a citizen for purposes of the German Estate Tax Treaty. After ten years, the traditional tie-breaker rules discussed above become applicable but only if both jurisdictions claim domicile under their respective internal laws.

Assuming that the Gordons move to Germany and assuming that both Germany and the U.S. claim that the Gordons are domiciled there, we must first look to the country in which they have a permanent home. In the Gordons' case, it could be argued that they have permanent homes in both countries, since Mr. Gordon owns a home on Marco Island and the Gordons would own a home together in Germany. Since they have a permanent home in both countries, we must then look to the country where the Gordons' personal and economic relations are the closest under the tie-breaker rules. Although the Gordons' children live in the U.S., it seems that all of their other personal and economic relations weigh heavily in favor of Germany, since Mr. Gordon is employed there, they vote there, they have driver's licenses there, they have religious and social affiliations there, and they have moved all of their personal property there. Therefore, due to the location of their center of vital interests, under the German Estate Tax Treaty, the Gordons would probably be found to be domiciled in Germany.

3. Estate and Gift Tax Treaty Between the United Kingdom and the United States

Under the Estate and Gift Tax Treaty Between the United Kingdom and the U.S.[26] (the "U.K. Estate Tax Treaty"), a person is deemed to be domiciled in the U.S. if he or she is a resident of the U.S. or citizen of the U.S. and had been a resident thereof at any time during the preceding three years. Under the U.K. Estate Tax Treaty, a person is deemed to be domiciled in the U.K. if he or she is domiciled in the U.K. in accordance with the law of the U.K. or is treated as so domiciled for the purposes of the tax that is at issue.

If under the above provisions the individual is deemed to be domiciled in both countries and is a citizen of the U.K., but not of the U.S., and had not been a resident of the U.S. for income tax purposes in seven or more of the ten taxable years ending with the year in which that time falls, the individual will be deemed to be domiciled in the U.K. If the individual is deemed to be domiciled in both countries, and is a citizen of the U.S., but not of the U.K., and had not been a resident of the U.K. in seven or more of the ten income tax years of assessment ending with the year in which that time falls, he or she shall be deemed to be domiciled in the U.S. at that time.

If the individual is deemed to be domiciled in both countries and the seven out of ten years rule set forth above does not apply, the U.K. Estate Tax Treaty "tie-breaker" provisions will apply. Under these rules, the individual who has dual domicile will be deemed to be domiciled in the country where he or she has a permanent home, or if he or she has a permanent home in both countries or neither country, in the country where he or she has his or her center of vital interests. If it cannot be determined where his or her center of vital interests is the closest, he or she will be deemed to be domiciled in the country in which he or she has a habitual abode, and if he or she has habitual abodes in both countries or neither country, he or she will be deemed to be domiciled in the country of which he or she is a citizen. If the individual was a citizen of both countries or neither country, the competent authorities of the two countries agree on the country where he or she resided.

Assuming that the Gordons move to the U.K. and assuming that both the U.K. and the U.S. claim that the Gordons are domiciled there, we must go through the same tie-breaker analysis that we went through with respect to Germany. Therefore, again, due to the location of their center of vital interests, under the U.K. Estate Tax Treaty, the Gordons would probably be found to be domiciled in the U.K.

4. Estate and Gift Tax Treaty Between the United States and France

Under the Estate and Gift Tax Treaty Between the U.S. and France[27] (the "French Estate Tax Treaty"), the question of whether an individual is domiciled in one of the two countries is determined according to the law of each country. If both countries hold that the person is domiciled there, the French Estate Tax Treaty "tie-breaker" provisions will apply. Under these rules, the individual who has dual domicile will be deemed to be domiciled in the country where he or she has a permanent home, or if he or she has a permanent home in both countries or neither country, in the country where he or she has his or her center of vital interests. If it cannot be determined where his or her center of vital interests is the closest, he or she will be deemed to be domiciled in the country in which he or she has a habitual abode, and if he or she has habitual abodes in both countries or neither country, he or she will be deemed to be domiciled in the country of which he or she is a citizen. If the individual was a citizen of both countries or neither country, the competent authorities of the two countries agree on the country where he or she resided.

Notwithstanding the general tie-breaker rules, the French Estate Tax Treaty, like the German and U.K. Estate Tax Treaties, has a period of time during which one retains his or her domicile in the country where he or she is a citizen. If an individual, at the time of his or her death or at the time of making a gift, was a citizen of one country and not a citizen of the other country and, under the respective laws of each jurisdiction, is deemed to be domiciled in both countries, but the individual has been domiciled in the country of which he or she is not a citizen for less than five years out of the previous seven years and he or she has a clear intention to retain his or her domicile in the country of citizenship, he or she will be deemed to be domiciled in the country of which he or she was a citizen for purposes of the French Estate Tax Treaty. The same rule also applies if the individual, the individual's spouse, or the individual's parent (if the individual is a dependent of the parent) is in the country of which he or she is not a citizen due to assignment of employment and has been in that country for less than five years of the previous seven years (or less than seven years of the previous ten, in the case of renewal of assignment of employment). There is no requirement of "intent" to leave the U.S. in the employment cases. After the period of years, the traditional tie-breaker rules discussed above become applicable, but only if both jurisdictions claim domicile under their respective internal laws.

Assuming that the Gordons move to France and assuming that both France and the U.S. claim that the Gordons are domiciled there, we must go through the same tie-breaker analysis that we went through with respect to Germany and the United Kingdom. Therefore, again, due to the location of their center of vital interests, under the French Estate Tax Treaty, the Gordons would probably be found to be domiciled in France.

III. New York Choice of Law Rules with Respect to New York Situs Assets

Notwithstanding the Gordons' move from New York and the U.S., they may decide to maintain their New York bank and brokerage accounts. In such a case they should be familiar with the New York choice of law rules for assets of non-domiciliaries of New York that are located in New York. The reason for this is that New York financial institutions may not recognize the process for disposition of assets upon death in the new country in which the Gordons become domiciliaries and may, instead, require the Gordons to have an executor or administrator appointed in New York to dispose of the New York situs property.

In New York, the surrogate's court of any county has jurisdiction over the estate of a non-domiciliary decedent who leaves property (including personal property) in the state.[28] Thus, in one case the court determined that a non-domiciliary decedent's New York bank account with only $1,405 left in it was a sufficient basis to grant ancillary letters of administration, although the court of appeals later determined that this jurisdiction was limited to assets located in New York.[29]

The relevant time to determine if jurisdiction is possible is at the time of filing the petition. Therefore, if there is property in the state at the time of the decedent's death that is later removed from the state before the petition for letters is filed, New York does not have jurisdiction over the property. Conversely, if the decedent's property is brought into New York after his or her death and it remains unadministered, New York does have jurisdiction.[30]

The surrogate's court's jurisdiction is discretionary, however, which means that the court will consider a number of factors before granting a petition. These factors include the following: whether the will was drafted and executed in New York; whether the will states that the testator is a resident of New York; how much of the decedent's estate is located in the state; and the convenience of the fiduciaries and beneficiaries.[31]

Typically, ancillary letters will only be granted when there is an actual administration in the probate or domiciliary jurisdiction, and the ancillary letters correspond only to the assets located in New York.[32] Surrogate's courts have, however, granted petitions in exception to this rule. For example, in a case where the sole asset of the non-domiciliary decedent was located in New York, and where no actual administration of his or her estate had been commenced in his or her domicile, the court granted ancillary letters so that the assets could be administered. Normally the court will grant ancillary administration to the principal administrator appointed in the decedent's domicile. However, in a case in which no such administrator existed, the court determined that, in the exercise of its discretion, the necessary and proper action would be to grant ancillary letters to the person named by one of the beneficiaries, who petitioned for this action.[33] Similarly, a surrogate's court determined that it had jurisdiction over a decedent's estate in a case in which a decedent left $40,000 in a New York bank account and no probate proceeding had been commenced in his domicile or in any other jurisdiction.[34]

As mentioned above, however, the surrogate's courts weigh a number of factors in making their decision, and they will not grant letters of administration in all probate cases involving property in New York. In *In re Spencer's Estate*,[35] the court held that it "is not required to entertain jurisdiction of the probate of a Will of a non-resident merely because assets of deceased are in this state," but noted that, although original probate jurisdiction was improper in New York, any administration that must take place in New York could be done through ancillary proceedings.[36] The court also denied its jurisdiction over the estate of a non-domiciliary decedent who had a trivial amount of money in a New York bank account versus very substantial amounts of real and personal property in his domicile and abroad, in order to allow the estate to be administered in a jurisdiction where the bulk of the decedent's assets were located. Although the will specified that it should be probated in New York, since the decedent was not domiciled in the state, the court determined that his insubstantial New York assets were an insufficient basis for New York jurisdiction over his estate, given that the bulk of it was located elsewhere.[37]

Similarly, the court denied jurisdiction over an estate with a trivial amount of money in a bank account in New York after determining that the decedent was not domiciled in New York and that the majority of her assets were located in her domicile, since "full and complete jurisdiction can and will be exercised" in that state.[38]

Finally, the court is reluctant to compete with probate proceedings in the decedent's domiciliary jurisdiction without strong reasons for so doing. For example, one set of beneficiaries of a Florida decedent's estate filed the will for probate in Florida, while another set petitioned for probate in New York. The surrogate's court in New York noted that it did not have jurisdiction to administer original probate proceedings after the will has been admitted in the domiciliary jurisdiction, except if ancillary probate is determined to be unduly expensive, inconvenient, or impossible; if the testator has directed in the will that it should be probated in New York; or if the laws of the testator's domicile discriminate against interested parties who are domiciled in New York. Although in this case the will had not yet been admitted in Florida, the court denied New York's jurisdiction since it would be unnecessarily costly for all parties involved to have to litigate the will in two jurisdictions, since it would not appear to violate the testator's administrative wishes, and since the petitioners had not shown that they would be prejudiced by administration in the testator's domicile.[39]

If the Gordons plan to retain substantial assets in New York, it does appear that, under the above rules, the surrogate's court of the county where the assets are maintained will have jurisdiction over the assets. If the Gordons want to avoid the need to probate their wills in New York, they should, in such a case, consider transferring their assets to a revocable trust, which disposes of their assets upon their deaths in the same manner as a will but avoids the need for probate since the trust itself determines who the successor trustee is and continues after death. Prior to their deaths, Mr. and Mrs. Gordon could each be sole trustee of his or her own trust. If a trust is used, the Gordons' assets in New York must be retitled in the name of the trust to avoid probate.

If the trust concept is not favorable, due to tax concerns or prohibitions against trusts in the Gordons' country of domicile or citizenship (for instance, Germany), another alternative might be to transfer their U.S. assets to a limited liability company of which they are the sole members. Upon their respective deaths, the interests in the company would be disposed of pursuant to the law of the country where they are domiciled, and their banks and brokers would not be concerned about probate, since the company would continue after their deaths, assuming the company has other members (to avoid a problem of dissolution upon the death of the sole member, Mr. and Mrs. Gordon should both be members and perhaps one of their children who is an adult should be a minority interest member).

If the Gordons do not want to deal with the complications of a trust or a limited liability company, at the very least they should each have a New York will that disposes of their New York assets to the same beneficiaries who would receive the assets in their country of domicile. The reason for this is that the banks or brokers in New York may not recognize a foreign executor and may require that an executor be appointed in New York before they will allow the assts in their accounts to be released. Even if a trust or limited liability company is used, the Gordons should have New York wills as a backstop in case assets are left out of the trust or company.

IV. IRS Circular 230 Disclosure

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

Endnotes

1. I.R.C. § 877(e)(1). The U.S. has both income and estate and gift tax treaties with the United Kingdom, Germany, and France.
2. Pub. L. No. 108-357, 118 Stat. 1418 (2004).
3. This amount is adjusted for inflation after 2004.
4. I.R.C. § 877(a)(2).
5. A U.S. citizen will not be deemed a U.S. resident for purposes of the expatriation rules if he or she never spent more than 120 days in the U.S. in any given year.
6. I.R.C. § 877(c)(2)(B).
7. Parents may never renounce their minor children's U.S. citizenship. A minor over the age of 14 may be able to renounce his or her U.S. citizenship before a U.S. consular officer but only if he or she is able to persuade the U.S. consular officer that he or she fully understands the nature and the consequences of renunciation and is voluntarily seeking to renounce his or her U.S. citizenship.
8. I.R.C. § 877(g).
9. *Id.*
10. I.R.C. § 877(g)(2).
11. I.R.C. § 877(b).
12. I.R.C. § 877(d)(1).
13. I.R.C. § 877(d)(2). With respect to an exchange during the ten-year period beginning on the date of expatriation, exchanged property will be treated as sold for its fair market value on the date of exchange if, on such exchange, gain would not be recognized, income derived from the property was from U.S.-sources, and income derived from the property so acquired would be from non-U.S.-sources.
14. I.R.S. Notice 97-19, 1997-1 CB 394.
15. I.R.C. § 877(d)(2)(C).
16. I.R.C. § 877(d)(4). This subsection applies if the corporation would have been a controlled foreign corporation at the time of the contribution and the individual would have been a U.S. shareholder, ignoring the fact of the expatriation.
17. I.R.C. § 2106(a).
18. I.R.C. §§ 2101(a) and 2103.
19. I.R.C. § 2107(b).
20. *Id.*
21. I.R.C. § 2501(a)(2).
22. I.R.C. § 2501(a)(3)(A).
23. I.R.C. § 2501(a)(5)(B).
24. Treas. Reg. §§ 20.0-1(b) and 25.2501-1(b).
25. Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Estates, Inheritances, and Gifts, signed at Bonn on 3 Dec. 1980.
26. Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Estates of Deceased Persons and on Gifts, signed at London on 19 Oct. 1978.
27. Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Estates, Inheritances, and Gifts, signed at Washington on 24 Nov. 1978.
28. N.Y. Surrogate's Court Procedure Act (SCPA) § 206; Linda B. Hirschson *et al*. eds., 1 WARREN'S HEATON ON SURROGATES' COURTS § 2.13[1] (6th ed., Rev. 2004) (hereinafter WARREN'S).
29. *In re Obregon's Estate*, 91 N.Y.2d 591, 673 N.Y.S.2d 972, 696 N.E.2d 984 (1998).
30. WARREN'S, note 28 *supra*, § 2.13[3][b].
31. *Id.* § 2.13[2].
32. *Id.* § 47.02[2].
33. *In re Lanari's Estate*, 243 N.Y.S. 2d 535 (Sur. Ct. 1963).
34. *In re Al-Ahmad's Estate*, 507 N.Y.S.2d 378 (Sur. Ct. 1986).
35. 7 N.Y.S.2d 891 (Sur. 1938).
36. *Id.* at 892.
37. *In re Brunner's Estate*, 339 N.Y.S.2d 506 (Sur. Ct. 1973).
38. *In re Feeney's Estate*, 285 N.Y.S. 320 at 322 (Sur. Ct. 1936).
39. *In re Nevai's Estate*, 788 N.Y.S.2d 843 (Sur. Ct. 2005).

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Estate and Income Tax Planning for the Transatlantic Family

The German Perspective

By Dr. Christian von Oertzen

I. German Law of Estates in the International Context

A. Substantive Law

Section 1 of Article 25 of the Introductory Law of the German Civil Code (EGBGB)[1] governs the conflict-of-laws principles applicable to the substantive law relating to legal succession *mortis causa*. The principles of the unity of the estate (*Nachlasseinheit*) and nationality (*Nationalitätsprinzip*) apply. That is, all legal questions in regard to legal succession *mortis causa* are governed by the nationality—not the residence—of the decedent.

Exceptions apply only if assets are situated in another country whose legal system has special regulations regarding inheritance. In the established practice of the German courts, this is the case with respect to real property in Anglo-American law and the law of the Romance countries, so that linking the inheritance of real estate to the situs under those legal systems is followed by the German courts. Real estate situated in any of the states of the United States would also, from a German point of view, be inherited in accordance with the relevant *lex situs*.

Foreign nationals may opt for the applicability of the German law of succession with respect to their real estate located in Germany. That option, however, is open to foreign nationals only and relates exclusively to real estate located in Germany.

B. Formal Issues

All formal issues are governed by the Hague Testament Convention[2] or Article 26 of the EGBGB, respectively. These bodies of law provide several formal requirements.

A testament is formally effective if it complies with the following:

(1) the law of the situs to which the decedent was subject at the time when he or she made his or her testamentary disposition or at the time of death;

(2) the law of the situs where the disposition was made;

(3) the law of the situs where the decedent had his or her residence or habitual abode at the time when he or she made his or her testamentary disposition or at the time of death;

(4) the law of the situs where real property is located, provided that such property is at issue;

(5) the law of the situs that is to be applied to the legal succession *mortis causa* or would have been applied at the time when the disposition was made.

It must be pointed out that formal issues may often also be issues under substantive law. The admissibility of a joint testament between spouses may, for example, qualify both as a formal issue and a substantive one.

C. Inheritability

Section 1 of Article 25 of the EGBGB does not address the issue of what types of legal rights are inheritable. Inheritability is governed by the specific conflict-of-laws rules concerning the matter in question; for example, the issue whether an interest in a business enterprise is inheritable is governed by the law of the corporate seat or the law of the place where the business enterprise was formed, as the case may be.

