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INTERNATIONAL ACADEMY OF COMMERCIAL AND CONSUMER LAW
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PREFACE

This special Symposium issue of the Penn State International Law Review contains papers presented at the 15th Biennial Meeting of the International Academy of Commercial and Consumer Law, held in Toronto, Canada, on July 22-24, 2010. Academy President Jay L. Westbrook presided over the Meeting. A distinguished and able Committee, chaired by Professor Tony Duggan, with Professors Benjamin Geva, Stephanie Ben-Ishai and Jacob Ziegel as members, served as Program organizer. The Program was graciously co-hosted by the University of Toronto Faculty of Law and Osgoode Hall Law School.

Presently consisting of approximately 112 leading world scholars from thirty-seven countries,¹ the Academy continues its tradition of Biennial Meetings addressing vital contemporary global issues at important legal and cultural centers around the world. At the Toronto Meeting, legal experts addressed a broad spectrum of topics including

1. Argentina, Australia, Austria, Belgium, Brazil, Canada, Chile, China, Colombia, Finland, France, Germany, Ghana, Hungary, Ireland, Israel, Italy, Japan, Mexico, the Netherlands, New Zealand, Norway, Poland, Puerto Rico, Russian Federation, Singapore, South Africa, South Korea, Spain, Sweden, Switzerland, Thailand, Turkey, Uruguay, UK, United States.
International Trade, Corporate Law, Banking and Finance, Bankruptcy and Insolvency, Consumer Protection and Conflicts of Law and Enforcement. The wide range of topics addressed suggests the broad spectrum of scholarly interests of Academy members.

The papers published in this Symposium address timely cutting-edge global issues. Emergence of global markets; new national, regional and global governmental entities; new information technologies; and the challenges of international terrorism require development of new institutions, procedures, and norms to meet the needs of the world community. The papers contribute to the development of the rule of law and a more rational world order by highlighting the international nature of commerce in an increasingly globalized world, the common problems faced across jurisdictions, and the benefits in solving commercial and consumer problems by attention to approaches elsewhere.²

We invite you to enjoy each of the papers which follow. They provide us with a useful frame of reference as we respond to the emerging needs of the increasingly interrelated and globalized twenty-first-century world.

Louis Del Duca and Gianluca Gentili

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Incoterms® 2010

Jan Ramberg*

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INCOTERMS 1936 AND SUBSEQUENT REVISIONS

After their initial introduction in 1936, Incoterms were revised for
This appears to suggest that, in recent times, Incoterms have been revised
at ten-year intervals. This, however, is a false impression. It is merely a
coincidence that the last three revisions are separated by two ten-year
periods. Indeed, the main purpose of Incoterms is to reflect international
commercial practice. Needless to say, commercial practice does not
change at a set interval.

It is a common misunderstanding that Incoterms represent nothing
more than standard contract terms that could be revised at any time. In
fact, the value of Incoterms as an expression of international commercial
practice would be endangered by frequent changes for some purpose or
other, such as to make them more reader-friendly or to clarify a few
points of minor importance. A revision of Incoterms therefore requires
that something important have taken place in commercial practice.

* Jan Ramberg, Professor Emeritus of the Law Faculty of the University of
Stockholm, First Rector of Riga Graduate School of Law, Chairman of CISG Advisory
and 2000.
The first version of Incoterms\(^1\) was clearly focused on commodity trading and fixed the important delivery points at the ship’s side or at the moment when the goods were taken onboard the ship. The risk transfer point in the latter case was deemed to be the moment when the goods passed the ship’s rail.\(^2\) This point was in the important and well known trade terms FOB (“Free On Board”), CFR (“Cost and Freight”) and CIF (“Cost, Insurance and Freight”). In cases where the goods were to be delivered alongside the ship rather than across the ship’s rail, the trade term FAS was available. Incoterms 1936 also contained a trade term representing the minimum obligation of the seller, namely EXW (“EX-WORKS”).

After the Second World War, work on the revision of Incoterms was resumed. Carriage of goods by rail had now increased, and it was necessary to introduce appropriate terms. In railway traffic, the seller frequently undertakes to arrange for the carriage in the same manner as under FOB. In 1957, two trade terms were added for this purpose, namely FOR and FOT (“Free on Rail” and “Free on Truck”). In 1976, a specific term for air transport was added, namely FOB Airport. All these trade terms, which applied to a specific mode of transport, were removed from the 1990 version of Incoterms, as it was deemed unnecessary at that time to have specific terms for different modes of non-maritime transport. It was sufficient to use the general term FCA (“Free Carrier named point”). This term was first introduced in the 1980 version of Incoterms, as by this time the carriage of goods in containers had increased to such an extent that it was necessary to introduce a new trade term (then with the acronym FCR).\(^3\) This was all the more necessary because the existence of various container terms could, at worst, lead to a chaotic proliferation of variants to the detriment of international trade. Nevertheless, the innovation represented by FCA was regarded as an experiment, which explains why it was introduced as an additional trade term at the very end of the relevant ICC publication. However, in the 1990 version, FCA became one of the more important Incoterms. Nevertheless, it took a considerable amount of time before merchants realized that it was no good using trade terms such as FOB when, in practice, the goods were not handed over to the carrier onboard the ship but at earlier reception points in the country of shipment: so-called container yards or container freight stations. It was difficult for

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2. The ship’s rail has been regarded as a border between the seller’s and the buyer’s land. See C.M. Schmitthoff, Legal Aspects of Export Sales, London 1953 p. 43.
3. See Eismann & Ramberg, supra note 1, at 293 et seq.
merchants to understand that a seller should not remain at risk after the goods had been handed over to a carrier nominated by the buyer.

In the 1980 revision of Incoterms, it was necessary to add CIP ("Carriage and Insurance Paid To") for non-maritime transport as an equivalent to CIF, under which the seller undertakes to arrange and pay for the carriage and insurance. As a result, the terms CPT ("Carriage Paid To") and CIP, corresponding to CFR and CIF for maritime transport, were both added to Incoterms. The transport document used for maritime transport—the bill of lading—is not used for non-maritime transport, the reason being that, except when carried by ship, goods are normally not sold in transit. Therefore, there is no need for a specific document like a bill of lading, which enables the holder to sell the goods by transferring the document to a new buyer. Consequently, CPT and CIP only make reference to the "usual transport document."

In 1967, it was necessary to add terms for cases in which the seller undertakes to deliver the goods at destination. In such cases, the seller concludes a contract of carriage in order to fulfil his or her obligation to deliver the goods to the buyer at the destination. Although he or she also pays for the freight under CFR and CIF, the seller actually fulfils his or her obligation upon the shipment of the goods. Under these trade terms, the seller's obligation is reduced to arranging and paying for the transport and tendering a document that enables the buyer to receive the goods from the carrier at destination. However, the seller assumes no risk for loss of or damage to the goods after they have been placed on board the ship in the country of shipment.

It is sometimes difficult for merchants to understand that a contract in which the point at destination is named—such as "CIF New York"—nevertheless signifies that the risk is transferred from the seller to the buyer before the indicated point, namely the point in the country of shipment where the goods are taken on board the ship. Indeed, all terms starting with the letter C signify that there are two critical points: one concerning the transfer of risk at the port of shipment and the other being the point up to which the seller has the obligation to arrange and pay for transport.

In the 1990 revision of Incoterms, it was deemed unnecessary to retain the earlier trade terms relating to specific modes of transport (FOR, FOT and FOB Airport). The revision was also triggered by the shift from paper documents to electronic communication. As a result, a

paragraph was added in the clauses dealing with the seller’s obligation to tender documents to the buyer stating that paper documents could be replaced by electronic messages if the parties had agreed to communicate electronically. ⁶

What then is the reason for the revision of Incoterms resulting in Incoterms 2010? It appears that the main problem with Incoterms 2000 was not so much what they contained but rather that it was not sufficiently clear how they should be used in practice. In addition, it is important to expand the use of Incoterms, particularly in the United States, where a possibility to do so has arisen as a result of the removal of the 1941 definitions of trade terms from the Uniform Commercial Code. Indeed, the key trade term FOB is understood differently in the United States than in Incoterms. In the United States, FOB merely represents a point that could be anywhere. In order to achieve an equivalent to FOB under Incoterms, it would be necessary to add the word “vessel” after the term FOB. A new trade term—DAP (“Delivered at Place”)—has therefore been added. When using this term, it is possible to indicate any appropriate place. However, DAP is inappropriate in cases where the goods should be made available to the buyer unloaded from the means of transport. Another new term—DAT (“Delivered at Terminal”)—has therefore been added for use when the unloading of the goods from the means of transport should be performed at the seller’s cost and risk. This means that the maritime terms DES (“Delivered Ex Ship”) and DEQ (“Delivered Ex Quay”) in Incoterms 2000 have been replaced, respectively, by DAP and DAT, since the “terminal” in DAT corresponds to the “quay” in DEQ where the goods are unloaded from a ship. If the parties continue to use DES or DEQ under Incoterms 2000, the result will be the same as under DAP and DAT in Incoterms 2010.

There are limits to what can be done to increase the understanding of Incoterms. In particular, merchants retain old habits and are not easily persuaded to depart from the traditional maritime terms, although this is clearly necessary when contemplating non-maritime transport. In order to promote a better understanding of Incoterms, the 2010 version starts by presenting trade terms that can be used for any mode or modes of transport and only then presents trade terms that can be used for sea and inland waterway transport. Hopefully, this will induce merchants to first consider the use of the “all modes terms.” Nevertheless, it is important

to consider the different needs of trading in commodities as compared to manufactured goods. Commodity trading will continue to focus on carriage of goods by ship, and it remains to be seen whether merchants will choose to use the new terms. Be that as it may, merchants need to understand that trading in manufactured goods—which frequently involves containerization—requires a range of trade terms that are tailored to contemporary commercial practice.

Another frequent misunderstanding concerns the very purpose of Incoterms. Although they are needed to determine key obligations of sellers and buyers with respect to the different modalities of delivery, transfer of risk, and cost, the terms do not represent the whole contract. It is also necessary to determine what rules apply when the contract is not performed as expected, owing to various circumstances, and how disputes between the parties should be resolved. While Incoterms tell the parties what to do, they do not explain what happens if they do not do so! For this purpose, the parties need to lay down applicable rules in a contract or by using a standard form contract as a supplement. In practice, disputes might nevertheless arise owing to unexpected events that the parties have failed to consider in their contract in a clear and conclusive manner. In such cases, the applicable law may provide a solution. Fortunately, the 1980 UN Convention on Contracts for the International Sale of Goods ("CISG") has now become recognized worldwide, thus contributing significantly to transparency and effective dispute resolution in international trade. However, the provisions of the CISG need to be supplemented with terms that offer the parties more precise variants suitable for their transactions. Thus, Incoterms appropriately supplement the CISG and have accordingly been endorsed by UNCITRAL.

**THE REVISION METHODOLOGY**

Incoterms have a well recognized standing in international trade because they reflect contemporary trade practices. The methodology used in creating these rules firmly rests upon a thorough research through the medium of the National Committees of ICC in order to find out what is actually going on in practice and then to seek a common denominator. Traditionally, the ICC has not endeavoured to find the ideal solutions and then to recommend the use of such solutions but rather has used the method of assessing the value of the usages actually appearing in the marketplace. True, it would be compatible with the traditional methodology to inform merchants about the shortcomings of the

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traditional trade terms, whenever these are difficult or impossible to use because of changed methods in cargo handling and transportation techniques and emerging innovations with respect to documentation and exchange of information between traders. But the difficulty starts when it is up to the ICC to decide whether a further step should be taken to *design trade terms* that are adapted to such new practices but do not yet exist in the marketplace. Should the ICC change its methodology and speed up the slow adaptation process in world commerce? This, in a sense, was the key issue in the revision leading to Incoterms 2010.

**THE PRESENTATION AND STRUCTURE OF INCOTERMS 2010**

In order to induce traders to use Incoterms correctly, the ICC publication No. 715 E on the front cover indicates: “ICC rules for the use of domestic and international trade terms.” It is important to note the word “domestic,” since Incoterms is a short expression for international commercial terms, which seems to indicate that their use is restricted to international contracts of sale only. However, by referring to Incoterms in any contract of sale they become incorporated as part of the contract in the same manner as other terms. The inclusion of the word “domestic” is intended to promote the use of Incoterms generally and particularly in countries such as United States where the transport of the goods from seller to buyer may cover much longer distance than between parties in neighbouring countries.

Old habits die hard, and it appeared that traders continued to use the traditional maritime terms also in situations where they were wholly inappropriate. In essence, the maritime terms should be used for the sale of commodities carried by sea from port to port. In particular, maritime terms are inappropriate for the sale of manufactured goods, which nowadays are usually containerised or delivered to a carrier inland. Needless to say, in such cases the carrier’s reception point cannot be the same as under the maritime terms where the goods are delivered to the carrier alongside or onboard the ship. Already with the presentation in 1999 of the ICC Model International Sale Contract (ICC publ. 556) the recommended terms did not include the maritime terms. This is now followed up with the presentation of the terms in two groups starting with Group I with rules for any mode or modes of transport followed by Group II with rules for sea and inland waterway transport. Group I contains the terms EXW, FCA, CPT, CIP, DAT, DAP and DDP, while the maritime terms FAS, FOB, CFR and CIF appear in Group II.
THE INTRODUCTION OF DELIVERED AT TERMINAL ("DAT") AND DELIVERED AT PLACE ("DAP")

The revised Uniform Commercial Code in the United States no longer includes the 1941 American Foreign Trade Terms Definitions. This may well induce traders in the United States to use Incoterms more frequently than before. In order to further induce them to do so the term DAP ("Delivered At Place") was introduced so that the use of FOB for delivery at a particular place could be discontinued. The use of FOB for other than maritime transport creates considerable confusion in international trade, as traders are not aware of the need to add "vessel" after FOB when maritime transport is intended. When the parties simply agree that the goods should be delivered at a particular place, it is often unclear exactly what should be done upon the arrival of the means of transport. In order to clarify this the term DAT ("Delivered At Terminal") was introduced. Under this term, the seller must unload the goods from the arriving means of transport and must then deliver them by placing them at the disposal of the buyer at the named terminal (DAT clause A 4). This is different from the seller's obligation under DAP, where it is enough that the goods are placed at the disposal of the buyer on the arriving means of transport ready for unloading (DAP clause A 4). The same applies under the term DDP ("Delivered Duty Paid").

Perhaps surprisingly, the maritime terms DES ("Delivered Ex Ship") and DEQ ("Delivered On Quay") no longer appear in Incoterms 2010. Logically they become superfluous as DAP and DAT—ready for unloading and unloaded respectively—could be used instead. The Guidance note to DAT of the ICC publication No. 715 E explains that "Terminal" includes any place, whether covered or not, such as quay, warehouse, container yard or road, rail or air-cargo terminal. Nevertheless, it may appear shocking to ship owners that ships nowadays as arriving means of transport are regarded in the same manner as lorries. It may be expected that traders will continue to use DES and DEQ. If so, it is reasonable to assume that they intend that these terms should be interpreted as set forth in Incoterms 2000. If, by mistake, they refer to Incoterms 2010 but nevertheless use DES or DEQ, one would have to choose between two alternatives. Either the parties must have meant Incoterms 2000 or acted in the belief that the terms had been retained in Incoterms 2010. In any case, the result would be the same under the old DES and DEQ compared with the new DAP and DAT, as there has been no change of substance.
ABOLISHING THE SHIP’S RAIL AS RISK TRANSFER POINT

Undoubtedly, the most radical change in Incoterms 2010 appears to be the shift of the risk transfer point under FOB, CFR and CIF. However, the change has been deemed appropriate, since the shortcomings of the ship’s rail to serve as an adequate point for the division of risk are well known. Indeed, any reference to the ship’s rail in this respect is sometimes covered by ridicule as is evidenced by the famous dictum in Pyrene v. Scindia Navigation: “Only the most enthusiastic lawyer could watch with satisfaction the spectacles of liabilities shifting uneasily as the cargo sways at the end of a derrick across a notional perpendicular projecting from the ship’s rail.” Nevertheless, the ship’s rail has in practice functioned quite well as a point for the division of responsibilities; the seller been responsible for those engaged to bring the goods over the ship’s rail and the buyer for those engaged to receive the goods onboard the ship. At first sight, it may appear clear enough that the goods should actually be placed on board and that this is the obligation of the seller. But it is now that the difference between placing the goods on the truck as compared with placing them on board the ship becomes apparent. How should the expression “place on board” be interpreted? Does it include the stowing and trimming of the cargo onboard? Or could the goods be placed on board in any fashion? An obligation to do something includes the obligation to do it appropriately. Presumably, therefore, it must be determined case-by-case exactly what should be done at the seller’s and the buyer’s risk respectively. Thus, the effect of using “placing on board” rather than “passing of the ship’s rail” may not represent a radical step at all, since the traditional seller’s and buyer’s responsibilities for those acting in connection with the loading of the ship may well be retained also in the future.

LEGAL STATUS OF INCOTERMS

The introduction of Incoterms 1936 was preceded by studies of trade terms as they were used in international trade in order to ensure that Incoterms were firmly based on international custom of the trade. As we have seen, the ICC has increasingly in the subsequent revisions endeavoured to assist traders in choosing the appropriate trade term. Also, when there was a need for additional trade terms, although not clearly based on commercial practice, the ICC did not hesitate to act, such as with the inclusion of FCA in Incoterms 1980 (then referred to as “FRC”). Further, the new terms DAT and DAP could not as such be

based on any existing custom of the trade. However, they reflect the most common practice with respect to the obligation to unload the goods from the arriving means of transport. It must therefore be concluded that Incoterms still reflect custom of the trade but, in some respects, amount to no more than a standard form contract. In any event, Incoterms 2010 should always by reference be expressly incorporated into the individual contract. If this is properly done, they simply join the other terms of the contract, and there is no need to determine their legal status.

Nevertheless, the policy of ICC—particularly expressed in connection with the launching of Incoterms® 2010—has regrettably resulted in a decline of Incoterms as an expression of international custom of the trade. In order to protect its intellectual-property rights, the ICC has proceeded to register Incoterms® as a trademark. Thus, the proper reference is no longer Incoterms 2010 but Incoterms® 2010. As expressed in the ICC publication No. 71 SE containing Incoterms® 2010.9

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“Incoterms” is a registered trademark of the International Chamber of Commerce.

Although ICC encourages and promotes the use of the Incoterms registered trademark rules by third parties in sales contracts in compliance with ICC’s copyright policy, “Incoterms” is not a generic term that may be used to designate any trade terms, but is a trademark used to designate only the terms devised by ICC and products and services from ICC.