D. Consequences for the Transatlantic Family

1. Concerning Mrs. Gordon née Stern

Mrs. Gordon's worldwide estate will be governed by German law due to her nationality. However, the residence in Harrison, New York, will be governed by New York law, and the small two-bedroom apartment in London will be governed by English law.

2. Concerning Mr. Gordon

Under German conflict-of-laws rules, the real estate owned in Harrison, New York, will be governed by New York law. The vacation home on Marco Island, Florida, will be governed by Florida law.

Concerning the personal property in Mr. Gordon's estate, the following should be considered. Under German conflict-of-laws rules, German law refers to English law, including English conflict-of-laws rules. If under English conflict-of-laws rules the applicable law depends on the domicile of Mr. Gordon and assuming that he established a domicile in Germany, German law would follow this renvoi so that German estate law would apply to the worldwide estate of personal property of Mr. Gordon.

I would recommend clarifying the domicile of Mr. Gordon in his last will. Nevertheless, the Gordons should consider whether multi-jurisdictional wills ought to be drafted or separate last wills: one dealing with personal property, the others dealing with their real estate abroad.

3. General Considerations

In providing the Gordons with estate planning advice, one has to consider the compulsory-portion[3] rights of the children in the event of the death of Mrs. Gordon and, if German law applies, on the personal property in the estate of Alexander Gordon. To minimize these forced heirship claims, the Gordons could enter into a postnuptial agreement choosing the German statutory property regime of the community of surplus (*Zugewinngemeinschaft*).[4]

Mr. Gordon would then be able to waive his compulsory-portion rights against Claudia in a notarial deed. If German law applied to the estate of Claudia or Alexander (except for the residence in Harrison, the vacation home on Marco Island, and the small two-bedroom apartment in London), the forced heirship quota at the death of the first of the spouses would go down from one-sixth to one-eighth for each of the children, as a result of choosing the community of surplus (*Zugewinngemeinschaft*).

II. German Law of Marital Property in the International Context

A. General Effects of Marriage

Under Section 1 of Article 14 of the EGBGB, the general effects of marriage are governed as follows:

(1) by the law of the state of which both spouses are nationals (special rules apply to persons who are nationals of more than one state);

(2) otherwise by the law of the state in which both spouses have their habitual residence or had their habitual residence if one of them resides there;

(3) ultimately by the law of the state with which the spouses are mutually most closely connected in some or another matter.

B. The Marital Property Regime

1. Overview

The marital property regime is governed by the law governing the effects of marriage in general at the time of marriage.[5] Unlike the general effects of marriage, the marital property regime is fixed at the time of marriage and does not change if the spouses change their nationality or domicile. The spouses may make a valid choice of law by a formally valid marriage contract. The spouses are not, however, completely free to choose any law they like. Under Section 2 of Article 15 of the EGBGB, their choice is restricted to the following:

(1) the law of the state of which one of them is a national;

(2) the law of the state in which one of them has his or her habitual residence; or

(3) for matters involving real property, the law of the state in which the property is located.

Such a choice-of-law clause may be changed at any time. Spouses should try to fix the law governing their marital property regime to coincide with the prospective law governing their estates.

2. Types of German Marital Property Regimes

(a) Three Marital Property Regimes

There exist three marital property regimes under German law. They can be briefly described as follows:

- **Separation of property.** The marital property regime of separation of property (*Gütertrennung*) requires a notarized marriage contract. Under this regime, the relation of the spouses to each other is that of unmarried persons. There will be no equalization of the surplus in the event of death or divorce.
- **Community of Property.** The community of property (*Gütergemeinschaft*) is the second optional marital property regime under German law. It will only be created if agreed to by the spouses in a notarized marriage contract. A community of property is established very rarely these days and can be found, at best, in rural, agricultural areas. A chief characteristic of this regime is that the property existing at the start of the marriage and the property acquired thereafter become joint marital property of both spouses. A community of property is characterized by its considerable legal complexity and offers no tax benefits but rather disadvantages. It is, therefore, of no significance in estate planning.
- **Community of Surplus.** The German statutory marital property regime of the community of surplus (*Zugewinngemeinschaft*) is characterized by the following features:[6]

    (i) - Each of the spouses remains the sole owner of the property he or she acquired prior to the marriage. Each of them will also become the sole owner of the property acquired by him or her following the date of the marriage.

    (ii) - Each of the spouses manages his or her property himself or herself. Each of them may, however, only dispose of his or her property as a whole, or items of the matrimonial household belonging to him or her, with the consent of the other spouse.

    (iii) - If the marriage is dissolved by divorce or the death of one of the spouses, the surplus will be equalized.

  - There is no mutual liability for debts of the other spouse in a community of surplus.

- If the marriage is terminated by divorce, the surplus gain is equalized. That is, if the gain in the value of his or her property realized by spouse A during the marriage exceeds the gain realized by spouse B during the marriage, then spouse B has a claim for one-half of the gain realized by spouse A over the gain realized by spouse B.

(b) Optimal Regime: Modified Community of Surplus

The most favorable marital property regime in terms of estate planning is the regime of the modified community of surplus (*modifizierte Zugewinngemeinschaft*), since it combines the benefits of the community of surplus with those of the separation of goods. It must be agreed before a notary and is characterized by the following features:

- While both spouses are living, the provisions of the separation of goods (i.e., no equalization) apply in the event that the marriage is terminated by divorce.
- In the event of death, however, the statutory provisions concerning the community of surplus apply (e.g., a special marital allowance (*Ehegattenfreibetrag*) with respect to estate tax is provided that does not exist under the marital property regimes of separation of goods or community of goods; and the children's compulsory portions are minimized.)

C. Consequences for the Transatlantic Family

Mr. and Mrs. Gordon do not have a pre- or postnuptial contract. They were married in France in 1984, where they were both residing and working at the time. They do not have a joint nationality. Since France was their first joint domicile, German conflict-of-laws rules would refer to French law (including its conflict-of-laws rules). Therefore, it is very likely that the Gordon spouses do not live in a German marital property regime. This may have a negative impact on planning opportunities to minimize forced heirship claims of the children; and, for estate tax planning purposes, for transfers between the spouses. Additionally, the applicable German law governing estates in the international context may differ from that governing the marital property; this may also have negative impacts.

Therefore, it is strongly recommended that, before they come to Germany, the Gordons enter into a postnuptial agreement that provides for a German marital property regime; that regime should be a (modified) community of surplus (*modifizierte Zugewinngemeinschaft*).

III. Trusts under German Civil Law

A. Trusts Disfavored Under German Law

The concept of trusts is unfamiliar to German civil law, and the German tax authorities take a hostile view towards them. This makes German/Anglo-American estate planning difficult. The German treatment of a trust typically consists of interpreting the trust in question as some other kind of legal arrangement recognized under German law. For instance, an *inter vivos* trust might be analyzed as a contract or perhaps as a corporation.

B. Testamentary Trust

A testamentary trust is a legal institution under the law of succession. Therefore, it is subject to Section 1 of Article 25 of the EGBGB. All legal questions, including legal succession *mortis causa*, are governed by the nationality (not residence) of the decedent. The consequence for German testators is that they may not, in principle, make a testamentary disposition to such a trust. They may only make their testament under the German law of succession. Any disposition to a testamentary trust must, therefore, be reinterpreted as a comparable legal device under German law. The trust is often interpreted as a dynastic executorship governed by German law and ordered by the testator under his or her last will. There exists an exception in the case of a statutory splitting of an estate (*Nachlassspaltung*) when a part of the estate is—from the German perspective—subject to a foreign succession regime, pursuant to Section 3 of Article 3 of the EGBGB, which would apply, for example, to real estate situated in the United States. This exception generally applies, for example, to real estate in the Romance countries like France and in common-law countries like the U.K. and the U.S.

C. *Inter Vivos* Trust

Germany takes two different views towards *inter vivos* trusts. According to one view, an *inter vivos* trust is a legal institution similar to a contract for a debt (*Schuldvertrag*).[7] In this case the principles of contract law relating to a debt in the international context will be relevant. In this way, German nationals can create an *inter vivos* trust.

The other, restrictive view considers the trust to be a legal institution under corporate law, in which case the principles of corporate law in the international context will be relevant. From a German law perspective, the principle of the relevance of the corporate seat (*Sitztheorie*) would be relevant; accordingly, the legal system at the actual principal office of the trust would govern.

D. Trust Assets

The question whether or not specific assets may effectively be made part of the trust assets must be examined separately. This is a legal issue that is subject to the respective conflict-of-laws rule governing all legal questions in rem.

As regards German property, this means that those assets may only become trust assets if the relevant legal system in rem so admits. Under German property law, there is a limited number (referred to as *numerus clausus*) of rights that can be held in *in rem* property. Thus, for example, the German High Court ruled in 1984 that a legal trust relationship was incompatible with German public policy for structural reasons.[8] An effective legal trust relationship may therefore not be created with respect to assets subject to German property law (e.g., claims governed by German law, German shares in a business enterprise, and real estate situated in Germany).

E. Compulsory Portion

If the German law of succession is applicable, the trust must be considered in light of the German law on compulsory portions. 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 involving a usufruct (*Nießbrauch*) for the benefit of the donor.

The consequence of this is that the transfer will not be treated for the calculation of monetary claims as irrelevant, and the transferred assets will increase the estate according to the law on compulsory portions. Revocable trusts will likewise be treated as an unsuitable structure. The same would apply to the calculation of monetary claims under the German statutory marital property regime (separation of the property of a married couple, with the right to a portion of the surplus (*Zugewinngemeinschaft*)).

F. Provisions in Trust Deeds Relating to the Law of Succession

One regularly finds in trust deeds very detailed provisions as to what body of law applies in the event of the death of the trust settlor or a beneficiary under the trust. From the German point of view, this will be an issue under the law of succession, with the consequence that the relevant provisions will be treated, also formally, as testamentary dispositions. For instance, typewritten trust deeds signed in Germany by a German trust settlor, which do not meet the formal requirements under German law with respect to valid testaments (notarized or handwritten and signed in person by the decedent) or under Article 26[9] of the EGBGB are null and void.

G. Consequences for the Transatlantic Family

The use of trusts may be impossible from the German point of view. To overcome this problem, it is common to use so-called hybrid-trust structures.

1. Description of the Strategy

A "hybrid trust structure" is a structure created under German civil law which the German tax authority knows how to qualify and which does not trigger, under German law, the special gift tax applicable to the creation of a trust but which is considered to be a foreign trust by the foreign taxing authority in the country where the assets are located.

2. Example of a *Mortis Causa* Structure

Such a hybrid trust structure would entail the creation of a long-term testamentary executorship in Germany *(Dauertestamentsvollstreckung)* that is similar to a testamentary trust under U.S. civil and tax law. The German last will would be bilingual. The left-hand side of the will would be in German, and the right-hand side in English. The provisions concerning the German testamentary executor would be as explicitly worded as they are in a U.S. testamentary trust, especially with respect to the rights of the executor to invest in or sell assets.

It is this author's experience that the U.S. Internal Revenue Service considers this a foreign trust-like structure, with the result that the heir can live in the U.S. but the German and third-country assets and the income from those assets are shielded from U.S. taxation so long as the executor does not distribute income from these assets to the heir in the U.S.

3. Example of an *Inter Vivos* Structure

An example of a disposition *inter vivos* is when a donor who is not domiciled in the U.S. gives assets to a child subject to various conditions (for example, the donor might retain the right to revoke the donation in case the donee predeceases the donor or dies after the donor without leaving the assets to specific persons).

4. Qualified Domestic Trust (QDOT)

If a qualified domestic trust (QDOT) is necessary for U.S. estate planning purposes, this QDOT may be achieved through the creation of a usufruct for the benefit of the surviving spouse. A usufruct is a strictly personal and uninheritable right to enjoy the entire benefits of the encumbered asset for the duration of the usufruct, which is generally a lifetime. In exercising the right of use, the usufructuary is required to maintain the previous economic purpose of the object of usufruct, to act in accordance with the established principles of proper management, and to ensure the economic maintenance of the object of right, respectively. The essential feature of a usufruct is the fact that the yield and the residual value are separate from each other. The residual value of the object rests with the owner, while the yield is realized by the transferor. An alternative would be a German executorship using a "prior heir" (*Vorerbe)* and "subsequent heir" (*Nacherbe)* structure, with a U.S. person as German executor (*Testamentsvollstrecker*), pursuant to which the prior heir inherits the object and may enjoy it but may not transfer it without the consent of the subsequent heir since it passes to the subsequent heir upon the prior heir's death.

IV. Inheritance Tax Matters

A. German Inheritance Tax in the International Context

1. Overview

Tax liability in Germany is based on residency (*Inländereigenschaft*), and liability may arise if the donor, the beneficiary or the decedent is a resident of Germany. There will be full tax liability in all cases unless none of the persons directly involved is a resident of Germany.

Residents are defined as individuals having their residence or habitual abode within the country. The terms "residence" (*Wohnsitz*) and "habitual abode" (*gewöhnlicher Aufenthalt*) are defined in Sections 8 and 9 of the German Fiscal Code (*Abgabenordnung*) (GFC). A person is deemed to have his or her residence at the place where he or she occupies a living accommodation in a manner suggesting that he or she maintains and uses such accommodation. If the occupant of the accommodation is absent, for example, it is sufficient if the accommodation is equipped in a manner such that it is possible for the occupant to return to it at any time and stay there. Pursuant to Section 2(1)(1)(b) of the German Estate and Gift Tax Act,[10] German nationals who have abandoned their domestic residence or habitual abode continue to have unlimited tax liability in Germany for five years.

When gift-tax liability arises on account of the German residency of the donor, the entire global property that was gifted will be taxable in Germany, regardless of the residence of the recipient of the gift.

The rules under the German Controlled Foreign Companies Act (the "CFC rules") provide for so-called extended limited liability, which applies if the donor gifts domestic property and was subject to unlimited income tax liability as a German national for at least five years during the last ten years prior to his emigration. As an additional prerequisite, the donor must be resident in a foreign territory in which the income is subject to a low taxation, as defined by the CFC rules. The donor is furthermore required to have direct or indirect economic interests, as defined by the CFC rules, in Germany. In such case and provided that the foreign gift tax burden is less than 30% of the German tax, further German domestic assets will be subject to German gift tax. This extended limited gift-tax liability does not apply to the United States.

Under the estate and gift tax treaty between the United States and Germany,[11] the German gift tax "shadow" (pursuant to which, a person is treated as if domiciled in Germany for the first five years after leaving Germany so long as he or she does not renounce German citizenship) is extended under Section 3 of Article 4 thereof to ten years for Germans moving to the United States.

2. Consequences for the Transatlantic Gordon Family

The Gordons will have unlimited tax liability for inheritance tax purposes when they move to Germany. Their children would also be subject to unlimited tax liability in Germany although they may be living in the U.S. because they also may have a residence in Germany with the parents. When they inherit something or something is given them by the parents, the children have unlimited tax liability in Germany simply because the testator or the donor was or is a resident of Germany. Since neither Alexander nor Claudia is a citizen of the United States, the extended U.S. gift tax "shadow" under Section 3 of Article 4 of the gift-tax treaty between the United States and Germany (discussed in the preceding paragraph) does not apply. Germany has not yet entered into an inheritance and gift tax treaty with France or the U.K.

B. Overview of the German Inheritance Tax and Gift Tax

1. Basic Elements

All acquisitions *mortis causa* are subject to estate tax,[12] as are *inter vivos* gifts.[13] The acquisition itself, and not the estate as a whole, is taxed. In principle, each acquisition without remuneration is subject to estate tax and gift tax. The tax is incurred upon death or at the time the gift is made, as the case may be.[14] The time is also relevant for determining the value of the estate or gift, as well as the personal relationships involved. The transferee is liable for the tax, as is also the donor of a gift.[15]

For purposes of a simplification of administration, a standardized assessment is applied to specific types of property. A consequence of this is the possibility of considerable deviations between current market values and such standardized assessments. For example, interests in partnerships and unquoted corporations and in domestic real estate are valued considerably lower than their respective current market values. Domestic real estate is valued at a reduced value (*Bedarfswert*),[16] which usually represents only 60% of the current market value. Business assets and interests in partnerships are taxed on the basis of the equity shown on the tax balance sheet.[17] Foreign assets are valued at their current market value.[18]

2. Special Rules

(a) Community of Surplus

The community of surplus is the most favorable form of marital property regime. (See Parts I.D.3 and II.B.2(b) above.) Any marital surplus that is due to a spouse is tax-free.[19] This fact can be taken advantage of for tax-planning purposes; for example, while both spouses are living, the marital property regime could be changed from that of a community of surplus to that of a separation of property, pursuant to which substantial property could be transferred to the other spouse tax-free.

(b) Tax-Exempt Transfer of Owner-Occupied House or Condominium

One spouse may make a tax-free, *inter vivos* gift to the other spouse of all or a part of such donor spouse's interest in a domestic owner-occupied family home.[20] This tax exemption applies only to *inter vivos* gifts and does not apply if one spouse inherits the interest upon the death of the other.

(c) Tax Relief with Respect to Certain Business Assets and Interests in Corporations and Partnerships

Certain domestic entrepreneurial property enjoys certain benefits with respect to estate and gift taxes.[21] These benefits in relevant part provide the following:

- an allowance of € 225.000 every ten years;
- a reduction in valuation of 35% of any property exceeding € 225,000 in value (this means that only 65% of the value of such property over € 225,000 is assessed);
- a tax-class privilege, pursuant to which the property is deemed given and distributed as being in tax class I, with the tax amount being the tax class I amount plus 12% of the difference between the class I amount and the amount payable under the otherwise applicable tax class.

With respect to shareholdings in corporations, these tax benefits are granted only if the shareholding of the decedent or donor amounted to more than 25% at the time the gift or death occurred. That minimum shareholding requirement does not apply to interests in partnerships.

These tax benefits, together with the favorable valuation method for profitable business enterprises in the legal form of a partnership, have led to the fact that very profitable business enterprises are typically operated in Germany as partnerships, or at least with a family holding as ultimate parent, despite potential disadvantages in terms of income tax.

The legislature has made special arrangements in the event that a business enterprise is sold or reorganized within five years after the gift was transferred or the death occurred. If such a sale or reorganization occurs within that five-year period, the benefits noted above are cancelled with retroactive effect. Therefore, corporate restructurings must be reviewed very carefully in the first five years following devolution of an estate or the making of a gift.

3. Consequences for the Transatlantic Family

Because gifts and transfers at death between spouses are nontaxable to only a limited extent, the new house in Germany, which will become the Gordons' family home, should be acquired by the spouse who might statistically be expected to live longer (i.e., Claudia), but the purchase should be funded by Alexander.

Additionally, before coming to Germany the wealthier spouse should make donations to the less wealthy one. German civil and tax law permits a gift to be accompanied by an agreement between the parties allowing the donor to revoke the gift in the event the donee predeceases the donor or in the event the spouses obtain a divorce.

Under current inheritance tax laws it would also be advisable to interpose a German corporation between Claudia and PL Publishers, Ltd. ("PLP"). If she gifts her shares in PLP or if the PLP shares are transferred upon her death, the valuation basis would be the fair market value of PLP, and the tax benefits for interests in domestic corporations and partnerships would not be applicable. This could be altered by having her inherit shares not in a U.K. company, but rather in a German corporation (which in turn owns the PLP shares). In such case, the 35% tax benefit discussed above would apply to any gift or transfer upon her death if, at the time of the gift or her death, she owned more than 25% of the shares in the German corporation.

As mentioned above in Part II.B.2(b), due to the benefits granted to couples living in the German marital property regime of the *Zugewinngemeinschaft*, it is recommended that the Gordon spouses enter into a German postnuptial marital agreement, opting for a *modifizierte* (modified) *Zugewinngemeinschaft*.

V. Income Tax Planning for the Gordons Prior to Moving to Germany

A. Overview of German Income Tax for Individuals

German income tax law imposes tax only on particular categories of income; there is no general provision that income be taxed irrespective of its source. According to Section 2(1) of the German Income Tax Law (*Einkommensteuergesetz* or *EStG)*, German residents are liable for income tax on their worldwide income from the seven categories listed below. Income in this context is the net amount of income or loss from the following categories realized in any tax year:

1. agricultural and forestry income (*Einkünfte aus Land- und Forstwirtschaft*) (EStG §§ 13 to 14 a)
2. business income (*Einkünfte aus Gewerbebetrieb*) (EStG §§ 15 to 17)
3. independent personal services income (*Einkünfte aus selbständiger Arbeit*) (EStG § 18)
4. dependent personal services income (*Einkünfte aus nichtselbständiger Arbeit*) (EStG §§ 19, 19 a)
5. capital investment income (*Einkünfte aus Kapitalvermögen*) (EStG § 20)
6. rental income (*Einkünfte aus Vermietung und Verpachtung*) (EStG § 21)
7. other income, including annuities and private short term capital gains (*Arten der sonstigen Einkünfte, private Veräußerungsgeschäfte*) (EStG §§ 22, 23).

Although this list is rather comprehensive, any financial benefit to an individual that is not covered by these categories of income is not subject to income tax. Among the items not covered are, e.g., gifts, bequests, prizes, and lottery winnings. The most important impact of this enumeration of income categories is that individuals are generally not taxed on long-term capital gains unless those gains arise from a trade or business. Under EStG § 17, long-term capital gains from the sale of corporate stock held as private property is subject to capital gains taxation if the taxpayer (who is otherwise subject to unlimited tax liability in Germany) owns a substantial participation in a corporation (i.e., one percent or more) within the meaning of EStG § 17.

B. Tax Rates

The individual income tax rates for 2005 are as follows. The minimum tax rate is 15%, and the maximum tax rate is 42%. Since the additional solidarity surcharge (as a consequence of the reunification of Germany in 1990) remains in effect at 5.5% of the individual income tax imposed, the effective marginal rate in 2005 is 44.3%. A taxpayer may be subject to an additional tax based on religious affiliation.

C. Special Rules for Persons Moving to Germany

1. Basic Rule: No Step-up upon Move to Germany

With respect to the sale of a substantial participation within the meaning of EStG § 17, the German Federal Fiscal Court has ruled[22] that any gain accrued prior to a person's being subject to unlimited tax liability in Germany is taxable. German law does not recognize a step-up in basis upon a person's migration to Germany. However, the provisions of Section 6(3) of Article 13 of the U.S.-German Income Tax Treaty have to be taken into account. Nevertheless this treaty provision is not applicable in the case at hand because the company does not have its residence or seat in the U.S. or Germany.

2. Calculating the Tax Rate for an Immigrant in the Year of Acquiring a Domicile in Germany

In the year of establishing a German domicile, all income of an individual is taken into account when calculating the applicable tax rate of the income to be taxable under German tax law; the income derived in the same fiscal year but before the individual's coming to Germany also has to be taken into account when calculating that tax rate.

3. Consequences for the Transatlantic Family

Claudia should consider contributing her 50% share in PL Publishers Ltd. to a foreign or German corporation to achieve a step-up in basis. This should be done before she becomes domiciled in Germany because once she is domiciled in Germany a so-called hidden or open contribution (that is, a contribution to another corporation in exchange for the issuance of new shares) would be treated as a taxable capital-gains event. This may be not necessary under the Tax Treaty with the U.S. for Income Tax Purposes. But for estate tax purposes this is highly recommended.

The house in Harrison, New York, should be sold in the year before the Gordons come to Germany because, if the house qualifies for the German capital-gain-tax rules for real estate, the capital gain would increase the German tax rate applicable to their income taxable in Germany after they establish a domicile in Germany.

The group life insurance policy on Mr. Gordon's life in the face amount of $1 million would be paid out as of the date of Mr. Gordon's death income-tax-free, but not free of inheritance tax. With respect to the group life insurance policy, gift tax strategies are available to minimize the gift tax burdens. For income tax purposes, under the Income Tax Treaty Germany would have the right of taxation concerning interests (Article 11) and capital gains (Article 13, Sec. 5). Dividends would be also taxable in Germany (Article 10). Only one-half of the dividends is taxable when owned by an individual under German income tax laws. The withholding tax imposed in the U.S. (i.e., 15%) would be credited against the German income tax. The German capital gains tax rules will not apply if in the two brokerage accounts there are no shares constituting more than a 0.9% interest and owned longer than one year. As a planning recommendation, the investment policy regarding the brokerage agency's handling of the brokerage accounts should be made in accordance with German private capital gains rules. Concerning the U.S. 401(k) pension plan and the IRA accounts, it must be noted that under the Income Tax Treaty they would be income taxable in Germany: income from IRA accounts is income taxable under Article 21. They may also qualify under Article 18 as a pension within the meaning of the Treaty if the IRA account was formed out of a former pension plan. Payments under an IRA are not taxable under German domestic income tax laws.[23] To avoid taxation of the 401(k) pension plan with KTI, Mr. Gordon might consider changing the pension plan into an IRA account. A German private letter ruling should be obtained before doing that.

VI. Summary of the Recommendations for the Gordons from the German Perspective

The recommendation discussed in this article may be summarized as follows.

1. Under Germany's conflict-of-law rules, Claudia Gordon's worldwide estate will be governed by German law, except for (i) the residence in Harrison, New York, which will be governed by New York law, and (ii) the two-bedroom apartment in London, to which English law will apply. German inheritance law would apply to the personal property of Alexander Gordon if, under English conflict-of-laws rules, the applicable law is determined by the domicile and if Mr. Gordon establishes his domicile in Germany. Mr. Gordon's real estate in the United States will be governed by the relevant U.S. law.

2. Mr. and Mrs. Gordon will become subject to unlimited tax liability in Germany for inheritance-tax and income-tax purposes when they move to Germany. Their children will also be subject to unlimited tax liability in Germany for inheritance tax purposes although they continue to live in the U.S.

3. It is highly recommended that Alexander and Claudia Gordon enter into a post-nuptial agreement, choosing German law as the relevant substantive law for their marital property regime and the German statutory marital property regime of the modified community of surplus (*modifizierte Zugewinngemeinschaft*). In doing so, the Gordon spouses will achieve the following:

   - minimize their children's forced heirship quotas; and
   - in case the spouse who predeceases the other will have realized a higher surplus than the surviving spouse, minimize the inheritance tax burden for the surviving spouse after the death of the spouse who predeceased the survivor.

4. Before coming to Germany, Claudia Gordon should transfer her 50% share in PL Publishers, Ltd. ("PLP"), to a German corporation. Claudia's interest in the German corporation should be at least 25%. By doing this, Claudia's interest in PLP would be assessed for inheritance-tax purposes at 65% of that portion of its value exceeding € 225,000, and, for income-tax purposes, Claudia Gordon will achieve a step-up in basis.

5. The Gordons should sell their joint real estate in Harrison, New York, before the year in which they move to Germany. This is important to prevent the income from this house (together with a potential capital gain) from increasing their German income-tax rate.

6. If necessary under U.S. law, a QDOT or another trust can be realized by creating a structure that is known and valid under German law but is designed similar to the desired trust structure. A QDOT for example could be structured under German law as a usufruct for the benefit of the surviving spouse.

7. The wealthier spouse should make donations to the less wealthy spouse before coming to Germany in order to transfer capital to the less wealthy while avoiding German gift tax in so doing. The gift can be made subject to revocation (e.g., in the event of a divorce or the death of the donee (perhaps only if no children are then surviving)).

8. The new family home in Germany should be acquired by Claudia because statistically she can be expected to live longer than her husband. The acquisition costs should be borne by Alexander, and his funding of Claudia's purchase will not be subject to German gift tax. While both spouses are living, they can transfer the family home in Germany to each other at their discretion without triggering any gift tax.

Endnotes

1. *Einführungsgesetz zum Bürgerlichen Gesetzbuche (EGBG).*
2. Hague Convention on the Conflicts of Laws Relating to the Form of Testamentary Dispositions, 5 October 1961, *accessible at* http://www.hcch.net/index_en.php?act=conventions.text&cid=40.
3. Under the right to a compulsory portion, a decedent's offspring, parents and spouse are guaranteed a minimum portion of the estate if they are excluded from succession as a result of a *disposition mortis causa. Bürgerliches Gesetzbuch* (BGB) § 2303 *et seq*. No right to a compulsory portion exists in the event the person otherwise entitled to the right disclaims it (except for spouses (BGB § 1371(3*); see also* BGB §§ 2306, 2307)).
4. *See* Part II.B.2(a) below for discussion of the community of surplus.
5. EGBGB art 15, § 1.
6. *See* Löffler/Löffier, *Die Unternehmerehe*, in Herrerckes (ed.), UNTERNEHMENSHANDBUCH FAMILIENGESELLSCHAFTEN 455 (Cologne 1995).
7. EGBGB art. 27 *et seq*.
8. *See* decision of 13 June 1984 (IPRax 1985, 221, 223 – IV a ZR 196/82).
9. Article 26 of the EGBGB is discussed above in Part I(B).
10. *Erbschaftsteuer- und Schenkungsteuergesetz* (ErbStG), as published on 27 Feb. 1997 (BGBI I, p. 378, Federal Tax Gazette I, p. 298), with subsequent amendments.
11. Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Estates, Inheritances, and Gifts, signed at Bonn on 3 Dec. 1980.
12. German Estate and Gift Tax Act § 1(1(1).
13. *Id.* § 1(1(2).
14. *Id.* § 9.
15. *Id.* § 20.
16. Valuation Law (*Bewertungsgesetz*) § 145 *et seq*.
17. Valuation Law § 95 *et seq*.
18. Valuation Law § 31.
19. German Estate and Gift Tax Act § 5.
20. German Estate and Gift Tax Act § 13(1)(4a).
21. German Estate and Gift Tax Act § 13a. Certain agricultural and forestry property also enjoy these benefits. *Id.*
22. *See* decisions of 30 March 1993 (BFH/NV 1993, 597) and of 19 March 1996 (BFH/BStBI. II 1996, 312).
23. *See* Debatin/Wassermeyer, DBA-Kommentar, Artikel 18 Rz. 43.

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Estate and Income Tax Planning for the Transatlantic Family

The French Perspective

By Jean-Marc Tirard

I. Overview

Under French tax law Alexander and Claudia Gordon will become residents of France as of the date of the transfer of their permanent home to this country, which is likely to be on 1 January 2006 (discussed in Part II below). Their worldwide revenue and assets will, thereafter, fall within the scope of French income tax (discussed in Part III below), wealth tax (discussed in Part IV below), and possibly gift and inheritance tax (discussed in Part V).

II. The Gordons' Place of Residence

Article 4 B of the French Tax Code (hereafter "CGI") sets out four alternative tests for determining whether an individual will be treated as being a resident in France for tax purposes:

(a) He or she has his or her home (*le foyer*) in France: the home is defined as the place where the individual and/or his or her family lives, i.e., their usual residence. Contrary to the first residence test of "*permanent home*" set out by Section 2(a) of Article 4 of the Model Convention with Respect to Taxes on Income and on Capital published by the Organization for Economic Co-Operation and Development (OECD) (the "OECD Model Convention"), a taxpayer can only have one home under Article 4 B of the CGI.

(b) His or her primary place of residence (*lieu de séjour principal*) is in France. As a general rule this usually means spending more that 183 days in France during the relevant calendar year. However, according to the French Supreme Court (*Conseil d'Etat*) even if an individual spends fewer than six months in France he or she will be regarded as meeting this test if he or she has spent more time in France than in any other country during the relevant calendar year. According to a Supreme Court decision of 3 November 1995 (*Larcher*), this second test is only relevant when the taxpayer does not have a home (*le foyer*) either in France or abroad.

(c) He or she performs an activity in France, unless it can be shown that this is not the individual's main activity.

(d) He or she has the center of his or her economic interests in France. This test is interpreted by the courts as being the place where the main investments are made, where the registered office of his or her business is established, where he or she has his or her most substantial assets.

Under application of the first test, the Gordons will be considered French residents since their house in France will be considered to be their home (*le foyer*). Home means the place where the taxpayer usually lives in a permanent way with his family. Although Mr. and Mrs. Gordon have to travel abroad for periods of time for professional purposes, their home in France will be their home if it is where the members of the family usually live and gather together (Instruction of 26 July 1977, 5 B-24-77 n° 3). This will be the case since Alexander and Claudia will usually live in their new home in France, and the children will spend their vacations there with their parents. The fact that Claudia goes to London at least four times a year to assist her brother with the running of the family business and that the children will attend a boarding school in the U.S. does not alter this analysis.

As a consequence, the Gordons are residents of France under internal French law.

Since the Gordons are green card holders, the U.S. Internal Revenue Service will consider that they are also U.S. tax residents even after the transfer of their permanent home to France (unless they voluntarily renounce the status of green card holder in writing to the U.S. Citizenship and Immigration Services). Accordingly, their tax residence will be defined under Article 4, paragraph 3 of the tax treaty of 31 August 1994 between the U.S. and France,[1] which adopts the residence test found in the OECD Model Convention[2] in providing that, if an individual is a resident of both Contracting States, that individual's status is to be determined as follows:

(a) He shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both Contracting States, he shall be deemed to be a resident of the Contracting State with which his personal and economic relations are closer (center of vital interests);

(b) If the State in which he has his center of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode;

(c) If he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;

(d) If he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

With their house in Marco Island and their new house in France, the Gordons may be considered as having a permanent home both in the U.S. and France (and also in the U.K. according to its tax treaty with France, which also adopts the OECD Model Convention residence test). If this is the case, the Gordons will be deemed to be residents of the country with which their personal and/or economic relations are closer. As their family and assets appear to be spread over different countries, it may be difficult to determine the state with which these relations are closer. However, the Gordons will then be considered to be residents of France, where they will clearly be treated as having their habitual abode.

Accordingly, the Gordons will be deemed to be subject to income tax, wealth tax, and possibly gift and inheritance tax in France on their worldwide income, capital gains and assets unless varied by virtue of the application of the tax treaty signed between the U.S. and France, the tax treaty between the U.K. and France,[3] and the tax treaty between Germany and France.

III. Income Tax

A. French Tax Rules

1. Overview

French individual residents are subject to income tax on their worldwide income and capital gains, unless varied by virtue of the application of an international tax treaty.

Personal income tax in France is paid on a household basis on the earnings, profits and capital gains received by the fiscally dependent individuals in the household. As a general rule tax is calculated by applying a progressive scale to the total net income, obtained by adding together the subtotal of net income from each category as determined according to that category's specific regime. A family quotient system flattens the tax scale to take account of real family expenses and the situation of each fiscal household. Based on their income, the Gordons should be subject to the highest marginal tax rate, which is 48.09% on taxable income over 49,624 euros, plus social surcharges of 11%.