Thus, it is evident that the ICC—using the original lex mercatoria as a basis for the interpretation of the trade terms FOB, CFR and CIF—now seeks to monopolize the required refinements of these and other trade terms through its efforts to preserve intellectual-property rights to what is referred to as its “collective work.” But, clearly, nothing would prevent other organizations—such as UNCITRAL or UNIDROIT—from engaging in efforts to interpret trade terms used in international

9. ICC publication No. 71 SE, p. 125.
commerce. The trademark “Incoterms®” may be registered but the product as a refinement of *lex mercatoria* should not be appropriated to any organization, however important. The interpreted trade terms should rather be regarded as default rules of the same kind as the rules of the CISG. In view of the ICC’s important and successful work to establish an authoritative interpretation of the trade terms on a worldwide basis, UNCITRAL decided to do no more than suggest some basic principles relating to delivery and transfer of risk in the CISG¹⁰ and instead to express its satisfaction by endorsing Incoterms. Under such circumstances, it is hardly acceptable that the default rules as such should be protected by a trademark of a non-governmental international organization such as the ICC.

There is a further risk that confusion may arise when an Incoterms rule is used as the basis but modified by the parties. To what extent does such an amended rule still represent the “collective work” of the ICC? But, more importantly, a decline of the Incoterms rules as an expression of *lex mercatoria* of the same kind as the default rules of the CISG, and as a part of international contracts of sale by the application of its article 9, is not in the best interests of international trade. Obviously, you cannot eat the cake and still have it. Either one would have to accept that the Incoterms rules have declined and are now of the same kind as standard contract terms, which normally require express and not only implied incorporation into the individual contracts, or induce the ICC to change its policy in order to achieve compatibility between the default rules of the CISG and the Incoterms rules.

International Sales Law—The Actual Practice

Prof. Dr. Ingeborg Schwenzer* and Dr. Christopher Kee**

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1. A chapter developed from this article will be published in INGEBORG SCHWENZER, PASCAL HACHEM & CHRISTOPHER KEE, GLOBAL SALES AND CONTRACT LAW (Oxford University Press) (forthcoming).

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425
I. INTRODUCTION

When addressing the topic of global sales law, a preliminary but very important consideration must be the prevalence of international trade. It is international trade which has, and continues to be, the catalyst for developments in global sales law.

As the statistics below demonstrate, the sustained overall development of international trade over the last half century is startling. Equally extraordinary was the dramatic decrease of world merchandise exports in 2009. As against the year 2000 figures, world merchandise exports fell just over 12% in 2009. When compared to the 2008 figure the decline was 23%—the greatest fall in over fifty years. However, preliminary figures indicate a strong rebound, with the value of trade in the first quarter of 2010 said to be more than 25% higher than of the same time in 2009. Furthermore, recent announcements suggest trade would likely grow by 13.5% in 2010.

While not dismissing the 2009 figures as a mere anomaly, it is, however, more useful to have regard to the demonstrated trend up to 2008. World Trade Organization ("WTO") figures for 2008 indicate that worldwide merchandise export trade amounted to $15,717 billion USD and worldwide merchandise import trade to $16,127 billion USD. These figures are approximately 100 times more than forty-five years ago and more than ten times the level at the time of the signing of the United Nations Convention on Contracts for the International Sale of Goods ("CISG") in 1980. The average annual growth from 2000 to 2008 was more than 5% for both exports and imports worldwide. No longer is the highest growth found in North America, Europe, and Japan, but instead it is the transition economies from different points of the globe—particularly China, Brazil, Russia, and some African countries.

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3. Id.
7. Id.
8. Id. at 7.
9. Id. at 8.
This change is not in the least part due to containerisation that revolutionised cargo shipping. It has been suggested that approximately 90% of non-bulk cargo is moved worldwide in containers on cargo ships. Anecdotally, today it is cheaper to ship a bottle of wine from Australia to Hamburg (approximately 15,403 km / 9,571 miles) than to take it from Hamburg to Munich (approximately 776 km / 482 miles).

Trade has always been an incentive for harmonising or unifying law. Differing legal regimes can be an obstacle to cross-border transactions. The impetus trade provides can be seen not only throughout the history of codification of laws in Europe in the nineteenth century, but also in the United States with the Uniform Sales Act and, subsequently, in the Uniform Commercial Code, as well as more recently in Africa with the Organisation for the Harmonisation of Business Law in Africa (“OHADA”). To this very day, European businesses still consider variation in legal systems and the costs of foreign legal advice to be the main obstacles to cross-border transactions after tax concerns.

Accordingly, in the legal context, there have been significant developments towards global harmonisation and unification of contract

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11. See generally Unif. Sales Act (1906).
law. The CISG, as alluded to above, was signed in 1980.\textsuperscript{15} It has become, without question, the most successful international treaty in the field of private law. Today, there are 76 member states\textsuperscript{16} and indications are that more will join in 2011.\textsuperscript{17} Nine of the top ten leading trade nations are member states today, with the United Kingdom being the sole exception.\textsuperscript{18} Theoretically approximately 80% of worldwide trade is governed by the CISG.\textsuperscript{19} In this regard, it must be noted that the CISG applies not only where both parties (i.e., seller and buyer) have their respective seats in contracting states, but—for most member states—also where the rules of private international law lead to the application of the law of a contracting state.\textsuperscript{20}

The International Institute for the Unification of Private Law ("UNIDROIT"), an independent intergovernmental organisation, issued its Principles for International Commercial Contracts ("PICC") in 1994,\textsuperscript{21} which were subsequently revised and updated in 2004.\textsuperscript{22} The PICC are intended to provide general rules of contract law beyond simply those that relate to contracts for the sale of goods. Although substantively the PICC have drawn heavily on the solutions already developed in the CISG, they do go beyond its scope. In particular, they encompass rules on agency, validity, third party rights, setoff, assignment and limitation periods—all of which are areas not covered by the CISG.\textsuperscript{23} However, because the PICC are not a convention, they are traditionally viewed as being "soft law." According to their preamble, the PICC will primarily be applied when the parties agree to have their contract governed by the

\begin{flushleft}
\textsuperscript{17} There are suggestions that Brazil and Portugal will become member states in 2011.
\textsuperscript{18} WTO, World Trade Developments, supra note 5, at 12.
\textsuperscript{19} This figure is arrived at by taking the contribution of the export values of CISG member states as a percentage of the world's fifty leading exporters as reported by the WTO. \textit{See id.} Typically conflicts-of-law rules lead to the application of the law of the seller's place of business, and thus it is appropriate to specifically consider figures relating to exporters.
\textsuperscript{20} CISG, supra note 15, at art. 1(1).
\textsuperscript{22} In 2005 the Governing Council of UNIDROIT established a working group to develop a third edition of the PICC. That working group meets annually. Further details of the topics the Working Group is addressing can be found at http://www.unidroit.org/english/workprogramme/study050/main.htm (last visited June 9, 2010).
\textsuperscript{23} Ingeborg Schwenzer & Pascal Hachem, \textit{Introduction to Articles 1-6}, in SCHLECHTRIEM & SCHWENZER COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALE OF GOODS (CISG), (Ingeborg Schwenzer ed., 2010).
\end{flushleft}
Furthermore they may be applied when the parties have agreed that their contract is governed by general principles of law, *lex mercatoria*, or the like. Thus, unlike the CISG, which is an opt-out system, the PICC are opt-in.

Besides endeavours to harmonise and unify international commercial law, trade usages have always been of significant importance to international trade. As long ago as 1936, the International Chamber of Commerce ("ICC") codified the then-current uses and distributed the first edition of the INCOTERS. These terms are shorthand descriptions that can be used by contracting parties to describe their respective duties on a wide variety of issues, such as delivery, necessary licences, transport, insurance, risk of loss, costs, etc. During the last seventy years, the development of the transportation techniques, handling practices, transmission of data, and commercial practices have necessitated numerous revisions and modifications. The most recent edition, "INCOTERS 2010," entered into force on January 1, 2011.

II. **EMPIRICAL RESEARCH**

**A. Previous Surveys**

Despite the importance of global trade, until very recently, little was known about how the law interacts with actual practice, though many anecdotal stories existed. One of these stories, in particular, was that parties disliked the CISG and, therefore, were regularly contracting out of its application. In recent years, there has been an increase in empirical research in this field; these surveys, however, have been limited by the geographic area approached, and the number of survey respondents. As far as geographic areas are concerned, these surveys focused on Germanic legal systems (Germany, Switzerland and...
Austria\textsuperscript{30}, the United States,\textsuperscript{31} and a rather small survey with under fifty respondents conducted in China.\textsuperscript{32} There have been other surveys that did not directly address the CISG, but considered cross-border transactions in Europe\textsuperscript{33} and the worldwide use of transnational law.\textsuperscript{34}

Against this research background, our research group in Basel decided to conduct a global survey on the use and understandings of law in international sales transactions.

\section*{B. Global Sales Law Surveys}

The Global Sales Law survey was conducted online in Fall 2009 and was supported by the United Nations Commission on International Trade Law ("UNCITRAL"). The survey was conducted in the six UN languages.\textsuperscript{35} Approximately 5,000 individuals received personally addressed letters in United Nations envelopes, and there were four target groups—practicing lawyers, arbitrators, businesses engaging in trade and law schools. Additionally, various e-mail lists were used to draw attention to the survey website. It is estimated that about 9,000 people across the globe would have received an invitation to participate. Approximately four weeks after the letters, follow-up e-mails were sent. The survey was open for a period of six weeks ending in early November 2009.