2. Salaries, Pensions and Annuities

Under Article 15, paragraph 2 of the tax treaty between the U.K. and France, any salary received by Claudia Gordon as the treasurer of PLP in London would be taxed in the State of the employer only. This provision is an exception to the general rule that taxation is usually operated in the jurisdiction where the employee is physically present when performing the activities for which the employment income is paid and leads to the mitigation of the French income tax burden, bearing in mind that, not counting social taxes, the marginal income tax rate in U.K. is 40% (as opposed to 48.09% in France).

In addition to the salary from PLP, Claudia Gordon may receive director's fees in return for her attendance of board meetings. According to Article 16 of the treaty signed between the U.K. and France, such income paid by a U.K. company is not subject to income tax in France. Director's fees and salary are however taken into consideration for determining the tax rate applying to income taxed in France (Article 24 paragraph b iii, of the treaty between the U.K. and France).

On the other hand, the salary received by Alexander Gordon in his position as the CEO of the new start-up pharmaceutical company based in France will be taxed in France. A basic deduction is allowed, corresponding to the higher of two amounts: (i) actual substantial expenses, or (ii) a lump sum of 10% of taxable income capped at 12,862 Euros. The balance is further reduced by a supplementary deduction of 20% subject to a limit of 23,580 Euros and deductible social taxes (see below). This net income is added to the other net income categories.

Social taxes on salaries are levied at the global rate of 8%, of which 5.1% is deductible for income tax purposes.

3. Income from Investments

Income from investments would be treated as follows.

(a) Brokerage Accounts

Both the brokerage accounts in New York City can generate dividends and capital gains. Dividend distributions are assessed for purposes of income tax in France but only at 50% of their amount. In addition, the Gordons will benefit from a tax-free allowance of € 2,440 and a tax credit of 50% of gross dividends capped to € 330. These allowances and this tax credit are granted, provided that the distributing companies are subject to a tax equivalent to French corporate income tax. In addition to income tax, dividends are subject to social taxes at the global rate of 11% on their full amount.

Capital gains from the transfer of securities are subject to income tax in the state of residence (Article 13 paragraph 6 of the tax treaty between the U.S. and France). Net taxable capital gains are taxed in France when the annual amount of transfer for valuable consideration made by the Gordons exceeds € 15,000. In this hypothesis, the overall net gain is taxed separately from other income at the rate of 16% to which social taxes are added, giving a total effective rate of 27%.

(b) Dividends from PLP

Claudia Gordon's 50% interest in PLP will give rise to dividends if the company decides to make distributions. In such case, according to Article 9, paragraph 2 of the tax treaty signed with the U.K., the dividends will be subject to income tax in France. The French tax system applies in the same manner as it does with respect to the dividends derived from the brokerage accounts in New York City, notwithstanding that gross taxable dividends are increased by 11.11%, corresponding to the U.K. tax credit chargeable to the amount of French income tax.

(c) Insurance Policy

Because the group life insurance policy on Alexander Gordon's life is located in the U.S., income derived from it falls into the category of "other income" set out by Article 22 of the tax treaty signed with the U.S. Such income is therefore subject to income tax in France. The gross income received by Alexander Gordon, reduced by premiums paid and the cost of subscribing to the policy, is added to the other source income for income tax purposes. The net income is also subject to social taxes with a global rate of 11%.

If the group life insurance policy were procured from an insurance company located in France or in the European Economic Area (EEA) (with the exception of Liechtenstein), it would be possible to elect that income derived from it be subject to income tax at a final levy, with flat rates depending on its duration. For contracts concluded after 25 September 1997, the overall rate (including social taxes) is 46% if the duration is less than four years; 26% if it is between four and eight years and 18.5% if it is eight years or more. In the latter case, a tax-free amount of € 4,600 (doubled for couples) is granted. This special tax treatment is preferential compared with the progressive income tax, which has an overall marginal rate, social taxes included, of 59.09% (i.e., 48.09 plus 11).

B. Planning Recommendations

Income and capital gains deriving from both brokerage accounts in New York City, dividends paid out by PLP, and income derived from the group life insurance policy may be collected by an intermediate base company instead of flowing directly to the Gordons. Thus, on the condition that French anti-avoidance provisions do not apply, the intermediate company would be able to shelter in a low-tax jurisdiction the income from taxation in France.

The French anti-avoidance provision at issue is set out in Article 123 bis of the CGI. The object of this provision is to tax French resident individuals on income derived from monetary or financial assets held through intermediary structures set up in foreign countries and benefiting from a privileged tax regime, even if the income is not distributed. Pursuant to Article 238 A of the CGI, a state is deemed to have a privileged tax system when the normal rate of tax is less than one-half of that which would have been assessed in France on the same taxable base.

The ambit of Article 123 bis of the CGI is extremely wide since the structures covered include legal entities, *fiducies*, and comparable institutions or organs. For the provision to be applicable, it is necessary for there to be a direct or indirect holding of at least ten percent in the structure concerned. "Indirect holdings" include rights held through a chain of holdings as well as those held by the spouse, antecedents and descendants. When the foreign structure is set up or established in a state or territory that has not concluded an administrative assistance treaty with France, the taxable income of the individual is a notional or theoretical income, being not less than the sum obtained by multiplying that part of the net assets (or of the net value of the property of the structure concerned) corresponding to the rights of the individual to derived income, by a rate equal to that allowed as a deduction for interest on shareholders' current accounts (rate of 4.2125% for 2005).

It emerges from the analysis of case law of both the European Court of Justice and the French Administrative Supreme Court that this provision would be successfully counteracted by invoking the free movement of capital rule,[4] the freedom of establishment of companies,[5] and nondiscrimination clauses laid down in tax treaties signed by France. The intermediate company should therefore be headquartered in an EU member state so that both EU principles and the tax treaty in question would thwart the application of Article 123 bis. As an exception, so-called 1929 holding companies of Luxembourg are not granted treaty benefits since they are tax-exempt vehicles. Such companies should therefore not be used for this purpose.

With respect to the selection of an intermediate company location, a number of key factors must be pulled together:

- No withholding tax (or a low tax rate) in the source country on income paid out to the intermediate company (e.g., U.S.-source dividends from the brokerage accounts in New York City would be subject to a withholding tax of 15% if the intermediate company is located in an EU member state, with the exception of Greece where the U.S. domestic rate of 30% applies);
- No tax (or a low tax rate) should apply on income received by the intermediate company in the base country (e.g., in Cyprus the corporation tax rate is only 10%, whereas in Denmark it is 30% and in Malta 35%);
- No tax (or a low tax rate) should be assessed on capital gains made when selling the assets in the intermediate company;
- No withholding tax (or a low tax rate) on dividend distributions made by the intermediate company should be assessed by the base country (e.g.,

Cyprus, Greece, Malta and the U.K. generally impose no withholding tax on outward dividends).

According to the Parent/Subsidiary EU directive,[6] dividend distributions which would be made by PLP to the intermediate company are 95% exempted (e.g., Belgium, Germany and Italy) or even 100% exempted (e.g., Austria, Cyprus, Denmark, Luxembourg, the Netherlands and Sweden) inasmuch as minimum holding requirements are fulfilled.

IV. Wealth Tax

A. French Tax Rules

Wealth tax is an annual tax payable in France when an individual or married couple has a private worldwide wealth, after deduction of debts, that exceeds the threshold of € 750,000 for 2006. Certain tax treaties signed by France and applicable to wealth tax exempt nationals of the other contracting state residing in France from wealth tax on all their property situated outside France, for five years following their having taken up residence in France. This is notably the case for U.S. and German nationals. Article 19 paragraph 4 of the tax treaty between France and Germany states that "[n]otwithstanding the provisions of the previous paragraphs of this article, for the assessment of wealth tax of a French tax resident individual who has German citizenship but not French citizenship, property located outside France held on 1 January of each of the five years following the year of his or her taking up residence in France, is not included in the tax base relating to each of these five years."[7] Therefore, the estate of Claudia Gordon located abroad, consisting of her apartment in London valued at $750,000, her brokerage account in New York City with a value of $1.5 million, her 50% interest in PLP (the entire company having a value of roughly $20 million) and her individual retirement account of € 300,000 will be wealth-tax exempt until 31 December 2011.

The net value of the remaining assets will be subject to wealth tax in France if the threshold is passed. According to Article 23 of the tax treaty on income and wealth tax between France and the U.S., France has the right to assess property located in the U.S., real estate included.

The assets held by Alexander Gordon that we assume to be located in the U.S. (i.e., the vacation home on Marco Island, with a net value of $700,000; his brokerage account at a firm in New York City, with a value of $1.5 million; the 401(k)/pension plan with KTI, which holds $1.5 million; and the group life insurance policy, with a face amount of $1 million) and the new home in France, jointly held by both spouses and valued at $1 million, will be subject to wealth tax in France.

French tax residents enjoy a 20% allowance on the net value of their main abode. The new house in France will thus be accounted for at $800,000. The value of the group life insurance policy is not included in the tax base if the policy has not yet matured and if it is not resalable (this exemption applies only to life insurance policies procured from and after 20 November 1991 and does not apply to premiums paid by the subscriber after he or she reaches 70 years of age). Assets relating to a business conducted by their owner, company shares and securities can be exempted under certain conditions and subject to a conservation commitment for the shares and securities. Other exemptions are granted with regard to antiques, art works and collector's items, and patents, trademarks, models, processes and formulas.

The taxable base is subject to progressive taxation. The tax calculated by application of the progressive scale is then reduced by an amount equal to € 150 per dependent child. The rates of tax to be applied for 2006 are as follows:

Fraction of the taxable net value of the patrimony in Euros				Applicable rate
Up to			750,000	0%
From	750,000	to	1,200,000	0.55%
From	1,200,000	to	2,380,000	0.75%
From	2,380,000	to	3,730,000	1%
From	3,730,000	to	7,140,000	1.30%
From	7,140,000	to	15,530,000	1.65%
Over			15,530,000	1.80%

For individuals who are resident in France, the total taxes due in respect of both wealth tax and income tax should not exceed 85% of net income. However, if a taxpayer has a total wealth taxable base in excess of € 2,380,000, the reduction in wealth tax cannot exceed 50% of the amount due before application of the ceiling or the amount of taxation corresponding to the limit of the third stage of the scale (i.e., € 11,325 for 2006).

In addition, as of 1 January 2006, a new capping mechanism called the "tax shield" is likely to be introduced enabling taxpayers to claim a tax rebate of taxes (including income tax, wealth tax and dwelling tax on their principal residence) paid in excess of 60% of their income.

For the Gordon's estate in the first five years after their taking up residence in France, the annual wealth tax bill would be $42,700.

B. Planning Recommendations

1. Professional Property Exemption

Under Articles 885 N-885 R of the CGI, assets necessary for their owner to carry on his or her principal business are defined as professional property, which is expressly exempt from wealth tax. Company shares and securities held by directors of companies subject to corporation tax qualify for this exemption, on the condition that these companies carry on business of an industrial, commercial, agricultural or liberal nature. Accordingly, companies whose main activity is the management of real estate or portfolio investments cannot benefit from this exemption.

This exemption is granted under the two-pronged condition that the holder of the shares or securities exercise one of the management positions expressly defined by law and that such holder and his or her family group directly or indirectly hold at least 25% of the company's share capital. According to Article 885 O bis 1° of the CGI, the positions of CEO and member of a board of directors qualify for the exemption. The minimum 25% shareholding is determined on 1 January of the year in question. Shares held directly by members of the family group (spouses or concubines as well as parents, children, brothers and sisters) and shares held by these same people through other companies holding shares in the company in which a qualifying position is exercised are also taken into account.

Claudia Gordon's 50% interest in PLP (if directly held) will qualify for the exemption. Alexander's holding participation in the new start-up company will also qualify, provided that he owns at least 25% of the voting rights and rights to dividends in this company. If the holding participation is held through an intermediate company to shelter dividends from French income tax (as mentioned above in Part III), the professional property exemption regime will apply only to that portion of the intermediate company's net value proportionate to the 50% interest held in PLP. The net value of the intermediate company corresponding to the current assets (i.e., the brokerage accounts in New York City and the group life insurance policy) will not enjoy the exemption unless the intermediate company performs the function of group coordinator, meaning that it controls and is the major decision maker in PLP.[8] This is not the case since the other 50% interest in PLP is directly owned by Pierre Stern, the brother of Claudia Gordon, who is the CEO and President of PLP. However, if Pierre Stern's interest in PLP were held through the same intermediate company, then the whole value of the latter could be eligible for the professional property exemption relating to Claudia's interest.

2. Insertion of a Trust

An alternative solution would be to hold in a trust the movable and real property situated outside France that does not enjoy any of the wealth tax exemptions set out above (i.e., the vacation home on Marco Island, with a net value of $700,000; Alexander Gordon's brokerage account at a *firm* in New York City, with a value of $1.5 million; and the 401(k)/pension plan with KTI in the amount of $1.5 million).

These assets will not be subject to wealth tax provided that:

In his capacity as settlor, Alexander Gordon is fully and finally relieved of the assets in trust and no longer retains control of them. The trust used must therefore be irrevocable and discretionary.

The trustee is not a French resident and cannot therefore be liable for wealth tax, even on the basis of the apparent-ownership doctrine. Indeed, for nonresidents, the scope of wealth tax extends only to assets located in France (with the exception of financial investments made in France), which is not the case here. If French-located assets would be put into trust (e.g., the new French house), this structure could remain tax-efficient by using a trustee company benefiting from a tax treaty signed between France and its country of residence (e.g., a trust resident in the U.S., the United Kingdom, Ireland or Singapore), and a subsidiary of a company quoted on a stock exchange.

The trust is discretionary, as a result of which the Gordons as the beneficiaries of the trust would only have an expectation of receiving payments from a legal viewpoint and would not enjoy a right to sell or assign their rights to third parties. Rights in a discretionary trust do not have a market value for wealth tax purposes. The assets in question are therefore not subject to wealth tax in the hands of the beneficiaries. This analysis has in fact been confirmed by case law.[9]

V. Gift and Inheritance Tax

A. Tax Rules

1. Overview

Gifts and inheritances are, in principle, subject to the same tax regime although some gifts benefit from specific deductions.

2. Inheritance Tax

The territorial ambit of inheritance and gift taxes is very large. When the deceased (or the donor) is domiciled in France, all property transferred is taxable in France unless provided otherwise by an applicable tax treaty.

According to the tax treaty on gift and inheritance tax between the U.S. and France,[10] double taxation is eliminated, by way of the exemption method, with an effective rate for France. The vacation home on Marco Island would be subject to inheritance tax in the U.S. only.[11] However, the value of this house would be taken into account for the determination of the applicable tax rate on the rest of the property subject to inheritance tax in

France.[12] Both brokerage accounts in New York City, the 401(k) plan with KTI, Claudia's IRA, and the life insurance policy on Alexander Gordon's life deemed located in the U.S. would be taxed in the country of residence of the deceased (or the donor), which would be France.[13] The new house bought in France will also be subject to inheritance tax in France.[14]

With regard to the apartment in London and the 50% interest in PLP headquartered in the U.K., the applicable tax treaty on inheritance tax vests in both the U.K. and France the right to assess inheritance tax. A tax credit corresponding to any inheritance tax paid in the U.K. is granted. This tax credit is capped at the amount of inheritance tax due in France on the property also taxed in the U.K.[15]

As regards the valuation of the property transferred, inheritance tax is, in principle, calculated on the market value (i.e., the price that could have been obtained on the open market for the property at the date of death). Debts encumbering the property are deducted from its value.

The house in France can enjoy an abatement of 20% of its monetary value if it had been, at the time of death, the principal residence of the deceased and if, at that date, the property had also been occupied as a principal residence by the surviving spouse.

The group life insurance policy on Alexander Gordon's life, the value of which is $1 million, would be exempt from inheritance tax, whatever the degree of relationship between the deceased and the beneficiary, up to the amount of € 152,500 per beneficiary. Any additional amount would be subject to a special levy of 20%, which applies instead of the usual rates. This special levy would not apply if the group life insurance policy at issue had been procured within the framework of Alexander Gordon's professional activity.[16]

The net share of the estate received by each of the heirs or beneficiaries is reduced by an allowance of:

- € 76,000 for the spouse;
- € 50,000 euros for each antecedent and living child;
- In the case of intestate succession, an overall abatement of € 50,000 is shared between each living or represented child and the surviving spouse proportionate to each one's right to the estate;
- If no specific rebate applies, a general € 1,500 euros rebate is applicable.