The survey website run by our research team received more than 1,500 hits and 640 useable responses.\textsuperscript{36} Responses were submitted from

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\item[29.] Justus Meyer, \textit{UN-Kaufrecht in der schweizerischen Anwaltspraxis}, 104 SJZ 421 (2008);
\item[30.] Corinne Widmer & Pascal Hachem, "Switzerland" in \textit{THE CISG AND ITS IMPACT ON NATIONAL LEGAL SYSTEMS} 281 (Franco Ferrari ed., 2008).
\item[32.] Köhler & Guo, \textit{supra} note 28.
\item[33.] Vogenerau & Weatherill, \textit{supra} note 14, at 105.
\item[34.] Klaus P. Berger & Holger Dubberstein, \textit{Anwendung Transnationalen Rechts in der internationalen Vertrags-und Schiedspraxis}, 101 ZvglRWiss 12 (2002).
\item[35.] English, French, Spanish, Chinese, Arabic and Russian.
\item[36.] Initial analysis has identified useable responses per category to be: Arbitrators, 98; Lawyers, 347; Businesses, 60; and Law Schools, 135.
\end{itemize}
\end{thebibliography}
eighty-five countries,\textsuperscript{37} of which 58\% are CISG member states. Many of these countries have not been included in reported surveys before, especially countries from South America, the Middle East, Africa and Asia.\textsuperscript{38}

In addition to the online survey, we continue to collect and review general terms and conditions of, thus far, seventy-nine businesses\textsuperscript{39} which were published and are freely available in English, French, or German on the Internet.

III. RESULTS IN DETAIL

A. Sales Cases in General

The increase in international trade is clearly reflected by a comparable increase in sales-law litigation and arbitration. Practitioners in law firms were asked to report on the total number of sales-law cases between 2004 and 2008. The results indicate a steady increase of approximately 5\% per year, which almost exactly equals the development of world trade during this period.\textsuperscript{40} On average, arbitrators indicated that 16\% of their caseload involved goods transactions over the last ten years. If this percentage is applied to the total number of arbitrations reported by arbitral institutions during that period (so not including ad hoc arbitrations), it can be hypothesised that nearly 5,000 arbitrations concerned the sale of goods over that period.\textsuperscript{41}

B. CISG Cases

With regard to the total number of sale of goods cases, the increase in the number dealing with the CISG is all the more impressive. Whereas throughout the 1990s CISG cases were scarce, at least in the majority of CISG member states, today it can confidently be said that

\textsuperscript{37} Including lawyers from sixty-six different countries. The IP addresses of respondents were examined to determine this figure. There is a certain margin of error in this number as some respondents may have been using a proxy server which would have hidden their true location. The likelihood of this affecting the figures was considered minimal.

\textsuperscript{38} A non-exhaustive example of some of the countries which do not appear to have been canvassed in others include: Albania, Algeria, Argentina, Benin, Bolivia, Brazil, Burkina Faso, Cameroon, India, Indonesia, and Saudi Arabia.

\textsuperscript{39} All companies searched are on the Forbes 500 list.

\textsuperscript{40} WTO, World Trade Developments, \textit{supra} note 5, at 7.

\textsuperscript{41} This figure is based on the reported statistics published by the Hong Kong International Arbitration Centre ("HKIAC"). See Hong Kong International Arbitration Center, \textit{available at} http://www.hkiac.org/show_content.php?article_id=9 (last visited Apr. 26, 2011).
more than 2,000 cases are listed in the leading case databases on the CISG.\footnote{42} We estimate that this is four times more than ten years ago. The significant majority of these cases have been decided by state courts. This fact is notable because it has been suggested\footnote{43}—and is confirmed by our survey—that more than 60% of international commercial disputes are not litigated before courts but rather go to international commercial arbitration. Arbitral awards are typically not published as confidentiality is one of the main features of arbitration. Thus, the real number of CISG cases must be a multiple of those published in the databases.

More than 100 decisions on CISG cases have been delivered by US courts alone,\footnote{44} however, despite this, in 2008 two decisions of the Southern District of New York claimed that there was "virtually no American case law on the CISG."\footnote{45} Presently, there are approximately 419 CIETAC arbitral awards that have been translated and reported on the Pace website.\footnote{46} CIETAC is the China International Economic and Trade Arbitration Commission. As CIETAC only publishes a selection of its arbitral awards and, even then, only three years after they have been rendered, it can be expected that virtually thousands of arbitral awards concerning the CISG must exist in China.

The importance of the CISG in international litigation and arbitration is clearly mirrored in the results of our survey. Arbitrators in particular reported a significant increase in the numbers of CISG cases they were asked to determine. Over the last ten years, respondent arbitrators indicated they had heard 1,306 cases in total involving the sale of goods. In 2008 alone, 217 of these were CISG cases. Thus,

\footnote{42} The precise number of cases is difficult to calculate and is in any event increased regularly. The Pace Website reports 2,500 cases and the CISG-online website report 2,094—although some cases are reported on both sites, there are many that are only reported on one database. Consequently the real figure may be closer to 3,000. For further detail about these websites see infra note 84.


\footnote{44} As of February 22, 2011, there were 123 reported US cases on the CISG-online website, and 146 on the Pace website. For further detail about these websites see infra note 84.


\footnote{46} Search of Pace database using jurisdiction field "China" conducted on Feb. 22, 2011.
extrapolations suggest that a very high percentage of all sale-of-goods cases involve the CISG.

C. **Familiarity with the CISG**

Time and again it has been suggested that, unfortunately, lawyers are still not very familiar with the CISG. In the surveys before ours, results regarding familiarity has varied greatly—an almost 100% familiarity reported from Germany and Switzerland, good familiarity reported from China and Denmark, to a much lower familiarity in mainly Common Law countries.

Our survey asked both law-firm practitioners and businesses to state their relative familiarity with the CISG. As a percentage of the total respondents in each sub-survey, 78% of lawyers and 45% of businesses reported being familiar or somewhat familiar with the CISG. However, to draw a meaningful comparison with other surveys, it is necessary to examine the responses coming from CISG member states alone, where the respective figures are 84% for lawyers and 63% for businesses. Although these figures are encouraging and are above those reported in previous surveys, the lack of familiarity of businesses is alarming. This is particularly the case as only 13% of businesses reported using external lawyers.

Lawyers were also asked whether they discussed the CISG with their clients. When examining the replies from those situated in CISG member states only, it can be seen that 45% always or sometimes raise the issue. Interestingly, 5% indicated they never discussed the CISG. However, it is not possible to draw any significant conclusions from these statistics. A high percentage of respondents failed to provide any response (40% of those from CISG member states) and even fewer answered a subsequent question inquiring about the circumstances under which the lawyers would discuss the CISG with their client.


49. See id.; for surveys on the U.S., see Various Articles, *supra* note 31.

D. Exclusion of the CISG

The question of the extent to which parties are opting out of or excluding the operation of the CISG has become a perennial one. Hearsay suggests the number of opt-outs is considerable; the empirical evidence from other surveys is less emphatic, suggesting that between 37% to 71% of lawyers promote opting out. The 71% comes from a survey of US lawyers, although the sample was very small.

Our survey figures are considerably less dramatic. Of the lawyers from CISG member states who answered this question, only 13% reported always excluding the CISG, and a further 32% reported they sometimes did so. A considerable 55% answered that they never or rarely excluded the CISG. The respective figures for US lawyers who provided a response were: 12% always excluding, 42% sometimes excluding, and 46% never or rarely excluding. The responses from non-contracting states are similar to the US. Amongst that group, 19% always excluded the CISG and 36% did so sometimes, while 45% rarely or never excluded it.

51. See Spagnolo, supra note 27, at 136.
Unlike in other surveys, unfamiliarity with the CISG is seldom mentioned as a reason to exclude it by the lawyers who responded to the question, although many respondents who exclude the CISG indicate a certain preference for their own domestic law. Some respondents from South America expressed their concern about a lack of case law—the two jurisdictions in question where Brazil, a non-member state, and Chile, a CISG signatory. It is evident though that many of the respondents do carefully consider the most appropriate law to be applied to their client’s situation and decide accordingly. This underscores the good degree of familiarity with the CISG already noted above.

Despite these survey results, it is not possible to completely dismiss the opt-out hearsay. The results from our examination of terms and conditions available online do point to a considerable preference for opting out. Amongst the companies examined from contracting states, 58% specifically excluded the CISG. Added to the difficulty in understanding this issue is that, amongst those companies from contracting states that had not excluded the CISG, 96% used choice-of-law clauses that simply referred to the laws of a contracting state (i.e., without express mention of the CISG). While such clauses may not, in law, exclude the application of the CISG, experience has shown that some parties do believe they are excluding the CISG when simply not mentioning it in their choice-of-law clause. A possible explanation of this discrepancy may be that the participants in our survey were rather pro-CISG, whereas those who were sceptical did not participate in our survey at all.
Businesses were asked whether they included a choice-of-law clause in their standard terms and conditions. It is significant that 47% indeed did so; this coincides with the findings of other surveys that the possibility to choose the applicable law is highly valued. Such a choice cannot on its own be interpreted as a decision to opt-out of the CISG, if for no other reason than that a choice-of-law clause is quite sensible to deal with those areas not covered by the CISG.