Progressive inheritance tax rates *vary* according to the familial relationship between the deceased and the beneficiary:

- For bequests between spouses:

Net taxable share				**Rate**
Up to	7,600			5%
From	7,600	to	15,000	10%
From	15,000	to	30,000	15%
From	30,000	to	520,000	20%
From	520,000	to	850,000	30%
From	850,000	to	1,700,000	35%
Over	1,700,000			40%

- For bequests to linear descendents:

Net taxable share				**Rate**
Up to	7,600			5%
From	7,600	to	11,400	10%
From	11,400	to	15,000	15%
From	15,000	to	520,000	20%
From	520,000	to	850,000	30%
From	850,000	to	1,700,000	35%
Over	1,700,000			40%

3. Gift Tax

Should Claudia Gordon contemplate making a gift of her apartment in London and/or the 50% interest in PLP and in the absence of a tax treaty between the U.K. and France on gift tax, double taxation will be avoided by way of a tax credit corresponding to the taxes paid in the U.K. (if any). The credit is limited to the amount of French tax paid on the property situated in the U.K.[17] With respect to the possible gift of the rest of the Gordons' property, the allocation of each state's right to tax will be computed in the same way as for inheritance tax according to the tax treaty signed between the U.S. and France on gift and inheritance tax (Discussed in Part V.A.2, "Inheritance Tax," above).

Gifts are, in principle, subject to the same tax regime as inheritances. Consequently, the rebates and rates set out above apply.

However, the abatement of 20% for the valuation of the principal residence for wealth tax purposes is not applicable. Some gifts benefit from specific reductions of the tax according to the age of the donor. For instance:

- 50% reduction where the donor is younger than 65;
- 30% reduction where the donor is older than 65 but younger than 75.

B. Planning Recommendations

1. Matrimonial Regimes and Succession Law

Under the legal precedent applying before the Hague treaty on matrimonial regimes, which came into force in 1992, spouses are considered to have elected the law regarding matrimonial regimes of the country where they took up their first abode after their wedding.[18] Alexander and Claudia were married in France in 1984. Their worldwide assets are therefore subject to French matrimonial property law.

Assuming that they did not enter into a marriage contract prior to their marriage, the statutory regime of "community reduced to acquisitions" *(communauté réduite aux acquêts)* applies.[19] This regime provides that assets of each spouse acquired prior to their marriage or acquired upon death or by gift during the marriage remain the private property of that spouse. All other assets acquired during the marriage are part of the community property of which both spouses are entitled to 50%. On the death of one of the spouses, the community is dissolved. Consequently the estate upon death includes one-half of the community assets and the separate property of the deceased.

The French courts usually consider that the law of the deceased's last domicile as defined by Article 102 of the Civil Code should govern succession. The term "*domicile*" is defined as the place where a person has his principal establishment. French property law thus applies in the following cases:

- if the testator is domiciled in France at the time of death (irrespective of whether the testator is of French or foreign nationality), French law applies to succession in respect of personal property;
- regardless of the testator's domicile and nationality, French law governs succession with respect to real property situated in France.

Accordingly, if one of the spouses in the hypothesis were to die while living in France, French property law would apply to his or her worldwide estate. On the other hand, if the predeceased spouse dies after the Gordons have moved out of France, only his or her share of real estate located in France will be subject to French property law.

In both situations the surviving spouse will not be entitled to receive the whole estate. In France freedom of testation is subject to one imperative restriction designed to protect "public order." Under the forced heirship rules, a certain portion of the estate subject to French property law is reserved for certain heirs *(la réserve héréditaire)* and cannot be disposed of by gift *inter vivos* or by will, other than to descendants and antecedents and under certain conditions to the surviving spouse. The entitlement of the surviving spouse to receive legacies will vary depending upon who survives the deceased. If the deceased leaves descendants, the surviving spouse may receive, at the testator's discretion:

- either the full ownership of the disposable portion, which is 1/3 if the deceased leaves two children;
- a quarter of the estate absolutely and the other three-quarters in *usufruit*; or
- the entire estate in *usufruit*

2. Circumnavigating Heirship Rules and Inheritance Tax

(a) Overview

French law, as opposed to U.S. law, does not permit one to disinherit one's children or parents. Furthermore, the rights of the surviving spouse are limited, even if the predeceased spouse has made a will leaving his or her entire estate to the surviving spouse. It is, however, possible to circumnavigate forced heirship rules and inheritance tax by adopting a particular type of universal community contract or by inserting a French company *"Société Civile Immobilière,"* with a tontine clause,[20] between the Gordons and their real property. Another solution that would avoid inheritance tax on the French property consists in separating the usufruct and the bare ownership and making a gift of the latter to the children.

(b) Adoption of a Universal Community Contract

The most straightforward solution would be for the Gordons to enter into a particular type of universal community contract *("communauté universelle")* with a complete allocation clause that would enable the surviving spouse to receive the full ownership of the spouses' property. Inheritance tax would be avoided when the first of them dies but would be due when the property comes into the hands of their children after the surviving spouse dies. This regime is only advisable if the couple is certain that there will be no divorce.

(c) Setting Up a SCI with a Tontine Clause

If the French property is purchased jointly, a distinction is made by French law between ownership "*en indivision*" (equivalent to a tenancy in common in the U.S.) and ownership "*en tontine*" (equivalent to a joint tenancy). In practical terms, the difference is that, when property is owned *"en indivision"* and one of the tenants in common dies, his or her shares devolve to his or her heirs according to forced heirship rules. When property is owned *"en tontine,"* the co-purchasers also benefit jointly from the property as long as they are alive but the surviving joint-purchaser has the right of property over the whole estate.

A tontine pact inserted in the contract of purchase of property by two persons means that the survivor is considered as having always been the only owner of the property, i.e., from the day the property was purchased *(condition suspensive).* The first deceased purchaser will be deemed never to have had any proprietary rights on the property *(condition résolutoire).* In other words, at the time of the earlier death of one of the co-purchasers, the *résolutoire* condition is then realized for the predeceased co-purchaser and the *suspensive* condition is realized for the survivor who is, therefore, considered as having always been the sole and unique owner. From the point of view of civil law, the property is then removed from the predeceased person's estate and the survivor has no responsibility towards that person's heirs.

A tontine pact is therefore a very effective solution for circumnavigating the forced heirship rules without having to compensate the legal heirs (i.e., the children). However, it does not allow the inheritance tax due on the part received by the surviving co-purchaser to be avoided.

Inheritance tax could be circumnavigated as well with the insertion of a French fiscally transparent company (meaning that it is not subject to corporation tax), such as a French *Societé Civile Immobilière* (SCI), between the Gordons and the property. The articles of association of the SCI should incorporate a tontine clause.

(d) Usufruct *(usufruit)* and Bare Ownership (*nue-proprieté*)

Under French law, ownership can be divided into two distinct elements: usufruct and bare ownership. Article 578 of the Civil Code defines usufruct as the right to enjoy property owned by another as if one were the beneficial owner, but subject to a duty to conserve its substance. Although a usufruct which allows a person to use the property and to receive any income thereon bears some resemblance to the common law concept of "life interest," the two concepts are significantly different. Article 617 of the Civil Code provides that a usufruct comes to an end with the death of the usufructuary, as a result of the expiry of the period for which it was granted or by reuniting in the same person the two qualities of usufructuary and bare owner.

For inheritance tax purposes, the transfer of the usufruct to the bare ownership holder upon the death of the usufructuary is exempt, provided that the usufruct has been given to the usufructuary more than three months prior to the death of the bare ownership holder.[21] The usufruct must then be first gifted to the children, giving rise to gift tax with a reduced base, calculated proportionately to the value of *full* ownership and varying according to the age of the usufructuary at the time of transfer.

Endnotes

1. The Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, signed on 31 August 1994.
2. In the OECD Model Convention, the residence test is found in Section 2 of Article 4.
3. Convention Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, signed on 13 July 2004.
4. *See* Articles 55 to 60 of the Treaty Establishing the European Community, 24 Dec. 2002, 2002 O.J. (C 325) 33 (the "EC Treaty").
5. Article 48 of the EC Treaty.
6. Directive 90/435/EEC, on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, 22 Sept. 1990, 1990 O.J. (L 225) 6, amended by Council Directive 2003/123/EC, 13 Jan. 2004, 2004 O.J. (L7) 41.
7. Convention between the French Republic and the Federal Republic of Germany for the avoidance of double taxation and for establishing reciprocal assistance administrative rules with respect to income and wealth taxes signed on 21 July 1959 ("the tax treaty between France and Germany").
8. Administrative instruction, 28 Apr. 1989, 7 R-1-89, D. adm. 7 S 3323, 1 Oct. 1999, issued by the French tax authorities.
9. Civil Court of Nanterre, 4 May 2004, no. 0303950, *Poillot v. Directeur des Services Fiscaux des Hauts-de-Seine*.
10. Convention between the government of the United States of America and the government of the French Republic for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on estates, inheritances, and gifts, signed, on 24 Nov. 1978 ("Franco-U.S. Estate Tax Treaty").
11. Franco-U.S. Estate Tax Treaty art. 5.
12. *Id.* art. 12, paragraph 2.
13. *Id.* art. 8.
14. *Id.* art. 5.
15. *Id.* art. 6.
16. CGI art. 990 I.
17. CGI art. 784 A.
18. French Civil Supreme Court, 12 Jan. 1982, n° 80-15176, Epoux Alain H-D et Danièle D-S: "The spouses set up their first marital home in Paris and as a result it follows that they tacitly intended to adopt the French standard matrimonial regime of community of property in force when their wedding was celebrated."
19. C. Civ. art. 1400.
20. A tontine clause provides a kind of joint ownership with right of survivorship but has a number of distinguishing characteristics. *See* discussion in subsection (c) below.
21. CGI art. 1133.

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Recognition and Enforcement of Foreign Judgments in the United States

By Helen Davis Chaitman

I. Introduction

A. Overview

Enforcement of foreign judgments in the United States is governed by three concepts discussed in this article: comity; the Uniform Foreign Money-Judgments Recognition Act; and reciprocity. The recently issued Hague Convention on Choice of Court Agreements, which may impact enforcement of foreign judgments, is also discussed.

B. Comity

The individual states of the United States recognize and enforce foreign judgments based upon the doctrine of comity, provided the judgments have been entered consistent with the respective state's view of due process of law.[1] Courts apply the same due process standards to foreign judgments that they apply to judgments of another U.S. state.

C. The Uniform Foreign Money-Judgments Recognition Act

A majority of the states in the United States also have adopted the Uniform Foreign Money-Judgments Recognition Act (the "Uniform Act"),[2] which sets forth the requirements for the discretionary recognition of money judgments issued in other countries. The Uniform Act has recently been amended but the amendments have not yet been adopted in any state.

D. Reciprocity

A "reciprocity" rule provides that a judgment rendered in a foreign nation will not be recognized in the United States unless that country would similarly recognize a judgment issued in the United States.

E. Hague Convention on Choice of Court Agreements

If ratified by the United States and other member countries, the recently issued Convention on Choice of Court Agreements (the "Convention")[3] will apply to give effect to exclusive-choice-of-court agreements entered into by private parties.

II. The Concepts Governing the Enforcement of Foreign Judgments

A. Comity

Courts in the United States have recognized and enforced judgments issued by courts in foreign nations based on the doctrine of comity. "Comity" was defined by the United States Supreme Court in 1895 as "the recognition which one nation allows within its territory to the . . . judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws."[4]

Comity is one of the most important factors in assessing whether a foreign judgment will be recognized and enforced.[5] Courts are not required to grant comity.[6] Application of the doctrine is a general edict rather than a mandated standard. One court has observed the following:

> Although courts in this country have long recognized the principles of international comity and have advocated them in order to promote cooperation and reciprocity with foreign lands, comity remains a rule of practice, convenience, and expediency rather than of law. Courts will not extend comity to foreign proceedings when doing so would be contrary to the policies or prejudicial to the interests of the United States. No nation is under unremitting obligation to enforce foreign interests which are fundamentally prejudicial to those of the domestic forum.[7]

With respect to laws and judgments of sister states, the Full Faith and Credit Clause of the United States Constitution (Article IV, Section I) and its implementing statute, 28 U.S.C. § 1738, require states of the United States to recognize legislative acts, public records, and judicial decisions of other states. There is nothing, however, in the United States Constitution, nor in its laws, which requires courts to recognize judgments entered by foreign courts.[8] Nevertheless, courts in the United States will normally give substantial deference to foreign judgments as a matter of comity.[9]

Comity will not be granted to recognize a foreign country's judgment absent a showing that the proceeding resulting in the foreign judgment provided some "fundamental level of due process of law."[10] Fundamental due process typically requires that the foreign court had proper jurisdiction over the case and that the defendant had an opportunity to defend against the plaintiff's claims.[11] For example, in *Cunard S.S. Co. v. Salen Reefer Servs. A.B.*,[12] the court granted comity to a pending Swedish bankruptcy proceeding and vacated an order of attachment issued by a United States court that violated the Swedish bankruptcy stay. The court found that reasonable notice had been given and that the foreign court was a court of competent jurisdiction.

B. Due Process

Additionally, an American court will not enforce a foreign judgment unless the foreign court's exercise of personal jurisdiction over the defendant complied with United States requirements of due process of law. These jurisdictional prerequisites include notice of the proceeding and minimum contacts with the foreign forum.[13] In *Koster v. Automark Indus., Inc.*,[14] the court refused to recognize a Dutch judgment because the defendant Illinois corporation had not had sufficient contacts with the Netherlands to justify the Netherlands court's jurisdiction over the defendant. Due process under United States law demands that personal jurisdiction be supported by minimum contacts such that the "maintenance of the action does not offend traditional notions of fair play and substantial justice."[15] The minimum contacts standard for foreign judgments is the same standard that a court uses to assess the validity of a judgment issued in a different state.[16] If a defendant had insufficient contacts with the forum foreign country such that, under United States precedent, exercise of jurisdiction would violate due process, the judgment will not be recognized in the United States.[17]

III. Uniform Foreign Money-Judgments Recognition Act

The Uniform Act provides explicit requirements for recognition of foreign money judgments. However, the Uniform Act has been adopted in only a slight majority of the fifty states of the United States, including Alaska, California, Colorado, Connecticut, Delaware, Florida, Georgia, Hawaii, Idaho, Illinois, Iowa, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Texas, Virginia, and Washington; it has also been adopted in the District of Columbia and the Virgin Islands.[18]

Although recognition of foreign money judgments remains discretionary under the Uniform Act, parties seeking to enforce foreign money judgments still should initially determine whether the state in which they seek enforcement has a version of the Uniform Act. In states where a version of the Uniform Act has been adopted, the statute will effectively preempt common law rules regarding recognition of foreign judgments.[19]

A "foreign judgment" within the scope of the Uniform Act is limited to "any judgment of a foreign state granting or denying recovery of a sum of money" and specifically excludes tax judgments, fines or penalties, or judgments for support in matrimonial or family matters.[20] A foreign judgment may be enforced under the Uniform Act regardless of any pending appeal but must be both "final" and "conclusive."[21]

The Uniform Act provides that the party against whom the foreign judgment is sought may request the court to stay enforcement of the judgment until "the appeal has been determined or until the expiration of a period of time sufficient to enable the defendant to prosecute the appeal."[22]

Recognition of foreign judgments under the Uniform Act may be denied based on a lack of comity or due process. The Uniform Act provides that a foreign judgment is not "conclusive" and thus may not be enforced if the foreign court lacked jurisdiction, failed to provide procedures that met United States standards of due process, or did not include an impartial tribunal.[23] Additional defenses may be included in the statute of the individual state where enforcement is sought.

In addition to lack of jurisdiction and due process, the Uniform Act provides other defenses that are available against the enforcement of foreign judgments, including the following: (i) the defendant in the foreign court proceedings did not receive notice of the pleadings in sufficient time to present a defense; (ii) the judgment was obtained by fraud; (iii) the cause of action upon which the judgment is based is "repugnant to the public policy of this state"; (iv) the judgment conflicts with another judgment deemed final and conclusive; (v) the foreign court proceeding was conducted contrary to an agreement by the parties pursuant to which the "dispute in question was to be settled otherwise than by proceedings in that court"; and (vi) jurisdiction was based on personal service and the foreign court was "a seriously inconvenient forum."[24]

With respect to the standard that the judgment not be repugnant to public policy, courts have noted that a mere difference in the law between the jurisdiction rendering the judgment and the state where the judgment is sought to be enforced is insufficient to effectively raise the defense.[25]

Parties seeking to enforce or defend against recognition of a foreign judgment in the United States should further note that on 28 July 2005 a new version of the Uniform Act was approved by the National Conference of Commissioners on Uniform State Laws (the "Revised Act").[26] The Revised Act, which has not yet been adopted by any state, updates and refines the definition and scope sections of the Uniform Act and creates a procedure by which a foreign judgment may be recognized. The Revised Act also contains amended grounds for denying recognition of foreign judgments and establishes a statute of limitations for bringing an action to recognize a foreign judgment.

In the Revised Act, new defenses against enforcement of a foreign judgment include (i) the foreign judgment's having been issued "in circumstances that raise substantial doubt about the integrity of the [foreign-judgment] rendering court" and (ii) incompatibility of the foreign judgment "with the requirements of due process of law."[27] Moreover, the new uniform act adds a provision that the party resisting recognition of the foreign judgment has the burden of establishing a ground for nonrecognition as provided in the Act.[28]

The revised uniform act also states the procedure for seeking enforcement of a foreign judgment in an "original matter" and in a "pending matter." If recognition is sought as an original matter, "the issue of recognition shall be raised by filing an action seeking recognition" of the judgment.[29] When a matter is already pending, "the issue of recognition may be raised by counterclaim, cross-claim or affirmative defense."[30]

Finally, the Revised Act establishes a statute of limitations restricting when an action to enforce a foreign judgment may be brought to "the earlier of the time during which the foreign-country judgment is effective in the foreign country or 15 years from the date that the foreign-country judgment became effective in the foreign country."[31]

Because of the substantive differences between the 1962 Uniform Act and the 2005 Revised Act, it is important that interested parties determine not only whether the relevant state adopted the Uniform Act, but also whether it enacted the Revised Act to replace the 1962 Uniform Act. Significantly, although no state has yet enacted the 2005 Uniform Act, many state legislatures will convene in the first quarter of 2006 to consider enactment of new legislation such as the Revised Act.

Finally, any newly enacted federal statute on the subject of foreign judgment recognition and enforcement must be considered. One such proposed federal statute is the "Foreign Judgments Recognition and Enforcement Act" being prepared by the American Law Institute. Although, at the present time, adoption of a federal statute is not imminent, if such a statute were adopted, it would preempt all state laws, including the Uniform Act.

IV. Reciprocity

Reciprocity also should be considered when one is seeking to enforce a foreign judgment in the United States. Under the doctrine of reciprocity, courts in the United States will not enforce a judgment rendered in a foreign country if the foreign country would not similarly recognize a judgment from a court in the United States.[32]

The reciprocity rule is derived from *Hilton v. Guyot*.[33] In *Hilton*, the United States Supreme Court refused to recognize a French money judgment arising from a concern that fraud affected the court's grant of the judgment in favor of a French citizen. Along with the reciprocity requirement, the Supreme Court pronounced the general rule that foreign judgments should be recognized as long as the foreign court had jurisdiction, there was a procedural fairness based on United States principles, and there was no fraud or prejudice.[34]

Since *Hilton* was decided, some federal courts have rejected reciprocity as a requirement under federal law.[35]

Despite reluctance by the federal courts to require reciprocity, reciprocity still may be required when there is an applicable state-law reciprocity element. After *Erie R.R. Co. v. Tompkins*,[36] federal courts have been required to apply state law, not federal common law, to their determination of whether to enforce a foreign judgment.[37] Accordingly, the fact that the federal common law disfavors a reciprocity requirement may not be determinative when there is an applicable state statute requiring reciprocity.

Similarly, parties seeking to enforce a foreign judgment in state court should determine if there is an applicable state reciprocity requirement. Parties first should review the relevant state's Uniform Act, if one has been adopted, regarding any reciprocity requisite. Eight states have adopted Uniform Acts containing a provision concerning reciprocity. Six of the eight states (Florida, Idaho, Maine, North Carolina, Ohio, and Texas) permit but do not require courts to decline enforcement of foreign judgments based on lack of reciprocity. Two states (Massachusetts and Georgia) have adopted provisions requiring that reciprocity be proven in order for a court to recognize and enforce a foreign judgment.[38]

Notably, the version of the Foreign Judgments Recognition and Enforcement Act recently proposed by the American Law Institute, which would be a federal statute if and when enacted, has a requirement of reciprocity. To that extent, this proposed (but not yet enacted) federal law departs from the law of the majority of states that have adopted the Uniform Act.[39]

V. Hague Convention on Choice of Court Agreements

On 30 June 2005, the Hague Conference on Private International Law issued its Convention on Choice of Court Agreements. If ratified by member nations, the Convention will ensure the effectiveness of exclusive choice of court agreements entered into by private parties in international civil or commercial cases. The Convention will assure that the court in the state selected by the parties will have proper jurisdiction over the case and that courts in other states will not have jurisdiction.[40] The Convention also provides for recognition and enforcement of foreign judgments issued by courts selected by the parties pursuant to a choice of court agreement.

The Convention defines "exclusive choice of court agreement" as "an agreement entered into by two or more parties" that "designates . . . the courts of one Contracting State or one or more specific courts in one Contracting State to the exclusion of the jurisdiction of any other courts."[41] Such agreement must be "in writing" or otherwise "render[] information accessible so as to be usable for subsequent reference."[42]

However, the Convention includes numerous noteworthy exclusions. Among others, the Convention expressly excludes from its scope (i) agreements in which a natural person is a party when such person was "acting primarily for personal, family or household purposes"; (ii) employment agreements; (iii) maintenance obligations and other family law agreements; (iv) wills and succession agreements; (v) agreements involving the carriage of passengers or goods; (vi) agreements resolving personal injury claims brought by natural persons or on their behalf; (vii) agreements involving rights *in rem* in immovable property and tenancies regarding the same; and (viii) the validity of intellectual property rights other than copyright or related rights.[43]

Courts in contracting states are generally required to "suspend or dismiss proceedings to which an exclusive choice of court agreement applies" if they have not been designated under the agreement.[44] However, there are significant exceptions for when a court may continue to conduct proceedings despite the fact that it was not the court chosen to decide the matter in the Choice of Court Agreement. These exceptions include, for example, situations in which (i) a party lacked the capacity to enter into the agreement under the law of the state whose court is subject to exclusion by the agreement; (ii) giving effect to the agreement would result in a "manifest injustice or would be manifestly contrary to the public policy" of the state excluded; and (iii) the agreement cannot reasonably be performed "for exceptional reasons beyond the control of the parties."[45]

The Convention also includes a chapter devoted to recognition and enforcement of judgments given by a court designated in an exclusive choice of court agreement.[46] The general rule is that any such judgment "shall be recognized and enforced" except "on the grounds specified in this Convention."[47] Furthermore, there "shall be no review of the merits of the judgment given by the court of origin."[48]

However, there are significant exceptions authorizing a court to refuse to enforce a foreign judgment issued by a court designated under a choice of court agreement. First, a court may postpone or refuse enforcement if there is an appeal pending in the court which issued the judgment.[49] Second, a court may decline to enforce a judgment if, for example, (i) the judgment was obtained by fraud; (ii) such recognition would be "manifestly incompatible with the public policy of the requested State, including situations where the specific proceedings leading to the judgment were incompatible with fundamental principles of procedural fairness of that State"; (iii) a party lacked capacity to enter into the choice of court agreement under the law of the issuing state; (iv) the judgment is inconsistent with a prior judgment involving the same parties given in the state where enforcement is sought or another state; and (v) the defendant was not notified of the proceedings in sufficient time to arrange for his defense or service of the original document of the proceeding was "incompatible with fundamental principles of the requested State concerning service of documents."[50]

As to damages, Article 11 of the Convention provides that a court also may refuse to enforce a judgment "if, and to the extent that, the judgment awards damages, including exemplary or punitive damages, that do not compensate a party for actual loss or harm suffered."[51]

Procedurally, a party seeking to have a court enforce a judgment issued by a court selected under a choice of court agreement must produce the following documents: (i) a certified copy of the judgment; (ii) the exclusive choice of court agreement; (iii) when judgment was given by default, a certified copy of the document establishing proper notification of the defaulting party; and (iv) any other documents necessary to show that the judgment is enforceable in the state of origin.[52]

If ratified by member states, the Convention will enable parties of such states privately to determine which courts will decide their commercial and other applicable civil disputes. Accordingly, ratification by member states will give private parties the opportunity to ensure more certainty regarding the resolution of their business disputes and thus may act to stimulate greater predictability for those engaged in international commerce.

VI. Conclusion

Parties seeking to enforce foreign judgments in courts in the United States must persuade the U.S. court, whether state or federal, to grant comity to enforce the foreign judgment. This requires a showing that the foreign proceeding provided some fundamental due process of law. Moreover, any individual state's version of the Uniform Act should be consulted to determine whether there are any particular state procedures or requirements. Along with state statutes, any newly adopted federal statute on foreign judgment enforcement also must be considered. If enacted, any such federal law would effectively preempt related state legislation and in particular the Uniform Act. Parties also should be aware that reciprocity or other fairness concerns raised by the Supreme Court in *Hilton v.*

Guyot may factor into a judicial determination of whether to enforce a foreign judgment. Finally, if the member states ratify the new Convention on Choice of Court Agreements, parties should consider the possibility of entering into an exclusive choice of court agreement for disputes arising in such states, to predetermine court jurisdiction and recognition and enforcement of resulting judgments.

Endnotes

1. *See, e.g., Hilton v. Guyot*, 159 U.S. 113, 205-06, 16 S. Ct. 139, 139-40 (1895); *Cunard S.C. Co. v. Salen Reefer Servs. A.B.,* 773 F.2d 452, 457 (2d Cir. 1985); *see generally* 18 James Wm. Moore *et al*., MOORE'S FEDERAL PRACTICE ¶ 130.50, at 130-51-52 (3d Ed. 2005) (hereinafter MOORE'S FEDERAL PRACTICE).
2. Uniform Foreign Money-Judgments Recognition Act (Nat'l Conf. of Comm. on Unif. State Laws 1962) § 1 (full text available at: http://www.nccusl.ort/Update/DesktopDefualt.aspx?tabindex=2&tabid=60).
3. Convention on Choice of Court Agreements, June 30, 2005 at Arts. 5-6 (Hague Conf. on Private Int'l Law) (full text available at http://www.hcch.net/index_en.php?act=conventions.text&cid=98.
4. *Hilton v. Guyot*, 159 U.S. 113, 205-06 (1895).
5. 18 MOORE'S FEDERAL PRACTICE, note 1 *supra*, ¶ 130.50 at 130-52.
6. *R.M.S. Titanic, Inc. v. The Wrecked and Abandoned Vessel*, 323 F. Supp. 2d 724, 731 (E.D. Va. 2004).
7. *International Nutrition Co. v. Horphag Research Ltd*., 257 F.3d 1324, 1329 (Fed. Cir. 2001) (citations omitted).
8. *See R.M.S. Titanic, Inc.*, 323 F. Supp. 2d at 731 ("international comity is not a rule of law but one of practice, convenience, and expediency"); *DeSilva v. DiLeonardi*, 125 F.3d 1110, 1114 (7th Cir. 1997) (there is no international doctrine of full faith and credit; comity "is some distance short of the legal obligation established by 28 U.S.C. § 1738").
9. *R.M.S. Titanic, Inc.,* 323 F. Supp. 2d at 731 (American court should give effect to foreign court's judgment if there was a fair trial with participation of all interested parties); *Miller v. Miller*, 240 F.3d 392, 400 (4th Cir. 2001); 18 MOORE'S FEDERAL PRACTICE, note 1 *supra*, § 130.50 at 130-52.
10. 18 MOORE'S FEDERAL PRACTICE, note 1 *supra*, ¶ 130.51 at 130-53; *Society of Lloyd's v. Reinhart*, 402 F.3d 982, 994 (10th Cir. 2005); *Dynamic Cassette Int'l, Ltd. v. Mike Lopez & Assocs., Inc.*, 923 F. Supp. 8, 11 (E.D.N.Y. 1996); *Bank Melli Iran v. Pahlavi*, 58 F.3d 1406, 1410 (9th Cir. 1995) (noting that "[i]t has long been the law of the United States that a foreign judgment cannot be enforced if it was obtained in a manner that did not accord with the basics of due process").
11. *See Society of Lloyd's,* 402 F.3d at 994.
12. 773 F.2d 452, 457, 460-61 (2d Cir. 1985).
13. 18 MOORE'S FEDERAL PRACTICE, note 1 *supra*, ¶ 130.51 at 130-54; *Koehler v. The Bank of Bermuda Ltd.,* 2004 U.S. Dist. Lexis 3772 at *34 (S.D.N.Y. 2004) (court had to decide whether contacts with Bermuda were sufficient to enforce Bermuda judgment); *Ma v. Continental Bank N.A.*, 905 F.2d 1073, 1076 (7th Cir. 1990) (observing that "[t]he United States will not enforce a judgment obtained without the bare minimum requirements of notice").
14. 640 F.2d 77, 80 (7th Cir. 1981).
15. *International Shoe Co. v. Washington*, 326 U.S. 310 (1945); *Koehler*, 2004 U.S. Dist. Lexis 3772 at *34-35.
16. *De La Mata v. American Life Ins. Co.,* 771 F. Supp. 1375, 1384 (D. Del. 1991) (recognizing a Bolivian judgment in Delaware as there were sufficient contacts with Bolivia to justify the Bolivian court's jurisdiction over the defendant). *See also Koehler,* 2004 U.S. Dist. Lexis 3772 at *34-35 (discussing minimum contacts cases).
17. *See generally id.;* 18 MOORE'S FEDERAL PRACTICE, note 1 *supra*, ¶ 130.51 at 130-54.
18. Uniform Act, Table of Jurisdictions Where Adopted.
19. 18 MOORE'S FEDERAL PRACTICE, note 1 *supra*, ¶ 130.52 State.
20. Uniform Foreign Money-Judgments Recognition Act (Nat'l Conf. of Comm. on Unif. State Laws 1962) § 1 (full text available at: http://www.nccusl.ort/Update/DesktopDefualt.aspx?tabindex=2&tabid=60).
21. *See* Uniform Act § 2, Applicability ("[t]his Act applies to any foreign judgment that is final and conclusive and enforceable where rendered even though an appeal therefrom is pending or it is subject to appeal.")
22. Uniform Act § 6, Stay in Case of Appeal.
23. Uniform Act § 4(a); 18 MOORE'S FEDERAL PRACTICE, note 1 *supra*, ¶ 130.52; *Society of Lloyd's*, 402 F.3d at 994 (discussing due process concerns under New Mexico's version of the Uniform Act); *Ingersoll Milling Mach. Co. v. Granger*, 833 F.2d 680 (7th Cir. 1987) (recognizing a Belgian judgment because the Belgian court had jurisdiction and had sufficient procedures to satisfy due process requirements); *Bank Melli Iran v. Pahlavi*, 58 F.3d 1406, 1410 (9th Cir. 1995) (refusing to recognize an Iranian default judgment against the sister of the former Shah of Iran where she showed she could not have obtained a fair trial in Iran after the Shah fled the country).
24. Uniform Act § 4(b), Grounds for Non-recognition.
25. *McCord v. Jet Spray Int'l Corp.,* 874 F. Supp. 436, 439 (D. Mass. 1994) (rejecting a defense that a Belgian judgment concerning an employment contract was repugnant to Massachusetts law, which provides for employment at-will).
26. Uniform Foreign-Country Money Judgments Recognition Act (Nat'l Conf. of Comm. of Unif. State Laws July 2005) (full text available at http://www.law.upenn.edu/bll/ulc/ufmjra/2005AMAppText.htm).
27. Uniform Act § 4(c)(7)-(8), Standards for Recognition of Foreign-Country Judgment.
28. *Id.* at § 4(d).
29. Uniform Act § 6(a), Procedure for Recognition of Foreign-Country Judgment.
30. *Id.* at § 6(b).
31. Revised Act, § 9, Statute of Limitations.
32. *See* 18 MOORE'S FEDERAL PRACTICE, note 1 *supra*, ¶ 130.50[2][a], Development of Principles Governing Recognition from *Hilton* to *Erie/Klaxon*, at 130-52.1.
33. 159 U.S. 113 (1895).
34. 18 MOORE'S FEDERAL PRACTICE, note 1 *supra*, ¶ 130.50[2][a] at 130-52.1 (citing *Hilton*, 159 U.S. at 202-03).
35. *Id.*, at ¶ 130.50[2][a], 130-52.1; *Daewoo Motor Am., Inc. v. General Motors Corp.*, 2004 U.S. Dist. Lexis 17401 at *28-34 (D. Fla. 2004) (recognizing that "the reciprocity requirement has fallen into some disfavor" in the Ninth Circuit; noting rejection by Second Circuit of reciprocity in comity analysis) (citing, *In re Petition of Kyu-Byung*

Hwang, 309 B.R. 842 (B. S.D.N.Y. 2004)); *Tahan v. Hodgson*, 662 F.2d 862, 867-68 (D.C. Cir. 1981) (noting that "[i]t is unlikely that reciprocity is any longer a federally mandated requirement for enforcement of foreign judgments"; referring to reciprocity merely as "magnificent dictum" under *Hilton*); *Johnston v. Compagnie Generale Transatlantique*, 242 N.Y. 381, 388 (1926).

36. 304 U.S. 64, 74-78 (1938).

37. *Id*. The Supreme Court held that federal courts exercising diversity jurisdiction must apply the law of the state in which the court sits, not federal common law. Except in matters governed by the United States Constitution or acts of Congress, state law should be applied. *Id*.; 18 MOORE'S FEDERAL PRACTICE, note 1 *supra*, ¶ 130.50[2][b] at 130-53. In *Klaxon Co. v. Stentor Elec. Mfg. Co.*, 313 U.S. 487 (1941), the Supreme Court extended the *Erie* rule to require that federal courts exercising diversity jurisdiction should apply the choice-of-law rules of the state in which the court sits. *Klaxon Co.*, 313 U.S. at 496 (finding that a Delaware federal court resolving conflicts of law must apply the conflicts of law rules prevailing in the Delaware state courts). In *Day & Zimmerman, Inc. v. Challoner*, 423 U.S. 3, 4 (1975), the Supreme Court reaffirmed *Klaxon* and required a Texas district court to apply the choice of law rules of Texas.

38. *See Recognition and Enforcement of Foreign Judgments: Analysis and Proposed Federal Statute*, at p. 99 (Am. Law Inst. April 2005).

39. Foreign Judgments Recognition and Enforcement Act, § 7(a), Reciprocal Recognition and Enforcement of Foreign Judgments (Am. Law Inst. April 2005).