Businesses and arbitrators were also asked to identify which law parties were choosing in their contracts; lawyers were asked to identify the law that they recommend. As can be expected, businesses and lawyers displayed a preference for their own national law. Arbitrators reported a variety of generic laws such as the law of the seller; however, references to English and Swiss law consistently recurred. Especially among South American participants, a reference to the law of the place of performance of the contract was popular. This is not surprising, as the conflict-of-law rules in this region usually designate the law of the place of performance of the contract as the proper law of the sales contract. A further interesting response from a small number of arbitrators was the suggestion that applicable law was that at the seat of arbitration, reminiscent of an old approach according to which the choice of the seat

53. See Vogenauer & Weatherill, supra note 14, at 120 (addressing the “Importance of Ability to Choose the Governing Law”).
of arbitration constitutes an implicit choice of law of that place at the same time.\footnote{57}

In this context it is also interesting that arbitrators indicated between 20%\footnote{58} and 36%\footnote{59} of cases involving the sale of goods applied non-national laws such as PICC and \textit{lex mercatoria}.

\subsection*{F. Specific Contract Clauses}

Our survey also addressed specific clauses contained in standard terms and conditions. Businesses were asked to report whether they included certain clauses in their contracts. The results of these questions reveal that, as can be expected, limitation-of-liability clauses are very frequent, with 55\% of respondents indicating their use. Marginally more than one-third of the respondents reported using both liquated-damages or penalty clauses, and \textit{INCOTERMS}.\footnote{60} It is remarkable that at least 12\% in their standard terms and conditions referred to the \textit{UN Global Compact} or similar ethical guidelines.\footnote{61} All these results are supported by our study of general terms and conditions published on company websites.

\subsection*{G. Dispute Resolution Clauses}

Our survey results clearly indicate that disputes in international trade are, today, primarily a matter for arbitral tribunals. Sixty percent of business respondents reported including a dispute-resolution clause in their general terms and conditions. While this, on its own, does not speak to the predominance of arbitration, it supports the other statistics, which do. Arbitration was strongly preferred by lawyers, 60\% of whom recommended it to their clients. To this figure can be added, to probably a significant degree, the 12\% who recommend a multi-tiered dispute-resolution clause. Only 21\% recommended litigation in state courts and 7\% mediation alone. These results are supported by other surveys that also report a 60 to 65\% preference for international arbitration over state-

\footnote{57. For example, this was the position in the UK before it was rejected in \textit{Compagnie d'Armement Maritime SA v. Compagnie Tunisienne de Navigation SA}, [1971] A.C. 572, 596 (H.L.).}
\footnote{58. Including non-responses. \textit{See also} Fitzgerald, \textit{supra} note 31, at 43 (reporting that 50\% of all respondents were not familiar with the PICC).}
\footnote{59. Valid percentage response.}
\footnote{60. 38\% and 37\%, respectively.}
\footnote{61. For a discussion of the consequences see Ingeborg Schwenzer \& Benjamin Leisinger, \textit{Ethical Values and International Sales Contracts}, in \textit{Human Security and Business} 124-148 (Benjamin Leisinger \& Marc Probst eds., 2007).}
court litigation. Confidentiality and speed are still noted as the primary reasons.

The preference for international arbitration is clearly reflected in the development of the reported caseload across many arbitral institutions. The caseload of some institutions, especially those in the Asian region, has doubled or even tripled in the last ten years.

IV. ANALYSIS

A. Domestic Orientation

Although our survey suggests that familiarity with the CISG has reached generally good levels, other evidence suggests that problems in practice still remain, most notably what might be termed the domestic orientation of lawyers. This is evidenced by the, albeit decreasing, but in our opinion still surprisingly high number, of those who are opting out of the CISG. As has been observed elsewhere, there are many degrees of familiarity, and it would appear unwise to equate familiarity with a genuine understanding of how the CISG operates and can operate in international trade.

Many of those who have considered this issue have suggested it is a problem with the standard of legal education. The results from our survey of law schools support this contention. Approximately two-thirds of responding law schools were from CISG member states. But even among these the exposure of students to the CISG appears to be very limited. Of the law schools from member states, 6% indicated that they did not teach the CISG at all. The majority, 40%, reported that the CISG is dealt with in optional courses, and in only 34% is it an obligatory course. However, in almost 90% of courses the CISG was taught as part of another course. Two observations can be made. First, that it is part of an obligatory (or optional) course, does not mean that it is necessarily mentioned much more than occasionally or in passing.

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62. See Vogenauer, supra note 43, question 48 (reporting that 63% of respondents preferred arbitration and 37% preferred litigation before a court when conducting cross-border transactions).

63. See id. (questions 49.1 & 49.2).

64. HKIAC website, supra note 41. See also SIMON GREENBERG, CHRISTOPHER KEE & J. ROMESH WEERAMANTRY, INTERNATIONAL COMMERCIAL ARBITRATION—AN ASIA-PACIFIC PERSPECTIVE 33-53 (Cambridge University Press, 2011).

65. See Spagnolo, supra note 27, at n.8. (citing Ulrich Magnus, Germany, in THE CISG AND ITS IMPACT ON NATIONAL LEGAL SYSTEMS 143 (Franco Ferrari ed., 2008).

66. In law schools from CISG member states this figure was 66%.

67. See Fitzgerald, supra note 31 (questions 28, 30, 33 & 35); Spagnolo, supra note 27, at 142 n.28.
Second, where the course is optional, it seems likely that only a small group of the student population will ever come into contact with this subject. Interestingly the percentage results from law schools situated in non-member states did not differ greatly. Other surveys have also yielded similar results.\(^{68}\) A positive example for international education can be found in China, where the CISG is not only part of the compulsory curriculum but also examinable within the National Judicial Examination for qualification.\(^{69}\)

A very important method of providing students with genuine international exposure are international student competitions, such as the Willem C. Vis International Commercial Arbitration Moot ("Vis Moot"). Although in 2009-10, 251 law schools participated in the moot in Vienna, and seventy-five law schools in Hong Kong, which are impressive figures, when compared to the total number of law schools around the world this represents quite a small number of students. This is the case particularly when it is estimated that there are usually only about five students on each team.

All in all, while CISG and international commercial-law issues are not totally unknown to most law students, the majority are still educated in and for a domestic environment. This is entirely understandable given that the majority of law students will never enter the international commercial legal community.

### B. Consequences of Choosing Domestic Rather than Uniform Law

The above observations about legal education suggest that when choosing domestic law over uniform law, the decision is not always an informed one. This may have severe and significance consequences.

Certainly there are situations where recourse to domestic law is indeed favourable to a party. If, for example, a party has enough economic power to force upon its co-contractant not only its own domestic law but also a choice of its own domestic courts, it would, at least at first sight, seem reasonable to do so. Thus, for example, the standard terms and conditions of a big pharmaceutical company in Switzerland include not only a choice of Swiss law but also a designation of the Swiss state courts at its seat.

However, a practice such as this is not without danger. First, the forum-selection clause might not be recognised by courts in the country

\(^{68}\) For a good discussion see Spagnolo, supra note 27, at 141.

\(^{69}\) Shiyuan Han, China, in The CISG and Its Impact on National Legal Systems 71, 71-72 (Franco Ferrari ed., 2008).
of the co-contractant, thus not preventing the other party from suing in its home jurisdiction. Furthermore, although it is now common ground in most Western industrialised countries that parties are free to choose the law applicable to their contract, it is certainly not a standard that holds true in all parts of the world. The fear of giving Western trade corporations too many advantages still leads developing and transitioning countries to deny validity to choice-of-law clauses. Brazil is a prominent example, as there, the validity of choice-of-law clauses is a matter of considerable controversy. An American party, proud and confident of having contracted on the basis of the UCC, may find itself in a precarious position when having to litigate before Brazilian courts. This is a particularly pertinent example given that Brazil is expected to become a CISG member state in the near future.

However, even if a choice-of-law clause is recognised, parties insisting on their own domestic laws may still encounter difficulties when litigating before the courts in a foreign country. As a first step, the law has to be proven in court. Consequently, it may not only be necessary to translate statutes, but also other documents and texts such as court decisions and scholarly writings. Expert opinions might also be required. In some jurisdictions, these experts may be appointed by the court; in others they will be party-appointed. In the latter case, multiple experts may be presented. Needless to say, the procedures can be very expensive. Such costs are not always recovered, particularly in jurisdictions where each party bears its own costs regardless of the outcome of the proceedings, as is especially the case under the so called “American Rule.” Even if a party is willing to take on these costs, the question of how these laws are to be interpreted and applied is at best unpredictable, and frequently, in reality, amounts to a lottery.

Often, parties wish to apply a “neutral law” to the resolution of their disputes. However, it seems likely that there is a misguided assumption that political neutrality guides the suitability of the chosen law for

71. Id.
72. For recent judicial criticism of this practice in the United States see Bodum USA, Inc. v. La Cafetiere, Inc., 2010 U.S. App. LEXIS 18374 (7th Cir. Sept. 2, 2010).
73. For example, see Germany and Switzerland.
74. For example, see the United States.
international transactions. A prominent example seems to be Swiss law. When parties choose such a third “neutral” law they are often even worse off. First, they have to investigate this foreign law. Second, the trouble and costs in proving it are even more burdensome. Last, but not least, in core areas it may be unpredictable and not suitable to international contracts; this is especially true of Swiss domestic sales law. Two examples demonstrate this problem. First, in relation to non-conformity of goods, the Swiss Supreme Court distinguishes between peius and aliud; the latter giving the buyer the right to demand performance during ten years after the conclusion of the contract notwithstanding whether it gave notice of non-performance or not. Where the line between peius and aliud will be drawn in a particular case is almost impossible to forecast. The second example is compensation of consequential losses. Whether there is a claim for damages without fault depends on the number of links in the chain of causation. Extremely short periods for giving notice of defects, as well as a limitation period of one year in case of a peius, further militate against domestic Swiss law for the international context.