40. Convention on Choice of Court Agreements, 30 June 2005 at Arts. 5-6 (Hague Conf. on Private Int'l Law) (full text available at http://www.hcch.net/index_en.php?act=conventions.text&cid=98.

41. *Id*. art. 3(a).

42. *Id*. art. 3(b).

43. *Id*. art. 2, § 1.

44. *Id*. art. 6.

45. *Id*. art. 6.

46. *Id*. arts. 8-15.

47. *Id*. art. 8, § 1.

48. *Id*. art. 8, § 2.

49. *Id*. art. 8, § 4.

50. *Id*. arts. 8-9.

51. *Id*. art. 11, § 1.

52. *Id*. art. 13.

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Particular Issues Affecting the Recognition and Enforcement of U.S. Judgments

By Michael Polonsky

I. The Enforceability of Punitive Damages Awards

A. Overview

At present, the United States and the United Kingdom are not parties to any bilateral or multilateral convention on the recognition and enforcement of money judgments. "Enforcement" of a U.S. money judgment in England therefore depends on the conflict of laws rules of England. These require a fresh action to be commenced in England for the amount of the foreign judgment debt. If the foreign court had "jurisdiction" over the defendant (as defined by English conflict of laws rules), the English court considers that the foreign judgment imposes an obligation on the judgment-debtor. That obligation becomes the subject matter of the fresh action in England, on which summary judgment will usually be granted. If the foreign court had jurisdiction in accordance with English conflict of laws rules, there are only a very limited number of grounds on which enforcement at common law can be resisted.

It is a rule of English conflicts of law that an English court will not enforce a foreign judgment where the amount due under the judgment is in respect of a fine or other penalty, because "crimes, including in that term all breaches of public law punishable by pecuniary mulct or otherwise, at the instance of the State Government, or of someone representing the public" are punishable only in the country where they are committed. A judgment for penalties which were "exigible by the State in the interest of the community" falls within the rule and is unenforceable, but a judgment for penalties claimed by a private person in his own interest is not.[1]

The orthodox view expressed by textbook writers on English law is that the fact that the foreign judgment was for, or included an element of, punitive damages is not a basis for the English courts to refuse recognition to that judgment. Referring to the rule that a foreign judgment is not enforceable if it is for a sum in respect of a fine or other penalty, Dicey and Morris, in their treatise *The Conficts of Law*, state that "A penalty in this sense normally means a sum payable to the State, and not to a private plaintiff so that an award of punitive or exemplary damages is not penal."[2]

B. Relevant English Case Law

1. *SA Consortium General Textiles v. Sun and Sand Agencies Ltd.*

There is no reported English case in which an English court has ruled on the enforceability of a judgment for punitive damages. In *SA Consortium General Textiles v. Sun and Sand Agencies Ltd.*,[3] however, issues were considered which are relevant to this question. In that case, an English buyer purchased goods from a French seller. When the buyer failed to make payment in response to a letter threatening proceedings, an action was commenced in the French court for the amount of the sum due under the contracts. In addition, the French plaintiffs claimed FF10,000 for "abusive resistance" on the ground that the English buyers were wrongly resisting payment.

The French court gave judgment to the plaintiff for the contractual sum claimed plus the additional FF10,000. The English judgment-debtor sought to resist enforcement of the French judgment in England on the ground that this was a sum payable in respect of a fine or other penalty. At first instance, the English court held that the award of FF10,000 was damages recoverable by a private individual against another in respect of a civil wrong, and bore no similarity to a fine.

In the Court of Appeal, Lord Denning M.R. made the only reference to punitive damages. He characterised the judgment-debtor's objection as being "that the 10,000 francs were claimed as punitive or exemplary damages which amount to a penalty . . . and therefore it should not be enforced as part of a foreign judgment."[4] Lord Denning applied the conventional view that "a fine or other penalty" was confined to a sum payable to the state by way of punishment and that a sum payable to a private individual was not a fine or penalty. He saw nothing contrary to English public policy in enforcing a claim for exemplary damages.[5] It is, however, clear that Lord Denning's comments on punitive and exemplary damages were dicta because he concluded that the claim for FF10,000 was not a claim for exemplary damages but was "a claim for compensatory damages so as to compensate the plaintiff for losses not covered by an award of interest, such as loss of business caused by want of "cashflow" or for costs of the proceedings not covered by the court's order for costs."[6] Neither of the other judges in the Court of Appeal referred to punitive damages at all. Both considered that the award of FF10,000 was compensatory only.[7]

It is the judgment in *SA Consortium General Textiles* that is cited as the authority for the view of Dicey and Morris that a foreign judgment for punitive damages will be enforced in England. However it is clear that only one judge used the expression "punitive damages," and that his comments are dicta.

2. *Adams v. Cape Industries plc*

In *Adams v. Cape Indus. plc*,[8] proceedings were brought in England seeking enforcement at common law of a judgment of a court in Texas. The main issue in the proceedings was whether by the English conflict of laws rules the foreign court had jurisdiction over the judgment-debtor. The English court held that it did not. However the English court was also required to consider a number of additional defences which were raised, one of which was that the judgment should not be recognised because no judicial hearing took place in the Texas court at which the quantum of damages was assessed.

At first instance, Scott J. held that the procedure adopted by the Texas court for fixing the amount of damages payable offended against English principles of substantial justice. He held that there had been no judicial assessment of damages and that the award of damages was arbitrary in amount, not based on evidence and not related to the individual entitlements of the plaintiffs. On appeal, in relation to the issue of whether there had been a judicial assessment of the damages, the Court of Appeal concluded that:

> When the claim is for unliquidated damages for a tortious wrong, such as personal injury, both our system and the federal system of the United States require, if there is no agreement between the parties, judicial assessment. That means that the extent of the defendant's obligation is to be assessed objectively by the independent judge upon proof by the plaintiff of the relevant facts. Our notions of substantial justice include, in our judgment, the requirement that in such a case the amount of compensation should not be fixed subjectively by or on behalf of the plaintiff.[9]

C. Punitive Damages Awards Are Likely to Be Unenforceable in England

Based on the Court of Appeal's approach in *Adams*, a good argument can be made that an English court will refuse to recognise a foreign judgment where the amount of the damages is arrived at without an investigation of the loss suffered by the defendant, and where an award of punitive damages is made without any judicial investigation of the plaintiff's loss. Such a judgment could well be contrary to English notions of natural or substantial justice.

There is the further argument—contradicting the orthodox view that a judgment is in respect of a fine or other penalty only if the sum is payable to the state rather than to a private plaintiff—that enforcement of a judgment for punitive damages does indeed involve enforcement of a penalty. Why should an English court not take at face value the language used by the foreign court and treat an award described as "punitive damages" as a penalty? If punitive damages are awarded with the objective of punishing unlawful conduct and deterring its repetition, an English court could well conclude that enforcement is contrary to public policy for this reason. Punitive damages by design bear no relation to the loss allegedly sustained by the plaintiff. Punitive damages are awarded in addition to such sum.

Additionally, plaintiffs seeking punitive damages in the United States are regarded as fulfilling the role of private attorneys-general, who in addition to seeking redress for a private wrong are also seeking redress on behalf of the state for a wrong done to more than one victim. If the function of a punitive damages award is to award the claim of a person functioning in the capacity of a private attorney-general, why should the award not be considered to be a "penalty," and for that reason be unenforceable in England?

In the exchange of diplomatic correspondence that took place when the Protection of Trading Interests Bill was being considered in Parliament, the U.S. Ambassador wrote a letter to the British government in which he stated on behalf of his government that

> The private treble damage action is a crucial aspect of United States anti-trust enforcement. It was adopted as a complement to governmental enforcement tools, in recognition of the limited resources available to governmental agencies to investigate and take action against all violations of the law. It acts as a deterrent to legal activity in the same manner as government enforcement, and provides an incentive to the victims to act as "private attorneys-general."[10]

The British Government's reply stated that Clause 5 of the Bill clarified a question of UK law "by declaring that the multiple damage judgments of other states, *which are regarded by Her Majesty's Government as penal*, are non-enforceable by the UK courts, just as are other judgments of a penal character."[11] The letter went on to state that Her Majesty's Government's main objections to a private treble damage action were "that it ha[d] been adopted as a complement to Government enforcement, that it provides an incentive to private parties to act as "private Attorneys-General," and that such a system of enforcement is inappropriate and in many respects objectionable in its application to international trade."[12]

The German Federal Supreme Court expressed views of a similar nature in *Re Enforcement of a United States Judgment for Damages.*[13] The plaintiff and defendant were U.S. citizens. Both parties had lived in the same town in California until the defendant was convicted of the sexual abuse of minors and fled to Germany to evade imprisonment. The California court awarded the plaintiff damages totalling $750,000, of which $400,000 was exemplary or punitive damages. The judgment-creditor sought enforcement of the judgment through the German courts. The German Federal Supreme Court refused to allow enforcement of that part of the judgment which went beyond the compensatory, holding that punitive damages conflicted with Germany's substantive public policy.[14]

The modern German legal system (said the Court) regarded the legal consequence of tortious conduct as being only to compensate for the injury and not to enrich the injured party. The intervention of the plaintiff as a "private prosecutor" was incompatible with the German legal conception that the State has a monopoly on punishment. In its conclusion the German Federal Court stated that:

> [T]he American concept of punitive damages is characterised by the main motives of punishment and deterrence. . . . Furthermore, since there is no measurable general relationship between the sums of money to be assessed and the injuries suffered, considerations of compensation are generally subordinate. On that basis it is clearly incompatible with essential principles of German law to grant enforcement in this country of punitive damages awarded as a lump-sum to any significant level.[15]

For these and other reasons, a respectable argument can be made that as a matter of principle an English court should not enforce a foreign judgment that awarded punitive damages. The nature of the civil litigation system in Western Europe and elsewhere is that legal proceedings are brought to compensate a victim for the loss he has suffered and to do no more. Punishment of the wrongdoer and deterrence of others is not the function of civil litigation.[16] It matters little whether the justification for non-recognition is said to be lack of proportionality, or public policy, or concepts of substantial justice. What underlies the resistance to recognition is the feeling that no assistance should be given to a victim making a profit from his civil claim. To non-US lawyers it appears bizarre that the amount of compensation awarded for an infringement of the plaintiff's civil rights should be increased to mark disapproval of conduct considered reprehensible and/or to punish the wrongdoer and deter repetition of the conduct by him or others.

The message is clear: there is a significant risk that a U.S. punitive damages award will not be enforced in England.

II. The Enforceability of Awards for Treble Damages

A. Overview

A U.S. judgment for multiplied (*e.g.,* trebled) damages is not enforceable in England. Section 5 of The Protection of Trading Interests Act 1980 (PTIA) provides that no court in the United Kingdom shall entertain proceedings for the recovery of any sum payable under a judgment for multiple damages. The definition of a judgment for multiple damages is "a judgment for an amount arrived at by doubling, trebling or otherwise multiplying a sum assessed as compensation for the loss or damage sustained by the person in whose favour the judgment is given."[17]

Although the text of PTIA prohibits any court in England from entertaining proceedings for the recovery of any sum payable under a judgment for treble damages, it is possible for the court to examine whether a single composite judgment can be broken down into separate severable parts, so that the presence of a treble damages award in a judgment does not mean that the non-treble part is not recoverable.

B. Help Ensure Enforceability; Beware of Trebled Damages

The boxer Lennox Lewis—then undisputed world heavyweight boxing champion—obtained judgment in New York against his former manager. The judgment was for $6.8 million for breach of fiduciary duty and for $400,000 for violation of the RICO statute. Lewis gave an undertaking to the English court to withdraw a pending application in the New York Court for the $400,000 award to be trebled, but the New York Court, of its own motion, increased that part of the award to $1.2 million.

In *Lewis v. Eliades*[18] the Court of Appeal considered whether the presence of the award of $1.2 million in a single composite judgment for $8 million meant that the $6.8 million part of the award was not recoverable because it was a sum payable "under" a treble damages judgment. As it was apparent from the judgment that only part was for treble damages, the court allowed recovery of the other part of the award, which could be separately distinguished and quantified. PTIA was to be construed purposively as precluding proceedings for recovery only to the extent of the part that was arrived at by multiplying any element of the judgment. It is clear that once the $400,000 basic RICO damages award had been trebled, PTIA prevented recovery of even the $400,000 element. However, if a U.S. court awards damages under a statute which entitles it to treble those damages, but the judgment is in fact limited to the "basic award" (i.e., the damages before they are trebled), it may well be that that judgment will be enforceable in England.[19]

The lesson is clear for U.S. plaintiffs whose claims include RICO claims, or other claims where the damages may be trebled: ensure that any judgment which is obtained clearly distinguishes and separately identifies and quantifies the RICO compensation from the compensation for other claims. Indeed, if it is known that the defendant's assets are principally located in England, it is prudent to restrict the RICO compensation by not seeking to have the award trebled.

C. Treble Damages May Turn the Table on a Foreign Judgment-Creditor

PTIA poses further risks for U.S. claimants. If a judgment for multiple damages has been awarded by a U.S. court against a UK citizen—or a corporation incorporated in the UK, or a person who carries on business in the UK—and where an amount on account of the damages has been paid by that judgment-debtor, section 6 of PTIA confers on that judgment-debtor the right to recover so much of the amount that was paid as exceeds the part of the judgment attributable to compensation. Further, the excess portion is statutorily defined as being "such part of the amount [paid] as bears to the whole of it the same proportion as the sum assessed by the court that gave the judgment as compensation for the loss or damage sustained by that party bears to the whole of the damages awarded to that party."[20]

Hence if a U.S. plaintiff obtains payment in the U.S. of the full amount of a U.S. judgment for treble damages, two-thirds of that payment will be recoverable in proceedings in England. English courts have statutory jurisdiction to entertain such recovery proceedings "notwithstanding that the person against whom the proceedings are brought is not within the jurisdiction of the court."[21] The only protection for the U.S. judgment-creditor at that point is if the judgment-creditor does not have any assets in the UK.

Endnotes

1. A modern application of this "rule" is to be found in *United States v. Inkley*, [1988] 3 All ER 144 (CA). In that case, a British subject charged with fraud in the state of Florida was released on bail after having posted an appearance bond to secure his appearance at trial. The defendant obtained permission from the court to return to England for a short period to attend his father's funeral, but failed to return to the U.S. The U.S. government as plaintiff obtained a judgment for the amount of the bond plus interest and then applied in England to enforce the judgment. The Court of Appeal held that, notwithstanding the civil form of the U.S. proceedings, the purpose of the action was to enforce the execution of a public procedure of the U.S. designed to ensure the attendance before its criminal courts of persons charged with criminal offences. The English court did not therefore have jurisdiction to entertain the action.
2. Dicey and Morris, The Conflict of Laws, p. 476 (13th ed. 2000).
3. [1978] 1 QB 279 (CA).
4. *Id.* at 299 G, 300A.
5. *Id.* at 300A.
6. *Id.* at 300B.
7. *Id.* at 306A.
8. [1990] 1 Ch 433 (CA).
9. *Id*, at 566 H- 567 A.
10. Reprinted in A.V. Lowe, Extraterritorial Jurisdiction, 176-186 (1983).
11. *Id.* (emphasis added).
12. *Id.*
13. [1994] ILPr 602.
14. *See* German Code of Civil Procedure (*Zivilprozessordnung*), ¶ 4, §§ 723(2), 328(1).
15. [1994] ILPr 602.
16. By way of exception, English law does permit the award of exemplary damages in two circumstances. The first is if a public servant (broadly defined) has indulged in oppressive or arbitrary conduct against the plaintiff, by, for example, carrying out a search of the plaintiff's premises without a valid warrant or by false imprisonment. Secondly, exemplary damages can be awarded against a defendant who has calculated that the economic benefit to him of his wrongful conduct will outweigh any award of compensation to the plaintiff, for example, where a newspaper publishes a defamatory statement having considered that increased sales are likely to exceed any damages payable to the plaintiff. It is not every case where the defendant's commission of a tort was calculated to provide him with an economic benefit in excess of any likely compensation that exposes a defendant to exemplary damages.
17. The 1980 Act does not deal with, and hence does not provide protection against, foreign judgments for punitive damages.
18. [2004] 1 WLR 692 (CA)a.
19. *Huntington v. Attrill*, [1893] AC 150.
20. Protection of Trading Interests Act 1980, § 6(2).
21. *Id.*, § 6(5).

The European Regime for Enforcing Foreign Judgments

By Richard Fentiman

I. Introduction

The recognition and enforcement of judgments within the European judicial area is regulated by three mutually exclusive but parallel regimes: (1) EC Regulation 44/2001 on jurisdiction and the enforcement of judgments[1] governs the effect in member states of judgments obtained in other such states (except Denmark); (2) the 1968 Brussels Convention[2] continues to govern cases involving Denmark; and (3) the 1980 Lugano Convention[3] governs cases involving certain states which are not party to the Regulation 44/2001 or the Brussels Convention. Where each of these regimes governs, the national law of member states is superseded.[4]

II. The Brussels Regulation

A. Overview

Part III of Regulation 44/2001 is intended to simplify the formalities for the recognition and enforcement of all judgments delivered by the courts of member states in civil and commercial matters. It aims to provide a simple and uniform procedure for enforcement, which reflects the principle of mutual trust between member states, and the policy of furthering the internal market by requiring the free movement of judgments between such states.[5] It is intended to avoid or reduce the possibility of contested enforcement proceedings.

B. Scope

Part III governs the effect in member states of judgments obtained in other such states. It governs only judgments within the scope of the Regulation, as defined in article 1.[6] The Regulation applies in civil and commercial matters excluding revenue, customs or administrative matters. It does not apply to: the status or legal capacity of natural persons, matrimonial matters, wills and succession; bankruptcy; social security; and arbitration.

The Regulation applies to all judgments obtained in member states, irrespective of whether jurisdiction in the proceedings was founded on the rules of the Regulation or national law.[7] It thus applies to defendants domiciled outside the European Community. For example: a default judgment in English proceedings, entered against a New York corporation, is enforceable in France pursuant to the Regulation. Alternatively, if a French court assumes jurisdiction over a New York corporation by virtue of the claimant's French nationality, as permitted by article 14 of the French Civil Code (and article 4 of the Regulation), the judgment is enforceable.

C. Procedure

The procedure for enforcement is governed by articles 38-56, but in particular articles 41, 53, 34, and 35. The intention is that enforcement should be automatic, subject to later challenge, and that no separate enforcement proceedings should be necessary. The object of the Regulation is to simplify the formalities for recognition and enforcement by providing a simple and uniform procedure. It embodies the principle of automatic recognition of judgments given in the European Community without any special procedure.

The court designated by each member state to examine applications for enforcement is required merely to make a formal check of the documents accompanying the application for enforcement.[8] A model certificate containing all the information needed for a rapid decision on recognition or enforcement is annexed to the Regulation. No additional legalisation in respect of the supporting documents is required.[9] An appeal may be lodged by one of the parties before one of the courts listed in the annex to the Regulation. No security, bond or deposit may be required of a party who applies for enforcement of a judgment given on the ground that he is a foreign national or that he is not resident in the Member State in which enforcement is sought.[10]

D. Enforceable Types of Judgment

Article 32 defines a judgment for Regulation purposes. It extends in principle to all judgments, final or provisional, emanating from other member states.[11]

The judgment need not be (1) for a fixed sum of money, or (2) final and conclusive (both requirements under English common law rules).[12] The judgment may thus take the form of an injunction or an order for specific performance.[13] For example, if an English court grants a freezing order in respect of the worldwide assets of a defendant, including those in France, the order is an enforceable judgment, even in France, once confirmed in *inter partes* proceedings.

"Judgment laundering" is not possible. A judgment in member state X, enforcing a judgment obtained in member state Y, is not enforceable in member state Z.[14] A judgment in member state X, enforcing a judgment obtained in a *non*-member state, is not enforceable in member state Z, because the Regulation applies only when the merits have been determined in a member state.[15]

E. The Ground for Enforcement

Judgments capable of recognition may be enforced, on a single ground: that a judgment was obtained in a Member State.

F. Defences to Recognition and Enforcement

1. Principles Governing Defences

Revision au fond is not permitted; no review as to substance is possible.[16] Jurisdictional error in the court of origin is in general no defence.[17]

2. Public Policy

Enforcement may be denied when *manifestly* contrary to the public policy of the forum.[18] The public policy defence has been narrowly construed by the Court of Justice.[19]

The concept of public policy apparently accommodates the defence that the judgment was obtained by fraud (as where it is alleged that it was obtained on the basis of false evidence). But the scope of fraud may be narrower than under the English common law rules. Even if there is fresh evidence of fraud, it is possible that the defendant must seek redress in the court of origin (if it is available there).[20] It is uncertain whether the concept of public policy accommodates the common law defences of want of natural or substantial justice.

A particular problem arises concerning the enforcement of any judgment obtained in breach of an arbitration clause. The Regulation does not include a provision equivalent to Section 32 of the United Kingdom Civil Jurisdiction and Judgments Act 1982, whereby judgments obtained in breach of jurisdiction and arbitration clauses are unenforceable. Moreover, pursuant to article 1(2)(d) "arbitration" is outside the scope of the Regulation. Suppose, for example, that C sues D in Greece in breach of an agreement to submit any disputes to arbitration in London. The Greek court assumes jurisdiction. Would the Greek judgment be enforceable in England (or in another Member State)? Perhaps, because the Convention does not expressly provide to the contrary.[21] But if the parties have agreed to arbitration, it is possible that the entire dispute (including any enforcement proceedings) falls outside the scope of the Regulation by virtue of article 1(2)(d). It has also been suggested that the public policy defence under article 34 might be employed in such a case, and that a judgment in breach of an arbitration agreement would be unenforceable.[22] Generally, it is improper to criticise another court's exercise of jurisdiction, but this defence may be justified if expressed as a criticism of the claimant's conduct, not the foreign court's acceptance of jurisdiction. The position is, however, unclear.[23]

3. Default Judgments Without Notice

A default judgment is unenforceable if given in the absence of notice—or of sufficient notice—to the defendant.[24] Whether there is due service must be determined by the enforcing court, even if the court of origin considered that notice was sufficient.[25] A finding that the requirements of service in the court of origin were complied with is not binding on the enforcing court.[26]

The broad defence of breach of natural justice, available under English common law rules, is not a separate defence under the Regulation but may be within the scope of public policy.

An English worldwide freezing order granted in *ex parte* proceedings is caught by the rule that default judgments are unenforceable.[27] But such an order will be enforceable (in principle, subject to public policy considerations) once it has been confirmed in proceedings of which the defendant had notice.[28] For example, suppose that an English court grants a freezing order in respect of the worldwide assets of a defendant, including those in France. Once confirmed in *inter partes* proceedings, the order is enforceable even in France.

4. Conflicting Judgments

Enforcement may be denied if the judgment is irreconcilable with a judgment obtained in the enforcing court.[29] This may have been given before or after the foreign judgment.[30] Enforcement may also be denied if the foreign judgment conflicts with an earlier judgment obtained in another member state.

Enforcement may be denied if the judgment conflicts with an earlier judgment obtained in a non-member state, provided the earlier judgment is entitled to recognition or enforcement under English law.[31] For example: C sues D in New York. D is present in New York but is domiciled in France, and has substantial assets in England. C fails in its action in New York, but re-litigates the same issue in France. C succeeds in its action in France, and attempts to enforce the judgment in England. The French judgment is unenforceable in England because an English court would recognise the New York judgment in D's favour.

5. Error as to Jurisdiction

A judgment is unenforceable if the court of origin assumes jurisdiction contrary to the Regulation's rules concerning insurance or consumer contracts, or those providing for exclusive jurisdiction under article 22, but not otherwise. For example: a French court gives judgment in a matter affecting land in England, contrary to the rule in article 22 that only the courts of the *situs* may exercise jurisdiction in such cases. This would be unenforceable in England.

A judgment given in breach of a jurisdiction agreement remains enforceable, although, by virtue of article 23, a court cannot assert jurisdiction when the parties have submitted by agreement to the exclusive jurisdiction of another member state's courts. The Regulation does not include a provision equivalent to Section 32 of the United Kingdom Civil Jurisdiction and Judgments Act 1982. For example: C sues D in Greece in breach of an agreement to submit any disputes to the exclusive jurisdiction of the English courts. The Greek court assumes jurisdiction. The Greek judgment would be enforceable in another Member State.

Endnotes

1. OJ 2001 L 12/1.
2. Brussels convention on jurisdiction and the enforcement of judgments in civil and commercial matters, consolidated version, OJ 1998 C 27/1.
3. Lugano convention on jurisdiction and the enforcement of judgments in civil and commercial matters, OJ 1988 L 191/9.
4. *De Wolf v. Cox*, [1976] E.C.R. 1759.
5. Treaty establishing the European Community (the "Treaty of Rome"), consolidated version, OJ 1997 C 340, art. 220.
6. *LTU v. Eurocontrol*, [1976] E.C.R. 1541 (revenue judgments and fines are not enforceable).
7. *Firma P v. Firma K*, Case C-178/83, [1984] E.C.R. 3033.
8. Regulation, note 1 *supra*, art. 41.
9. *Id.* art. 56.
10. *Id.* art. 51.
11. A settlement, even if supervised or approved by a court, is not a judgment but an "authentic instrument"; *Solo Kleinmotoren v. Boch*, [1994] I.L. Pr. 457.
12. *The Heidberg*, [1994] 2 Lloyd's Rep. 287.
13. *Berkeley Administration Inc. v. McClelland*, [1995] I.L. Pr. 201, 220.
14. Droz, Competence judiciaire et effets des jugements dans le Marché Commun *(1972)*, para. 437.
15. *Owens Bank Ltd. v. Bracco*, Case C-129/92, [1994] E.C.R. I-117.
16. Regulation, note 1 *supra*, art. 36.
17. *Id.* art. 35.
18. *Id.* art. 34(1).
19. *Krombach v. Bamberski*, Case C-278, [2000] E.C.R. I-1935 (enforcement must be unacceptably at variance with the requested state's policy, a manifest breach of an essential rule of law, or a fundamental right).
20. *Interdesco v. Nullifire*, [1991] 1 Lloyd's Rep. 180; *Soc. d'Information Inc. v. Ampersand* [1994] 5 I.L.Pr. 55 (CA).
21. *The Heidberg*, [1994] 2 Lloyd's Rep. 287, 301 (Judge Diamond QC).
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Richard Fentiman is Reader in Private International Law at the University of Cambridge and has written extensively on aspects of international commercial litigation.

APPENDIX

EC Regulation 44/2001, CHAPTER III

RECOGNITION AND ENFORCEMENT

Article 32

For the purposes of this Regulation, "judgment" means any judgment given by a court or tribunal of a Member State, whatever the judgment may be called, including a decree, order, decision or writ of execution, as well as the determination of costs or expenses by an officer of the court.

Section 1

Recognition

Article 33

1. A judgment given in a Member State shall be recognised in the other Member States without any special procedure being required.

2. Any interested party who raises the recognition of a judgment as the principal issue in a dispute may, in accordance with the procedures provided for in Sections 2 and 3 of this Chapter, apply for a decision that the judgment be recognised.

3. If the outcome of proceedings in a court of a Member State depends on the determination of an incidental question of recognition that court shall have jurisdiction over that question.

Article 34

A judgment shall not be recognised:

1. if such recognition is manifestly contrary to public policy in the Member State in which recognition is sought;
2. where it was given in default of appearance, if the defendant was not served with the document which instituted the proceedings or with an equivalent document in sufficient time and in such a way as to enable him to arrange for his defence, unless the defendant failed to commence proceedings to challenge the judgment when it was possible for him to do so;
3. if it is irreconcilable with a judgment given in a dispute between the same parties in the Member State in which recognition is sought;

4 if it is irreconcilable with an earlier judgment given in another Member State or in a third State involving the same cause of action and between the same parties, provided that the earlier judgment fulfils the conditions necessary for its recognition in the Member State addressed.

Article 35

1. Moreover, a judgment shall not be recognised if it conflicts with Sections 3, 4 or 6 of Chapter II, or in a case provided for in Article 72.
2. In its examination of the grounds of jurisdiction referred to in the foregoing paragraph, the court or authority applied to shall be bound by the findings of fact on which the court of the Member State of origin based its jurisdiction.
3. Subject to paragraph 1, the jurisdiction of the court of the Member State of origin may not be reviewed. The test of public policy referred to in point 1 of Article 34 may not be applied to the rules relating to jurisdiction.

Article 36

Under no circumstances may a foreign judgment be reviewed as to its substance.

Article 37

1. A court of a Member State in which recognition is sought of a judgment given in another Member State may stay the proceedings if an ordinary appeal against the judgment has been lodged.

2. A court of a Member State in which recognition is sought of a judgment given in Ireland or the United Kingdom may stay the proceedings if enforcement is suspended in the State of origin, by reason of an appeal.

Section 2

Enforcement

Article 38

1. A judgment given in a Member State and enforceable in that State shall be enforced in another Member State when, on the application of any interested party, it has been declared enforceable there.
2. However, in the United Kingdom, such a judgment shall be enforced in England and Wales, in Scotland, or in Northern Ireland when, on the application of any interested party, it has been registered for enforcement in that part of the United Kingdom.

Article 39

1. The application shall be submitted to the court or competent authority indicated in the list in Annex II.
2. The local jurisdiction shall be determined by reference to the place of domicile of the party against whom enforcement is sought, or to the place of enforcement.

Article 40

1. The procedure for making the application shall be governed by the law of the Member State in which enforcement is sought.
2. The applicant must give an address for service of process within the area of jurisdiction of the court applied to. However, if the law of the Member State in which enforcement is sought does not provide for the furnishing of such an address, the applicant shall appoint a representative ad litem.
3. The documents referred to in Article 53 shall be attached to the application.

Article 41

The judgment shall be declared enforceable immediately on completion of the formalities in Article 53 without any review under Articles 34 and 35. The party against whom enforcement is sought shall not at this stage of the proceedings be entitled to make any submissions on the application.

Article 42

1. The decision on the application for a declaration of enforceability shall forthwith be brought to the notice of the applicant in accordance with the procedure laid down by the law of the Member State in which enforcement is sought.
2. The declaration of enforceability shall be served on the party against whom enforcement is sought, accompanied by the judgment, if not already served on that party.

Article 43

1. The decision on the application for a declaration of enforceability may be appealed against by either party.
2. The appeal is to be lodged with the court indicated in the list in Annex III.
3. The appeal shall be dealt with in accordance with the rules governing procedure in contradictory matters.
4. If the party against whom enforcement is sought fails to appear before the appellate court in proceedings concerning an appeal brought by the applicant, Article 26(2) to (4) shall apply even where the party against whom enforcement is sought is not domiciled in any of the Member States.
5. An appeal against the declaration of enforceability is to be lodged within one month of service thereof. If the party against whom enforcement is sought is domiciled in a Member State other than that in which the declaration of enforceability was given, the time for appealing shall be two months and shall run from the date of service, either on him in person or at his residence. No extension of time may be granted on account of distance.

Article 44

The judgment given on the appeal may be contested only by the appeal referred to in Annex IV.

Article 45

1. The court with which an appeal is lodged under Article 43 or Article 44 shall refuse or revoke a declaration of enforceability only on one of the grounds specified in Articles 34 and 35. It shall give its decision without delay.
2. Under no circumstances may the foreign judgment be reviewed as to its substance.

Article 46

1. The court with which an appeal is lodged under Article 43 or Article 44 may, on the application of the party against whom enforcement is sought, stay the proceedings if an ordinary appeal has been lodged against the judgment in the Member State of origin or if the time for such an appeal has not yet expired; in the latter case, the court may specify the time within which such an appeal is to be lodged.
2. Where the judgment was given in Ireland or the United Kingdom, any form of appeal available in the Member State of origin shall be treated as an ordinary appeal for the purposes of paragraph 1.
3. The court may also make enforcement conditional on the provision of such security as it shall determine.

Article 47

1. When a judgment must be recognised in accordance with this Regulation, nothing shall prevent the applicant from availing himself of provisional, including protective, measures in accordance with the law of the Member State requested without a declaration of enforceability under Article 41 being required.
2. The declaration of enforceability shall carry with it the power to proceed to any protective measures.
3. During the time specified for an appeal pursuant to Article 43(5) against the declaration of enforceability and until any such appeal has been determined, no measures of enforcement may be taken other than protective measures against the property of the party against whom enforcement is sought.

Article 48

1. Where a foreign judgment has been given in respect of several matters and the declaration of enforceability cannot be given for all of them, the court or competent authority shall give it for one or more of them.
2. An applicant may request a declaration of enforceability limited to parts of a judgment.

Article 49

A foreign judgment which orders a periodic payment by way of a penalty shall be enforceable in the Member State in which enforcement is sought only if the amount of the payment has been finally determined by the courts of the Member State of origin.

Article 50

An applicant who, in the Member State of origin has benefited from complete or partial legal aid or exemption from costs or expenses, shall be entitled, in the procedure provided for in this Section, to benefit from the most favourable legal aid or the most extensive exemption from costs or expenses provided for by the law of the Member State addressed.

Article 51

No security, bond or deposit, however described, shall be required of a party who in one Member State applies for enforcement of a judgment given in another Member State on the ground that he is a foreign national or that he is not domiciled or resident in the State in which enforcement is sought.

Article 52

In proceedings for the issue of a declaration of enforceability, no charge, duty or fee calculated by reference to the value of the matter at issue may be levied in the Member State in which enforcement is sought.

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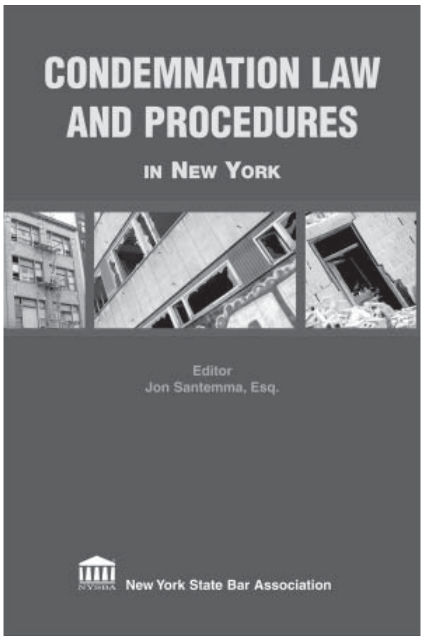

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