These difficulties and shortcomings of domestic laws are prevented by applying the CISG. The CISG is not only available in six authoritative languages but also has been translated into numerous other

78. See Fountoulakis, supra note 76, at 308.
79. See Bundesgericht [BGer] [Federal Supreme Court] Nov. 28, 2006, 133 Entscheidungen des Schweizerischen Bundesgerichts [BGE] III 257 para. 2.5.4 (Switz.).
80. See Schweizerisches Obligationenrecht [OR] [Code of Obligations] Mar. 30, 1911, as amended, art. 201 (Switz.) (demonstrating that article 201 of the Code of Obligations speaks of “immediately;” this requirement is interpreted very narrowly). Cf. Bundesgericht [BGer] [Federal Supreme Court] June 27, 1950, 76 Entscheidungen des Schweizerischen Bundesgerichts [BGE] II 221, 225 (Switz.) (stating that four days are still sufficient because these included Sunday), see Hannes Zehnder, *Die Mängelrüge im Kauf, Werkvertrags und Mietrecht*, 96 SCHWEIZERISCHE JURISTENZEITUNG, 545, 548 (2000) (demonstrating that even the minority view only advocates an average period of seven days); Bundesgericht [BGer] [Federal Supreme Court] May 28, 2002, (Switz.) CISG-online 676 para. 2.1.2, available at http://www.globalsaleslaw.org/content/api/cisg/urteile/676.htm (stating that the notice requirement within Swiss law is harsher than that of Germany and Austria which have similar rules in § 377 of their respective commercial codes; this is all the more true with regard to the CISG).
81. Cf. Schweizerisches Obligationenrecht [OR] [Code of Obligations] Mar. 30, 1911, as amended, art. 201 (Switz.).
82. See Fountoulakis, supra note 76, at 311. But see Sebastian Brachert, & Andreas Dietzel, *Deutsche AGB-Rechtsprechung und Flucht ins Schweizer Recht*, in ZEITSCHRIFT FÜR DAS GESAMTE SCHULDRECHT 441 (2005) (recommending the choice of domestic Swiss law as this provided appropriate solutions for business-to-business contracts especially in transnational contracts).
languages. Many court decisions, arbitral awards and scholarly writings are either written or translated into today's *lingua franca* of international trade, namely English. These are readily accessible not only via books or journals but also via websites.

To sum up, better accessibility of the CISG saves time and costs, and makes the outcome of cases more predictable. These are the main advantages of the CISG when compared to the application of domestic law.

**C. Dispute Resolution in International Sales Cases**

If uniform law is applied, then it should be reasonable to expect uniform application and interpretation. In other words, it should be predictable. This is one of the core reasons for harmonising and unifying law in the first place. Unfortunately this is not always the case.

Much has been said, particularly in recent times, about the homeward trend by domestic courts when applying the CISG.

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trend takes different forms. First, it is as simple as not applying the CISG where it should be applied. Second, a domestic court may interpret the CISG according to existing or merely presumed domestic counterparts. Finally, the last form is to resort to concurring domestic remedies.

A number of countries are accused of being particularly prone to a homeward trend. Common Law countries, especially Australia, New Zealand as well as the United States are first among them. However, French courts do not fare much better, and despite the fact that German authors emphasize the achievements of the German judiciary in uniform interpretation of the CISG, a closer examination of German decisions reveals that they too are much less international than would be expected. Finally, the high praise of Italian courts must, ultimately, also be questioned. While some Italian decisions mention up to forty

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87. See generally Ferrari, supra note 85, at 171.


91. See Magnus, supra note 65, at 233 (arguing that the "decisions [of the German Federal Civil Court] give good guidance and meet the necessary balance between certainty of law and justice in the case at hand. . . . A good number of cases are now internationally accepted leading cases concerning the interpretation and application of the CISG.").


93. See Franco Ferrari, Applying the CISG in a Truly Uniform Manner: Tribunale di Vigevano (Italy), 5 Uniform Law Review 203, 207 (2001) (stating that "the importance of the Tribunale di Vigevano decision is self-evident. . . . [T]he court referred to some 40 foreign court decisions and arbitral awards. In other words, the court has. . . . taken into account the need to have regard to foreign case law in order to promote uniformity.").
foreign cases, it should not be overlooked that in most cases this was just a formalistic exercise. For example, the conclusion that the CISG applies if both parties have their places of business in Contracting States may simply be determined from CISG Art. 1(1)(a); relying on an abundant number of foreign decisions to support this result seems at best to be superfluous. Amongst this forest of concern there are nevertheless some positive exceptions. In China, for example, courts are reported to have applied the CISG in an international manner. Similarly, in the United States, it can be hoped that a recent case signals a change of approach. A judge of the District Court of the Eastern District of Arkansas, Western Division, first considered the writings of various international commentators and then observed "a tort that is in essence a contract claim and does not involve interests existing independently of contractual obligations (such as goods that cause bodily injury) will fall within the scope of the CISG regardless of the label given to the claim."

A statistic that is truly startling and alarming is the suggestion that 82% of the American federal district court judges surveyed were "not at all" familiar with the CISG as recently 2007. As it appears only seventeen federal district judges responded to the survey, the percentage figure is hopefully not truly indicative, but it does point to a very real problem. So in some parts of the world the first step to take is to improve the awareness of national judges, which again comes back to legal education. This alone, however, will not secure a uniform application and interpretation of the CISG.

Language barriers may also frustrate a truly international application and interpretation. This is the case even though many CISG court decisions and arbitral awards are translated into English and are freely accessible via websites, as noted above.

96. See Han, supra note 69, at 79 (acknowledging, however, that not every court decision is a good one).
98. See Fitzgerald, supra note 31, at 42.
While at least for those lawyers who act internationally, English is the *lingua franca*. This is not the case for many, if not most, domestic judges in French, Germanic and Ibero-American legal systems. Even if English as a language may be widely spoken in these societies—at least in academic circles—the command of “legal” English is still developing. It is really only in very recent times, and with differing levels of enthusiasm, that at least some law classes are taught in English. As the number of classes increases, this picture may hopefully change in a couple of years. Also encouraging is the growing number of English courses specifically teaching Legal English. Naturally, native English speaking judges do not have this excuse. These judges must become accustomed to consulting case law outside their own jurisdictions and beyond Common Law jurisdictions generally.

Language skills aside, it must be recognized that, in many countries, judges work under severe time constraints. When dealing with their daily domestic cases they may only have time to consult one handbook or commentary—if at all. It seems more than likely that they will be relying exclusively on a domestic database provided by the justice administration of that country. Expecting these judges to consider foreign decisions, to access foreign databases once in a year or even less if they are confronted with a CISG case is asking a lot—perhaps too much. They just do not have the necessary time to do so let alone to learn how to do so on the job.

Finally, the number of international-sales-law cases being litigated in domestic courts should not be overestimated. A closer look at the facts of the cases being decided by domestic courts reveals the relative insignificance of these cases, at least from a global trade perspective. A random look at fifty cases from all over the world reveals the following picture. The parties involved in these cases are typically small- to medium-sized businesses. In a majority of cases, the goods sold are agricultural products—fruits, trees, cherries, potatoes, etc.
rice,\textsuperscript{105} watermelons,\textsuperscript{106} and poppy seeds\textsuperscript{107}—or other foodstuffs such as beer,\textsuperscript{108} crabs\textsuperscript{109} and shrimp.\textsuperscript{110} A second group comprises textiles, including yarn,\textsuperscript{111} leather,\textsuperscript{112} shoes\textsuperscript{113} and the like, as well as small- and medium-sized machinery such as heaters.\textsuperscript{114} Most notable are the respective amounts in controversy. The vast majority of these cases involve amounts well under $100,000 USD\textsuperscript{115}; in only one out of the 50 cases did the claim amount to more than $1 million USD.\textsuperscript{116}

The reason why more or less marginal cases are treated by domestic courts is self-evident—larger cases are referred to arbitration. This fact is not only shown by the number of parties that indicated a preference for arbitration in the first place as explained above, but also is evidenced in the replies of arbitrators to our surveys. Responding arbitrators reported


\footnotesize{106. See Rechtbank Breda [Rb Breda] [District Court Breda], Jan. 16, 2009, CISG-online 1789 (Neth.), available at http://cisgw3.law.pace.edu/cases/090116n1.html.


\footnotesize{109. See Rechtbank Rotterdam [District Court Rotterdam], Nov. 5, 2008, CISG-online 1817 (Neth.), available at http://www.globalsaleslaw.org/content/api/cisg/urteile/1817.pdf.


\footnotesize{112. See Jorge Plaza Oviedo v. Sociedad Agricola Sacor Limitada [Corte Suprema Chile] [Supreme Court Chile], Sept. 22, 2008, CISG-online 1787, available at http://cisgw3.law.pace.edu/cases/080922ch.html.


\footnotesize{115. Polytechnique Fédérale de Lausanne v. Y.S.A Bundesgericht [BGer] [Federal Supreme Court], Dec. 16 2008, CISG-online 1800, available at http://cisgw3.law.pace.edu/cases/081216s1.html#ex (Switz.) (showcasing one of the rare cases where the amount in dispute exceeded $100,000).

\footnotesize{116. Bundesgericht [BGer] [Federal Supreme Court], May 18, 2009, CISG-online 1900 (Switz.), available at http://cisgw3.law.pace.edu/cases/090518s1.html.
that among the sale-of-goods cases arbitrated in 2008 only 18% were below $500,000 USD. The bulk, 49%, ranged between $1 and $10 million USD. A significant number, 22%, were valued at over $10 million USD.

We can only speculate, but from good grounds, that the CISG is applied in a more international, consistent and predictable manner in arbitration. There are many reasons for this assumption. Arbitrators are often chosen because of their familiarity and expertise in a particular field, in this case the international sale of goods. Whereas in some countries it would not be possible to have a court-appointed expert on the CISG, experts both tribunal- and party-appointed are frequently utilised in international arbitration. By its very nature, international arbitration promotes internationality. In an arbitral tribunal with three arbitrators, often the arbitrators are from different jurisdictions, each of whom will have had different levels exposure to the CISG during their legal training and professional experience. Furthermore, international arbitrators tend to live a life of comparative law, that is, they regularly interact with foreign laws and foreign lawyers. An irresistible consequence of which must be that they lose their domestic-oriented lenses.

V. CONCLUSION

Laws tend not to be the engine room of an economy; rather they follow some steps behind. International trade, or perhaps more accurately, global trade, is no different. The globalisation of trade transforms law. Industrialisation at the beginning of the nineteenth century precipitated the codification and rationalisation of law worldwide at the level of nation states. Global trade in the twenty-first century is moving us towards the a-nationalisation and delocalisation of law.

Whether a truly global sales law that satisfies all the needs of global trade will ultimately emerge, and indeed whether it would be entirely desirable, is something we can debate. However, we can already recognise and acknowledge the important contribution the CISG has made and continues to make to international trade. One must also acknowledge the role of instruments like PICC and INCOTERMS, and last but not least, international arbitration. All of these enhance predictability, which in turn saves costs and increases trade. More trade will mean more of the positive effects upon law referred to above, and consequently a positive spiral emerges.
Revitalising Gower’s Legacy: Reforming Company Law in Ghana

Justice S. K. Date-Bah*

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This paper discusses some of the reform proposals put forward in a draft Companies Bill currently under consideration by the Cabinet of the Government of Ghana. As a background to this legislation, this paper begins with an overview of its genesis, the country's preceding companies legislation, and the dynamics of the current reform process.

I. INTRODUCTION AND BACKGROUND—PROF. GOWER'S 1963 GHANA COMPANIES ACT—APPOINTMENT OF THE 2008 BUSINESS LAW REFORM COMMITTEE OF EXPERTS

The Companies Ordinance, 1907 was the first companies legislation to be enacted in the Gold Coast, as Ghana was then called.¹ The legislation was based on the 1862 English Companies Act,² which, even in 1907, was regarded as obsolete and was on the verge of being repealed and re-enacted, with substantial changes, as the Companies (Consolidation) Act, 1908 in England. Professor L.C.B. Gower, then of the London School of Economics and Political Science, who was commissioned half a century later to reform the Ghanaian legislation, observed in this regard in his well-known Report that, “It was nearly 50 years behind the times when enacted; it is now out-of-date.”³ Professor Gower undertook his commission by the Government of the newly independent State of Ghana in 1958 to inquire into the working and administration of the existing company law and to make recommendations for its reform. These recommendations resulted in the Ghana Companies Act 1963. It has taken almost another half-century for major reforms to Ghana’s companies legislation to be proposed.

The legislation enacted on the recommendation of Professor Gower placed Ghana on the company law map of Commonwealth jurisdictions. Professor Gower’s report, which preceded the enactment of the new legislation, has served since then as virtually a textbook on the Act and has acquired an enviable reputation, not only in Ghana, but elsewhere, and has been used in several universities as a book of instruction. The Ghana Companies Code, 1963 (Act 179) (later to be known as an Act, pursuant to the Laws of Ghana (Revised Edition) Act, 1988 (Act 562)), has also inspired reform in other Commonwealth jurisdictions.

Among the innovations that Professor Gower introduced into Ghanaian law were the following:

- the law stated as a Code, restating much of the case-law;
- introduction of the single-document constitution to replace the traditional memorandum and articles;
- abolition of the ultra vires doctrine (at least of its worst aspects);
- the single-member company;
- compulsory no-par-value shares and the abolition of authorised capital;
- rationalisation of the law on pre-incorporation contracts;
- authorisation of the repurchase of shares;
- abolition of the doctrine of constructive notice of registered documents;
- a statutory statement of directors’ duties; and
- dissolution without going through the full winding-up procedure.

In spite of the forward-looking nature of many of its provisions, the Companies Act, 1963 is now ripe for review. Other Commonwealth jurisdictions with English-derived companies legislation have reviewed their legislation during the period that the Ghanaian Companies Act has been in force. Among these Commonwealth jurisdictions are: Australia, Canada, Mauritius, New Zealand, South Africa and the United Kingdom. Lessons learnt from such reviews are available to inform an update of the current Ghanaian legislation.

Nevertheless, the excellence of Gower’s original work has put a particular responsibility on any reformer wishing to build on his work. Such a reformer should eschew change for the sake of change. In other words, there should be clearly discernible policy rationales for all the changes recommended. Reform should be based on practical problems that have been encountered by practitioners in the actual operation of the Act or on needed practical conceptual advance, such as that enacted in other relevant jurisdictions, such as those mentioned above.

It is in this context that a Business Law Reform Committee of Experts was established by the Attorney-General of Ghana in April 2008 to offer independent advice on the reform of the business law of Ghana. The theme adopted by the Government for this reform programme was: “Improving the Ease of Doing Business.” The Committee has an interesting multidisciplinary membership, drawn from both the private and public sectors. Its membership includes the Managing Partner of PriceWaterhouseCoopers, who is a chartered accountant, the Chief Executive of the Ghana National Chamber of Commerce, who is both a

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4. Mr. Felix Addo.
lawyer and an economist;\(^5\) the Dean of the Business School of Cape Coast University, a company law specialist who is also in legal practice;\(^6\) a Chief State Attorney in the Attorney-General’s Department;\(^7\) a senior member of the Bar, with considerable experience of company law matters;\(^8\) two other Chief State Attorneys assigned to the Registrar-General’s Department (which is currently the Government agency responsible for administering the Companies Act);\(^9\) and a former President of the Association of Ghana Industries, also both an economist and a lawyer.\(^10\) I have had the privilege of chairing this group.

The Committee decided, in conformity with its terms of reference, to make the reform of company law its first priority. A major element in the approach adopted for its work was to hold extensive stakeholder consultations on the existing Companies Act, 1963. Among the stakeholders consulted were: the Securities and Exchange Commission of Ghana, the Ghana Stock Exchange, the Ghana Association of Restructuring and Insolvency Advisors (or GARIA, for short), the Office of the Registrar-General, the Bank of Ghana, the Internal Revenue Service of Ghana, and the Department of Social Welfare of Ghana. Individual lawyers were also consulted either by way of memoranda they submitted to the Committee or by personal appearance before it. The culmination of these consultations was the National Stakeholders’ Consultative Conference that the Committee organized at a convention centre in Ghana’s capital, Accra, on July 17, 2008, and the three further conferences/workshops that the Committee convened subsequently in the regional capitals of Tamale and Kumasi, and again in Accra. The Committee’s work has also been facilitated by the input of Professor Peter McKenzie QC of New Zealand, who was engaged as the Committee’s external consultant.

II. PROPOSALS FOR REFORM: MAIN CHANGES PROPOSED IN THE DRAFT COMPANIES BILL 2010

Following the extensive consultative process outlined above, the Committee reached policy decisions, later endorsed by the Attorney-General, which have formed the basis for drafting instructions for a Bill to enact a new Companies Act for Ghana. Below is a selection of the proposals embodying these policy decisions.

5. Mr. Salathiel Amegavie.
6. Prof. Bondzi-Simpson.
7. Mrs. Naana Dontoh.
8. Mr. Felix Ntrakwah.
10. Mr. Oteng-Gyasi.
The Proposals

1. Change from Regulations to Constitution and Abolition of the Need to File a Constitution as Part of Incorporation Process

The single constitutive instrument of a company, which under the existing law is called “the Regulations” of the company, is now to be called the “constitution.” Moreover, the proposals remove the need to register a constitution in order to incorporate a company. Where the promoters of a company do not register a constitution for the company, the Second Schedule of the Act is deemed to be the default constitution of the company, if it is a private company. The Third Schedule is the deemed constitution, if it is a public company. Finally, the Fourth Schedule is the deemed constitution, if it is a company limited by guarantee. A company limited by guarantee is, in the legislation derived from the United Kingdom of Great Britain and Ireland, one in which the members promise to contribute a guaranteed sum of money when the company is liquidated. It is a vehicle for not-for-profit activities.

2. Full Abolition of the Doctrine of Ultra Vires

The Committee and the Bill propose a complete abrogation of the ultra vires doctrine. Although the Companies Act, 1963 abolished the worst aspects of the doctrine of ultra vires, it in fact retained the ultra vires rule in a restricted form. Professor Gower recommended that a company should have as regards third parties the same powers as an individual, but that an objects clause should continue to operate as a contract between the company and its members as to the powers that the directors can exercise. (An objects clause, as is well-known in Commonwealth jurisdictions, is one which specifies the objects that the company may lawfully pursue.) The draft Companies Bill, 2010 goes further to provide that a company may be incorporated without an objects clause and in fact makes this the default situation. This implies that, for such a company, the doctrine of ultra vires becomes completely irrelevant. There are no objects in relation to which there can be a determination of excess of powers. The company then has the capacity of a natural person simpliciter.

3. Suffixes to Company Names

Under the Companies Act, 1963, there was only one abbreviation required to be the last word of the name of a company limited by shares. This was the word “limited” or Ltd. The draft Bill under consideration
introduces new requirements regarding the last words of the registered names of companies. These are as follows: plc for public companies limited by shares; Ltd. for a private company limited by shares; and Lbg for companies limited by guarantee.

4. Major Transactions Requiring Authorization of Shareholders

In order to increase the influence of shareholders, certain transactions, characterised as “major,” will require a special resolution before a company can validly enter into them. These are transactions involving:

- The acquisition or an agreement to acquire assets worth more than 75% of the value of the company before the acquisition or the agreement to acquire;
- The disposition or an agreement to dispose of assets worth more than 75% of the value of the company before the disposition or the agreement to dispose;
- A deal that has or is likely to have the effect of the company acquiring rights or interests, or incurring obligations or liabilities, whose worth is more than 75% of the value of the company.

The definition of a “major” transaction does not, however, include an agreement by the company to give a charge, secured over assets of the company, representing more than 75% repayment of money or the performance of an obligation. The major transaction provision does not apply also to the appointment of a receiver under a charge instrument covering the whole or a substantial part of the property of the company.

The effect of this proposal is to remove from the board of directors the authority to enter into such major transactions without the authorisation of the majority of shareholders. It therefore strengthens shareholder democracy.

5. “Buy-out” Remedy for Dissenting Minority Shareholders

The proposals adopt for minority shareholders a remedy that exists under Canadian and New Zealand legislation. It is the remedy of “buy-out.” There are provisions in the draft Bill which confer on shareholders who have opposed particular transactions of a company, but have been outvoted, the right to demand to have their shares bought out. This remedy provides an outlet for minimising dissention in a company and an additional relief against oppression of minority shareholders. The Business Law Reform Committee considered that Ghanaian law would
be well served by its adoption. The right is triggered in relation to certain transactions which need, under the draft Bill, the approval of shareholders by special resolution, or, in the case of variation of rights, the written agreement of 75% of the shareholders. The transactions concerned are as follows:

- Approving a “major transaction,” within the meaning earlier explained;
- Variation of class rights;
- Altering the company’s constitution so as to vary or dispense with the objects or stated business activities of the company; and
- Approving an arrangement, merger or both under the provisions of the draft Bill.

A shareholder who has voted against these transactions, but in respect of which the approval has gone through, is entitled to request that the company should purchase his shares at a fair value. The fair value is to be settled either by agreement between the company and the shareholder, or by arbitration in accordance with the provisions of the draft Bill. The courts are given power to grant an exemption from the obligation of the company to purchase shares where a purchase of the shares of a dissenting shareholder would impose a disproportionately damaging obligation on the company. Also, the courts may grant an exemption where the company cannot reasonably be required to finance the purchase, or where it would not be just and equitable to compel the company to purchase the shares concerned. The draft Bill makes provision for the reinstatement of shares if, within one year from the date of passing of the special resolution complained of by the dissenting shareholder, the company has been unable to carry out the proposed objects or any of the business activities contemplated under the special resolution.

6. Creation of the Office of the Registrar of Companies

Professor Gower had anticipated that the Registrar of Companies would take charge of the administration of the Companies Act, 1963, after a brief interim period during which the Registrar-General of Ghana would be in charge. However, this interim arrangement has persisted until today. The new draft Bill endorses Gower’s original idea by making provision for the establishment of a new statutory body to be known as the Office of the Registrar of Companies to administer the new Act, when passed. The Committee was of the strong view that the new
Act should be administered by a Registrar dedicated exclusively to business units and their administration, in the interest of greater efficiency and the easing of doing business. The new body’s proposed functions include the registration and regulation of all types of businesses: companies, incorporated private partnerships, and registered business names. The body is also to be responsible for the appointment of inspectors under the new Act and will assume the functions of the Official Liquidator under the Bodies Corporate (Official Liquidations) Act, 1963. Furthermore, it is to undertake public education programmes on the operation of companies.

7. Electronic or Digital Means of Registration, Communication and Service

The draft Bill gives power to the Registrar of Companies to authorise the performance electronically, through an electronic system approved by the Registrar, of any of the following acts:

- the incorporation or the registration of a company;
- payment of any fees; and
- submission of annual returns and the filing of any notice or document.

8. Financial Statements

The draft Bill updates the accounting terminology contained in the 1963 Act. Thus, “financial statements” is used instead of “accounts” and “income statement” instead of “profit and loss account.” Companies are now to be required to include a statement of cash flows in their financial statements. Financial statements and auditors’ reports are to be prepared in accordance with International Financial Reporting Standards approved by the Institute of Chartered Accountants of Ghana.

9. Retention of the Prospectus Provisions Pending Their Inclusion in a Separate Securities Industries Statute

Originally, it had been the intention of the Business Law Reform Committee to remove the prospectus provisions from the proposed new Companies Act and to incorporate it in an amendment Act to the Securities Industry Act, 1993, which regulates securities in general.\footnote{Securities Industry Act of 1993 PNDCL (Provisional Defence Council Law) 333.} It
was clear that several Commonwealth jurisdictions (such as, Canada, New Zealand and Mauritius) had taken the initiative to remove prospectus provisions from their companies legislation and had rather embodied such provisions in their securities legislation. This is a logical reform since it is not only companies that are authorised to offer securities to the public. Other entities, such as statutory corporations, including local governments, trusts or partnerships, can offer securities to the public and should be subject to prospectus provisions on the same footing as companies. However, it transpired that the Securities and Exchange Commission of Ghana was working on a comprehensive revision of the Securities Industry Act. The Business Law Reform Committee therefore thought that it would be inappropriate to enact an amendment Bill on only one issue ahead of the comprehensive new legislation. At the same time, the Committee did not want to delay the enactment of the proposed new Companies Act. Accordingly, the Committee abandoned its initial position to recommend removal of the prospectus provisions from the new Companies Act. This will now have to be done by amendment contained in the comprehensive securities legislation, when enacted. In the meantime, a Companies Act still retaining the prospectus provisions would not be all that anomalous since several Commonwealth jurisdictions, including Australia, Singapore, South Africa and the U.K., that have recently revised their companies legislation have kept prospectus provisions in their Companies Act.

10. Derivative Actions

The draft Bill introduces new provisions enabling shareholders to enforce the rights of their company through derivative actions. Under this procedure, shareholders are enabled to apply to the court for leave to bring an action in the name, and on behalf, of the company. The court has discretion to grant such leave. This procedure is additional to the representative action provided for in Gower’s original proposals, and it strengthens the capacity of shareholders to hold the directors accountable. As is well known, under the rule in *Foss v Harbottle*, courts operating under English-derived companies legislation have not entertained actions by individual shareholders seeking a remedy for a wrong committed against the company by directors. The derivative action is a derogation from the rule in *Foss v Harbottle* in the interest of the protection of minority rights. Where the company is controlled by directors or majority shareholders who are set on preventing the company from seeking a remedy for a wrong done to it, the derivative

12. See *Foss v Harbottle* (1843) 67 ER 189.
action is a useful option to have. The derivative action enforces the company's rights, distinct from the personal rights of the shareholders.

CONCLUDING REMARKS

This account of the endeavour to revitalise the legacy of Professor Gower is offered to update colleagues on developments in the company law field in Ghana and to generate a discussion on what reform is appropriate in a jurisdiction such as the Ghanaian. As law reform is always a complex, nuanced matter, a critique of this Ghanaian initiative would be most welcome. Providing a conducive framework for the conduct of business is an important aspect of the relationship between law and development. This project on company-law reform therefore needs to be viewed in this context as an important measure affecting the development of Ghana. Of course, facilitating the use of the corporate form carries a downside risk to consumers of products and services of companies. Unscrupulous entrepreneurs may use the corporate form to dupe and defraud. The response to this risk should be the promulgation of strengthened consumer-protection laws, rather than maintaining restraints on the ease of incorporation and the doing of business through companies.
Corporate Business: Comparative Analysis of the Argentine Cooperation Consortium and the New Colombian Corporation Law

Raúl Aníbal Etcheverry*

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1. INTRODUCTION

This paper compares the two different legal systems used by business enterprises in Argentina and Colombia and demonstrates that Latin American law needs more flexible structures to manage business. The international interest of this comparison may lie in that it involves the business structures of two South American legal systems that are in different coordinates. These two legal frameworks, updated by recent laws, allow the use of more open and less dogmatic legal structures which help businessmen to solve the legal cases that may arise.

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The laws that determine concrete legal systems may be interpreted according to the latest world trend which is the creation of a sort of “soft law” or more open laws, which may better adapt business to the region. An international work confirms this trend, which is also shown in the wording and application of the Unidroit Principles for International Contracts; a clear sign of the new International Business Law, which is halfway between the rigid rules of Latin American and European Civil Law; and the Common Law, which gives rise to a wider soft law linked with the *lex mercatoria*.

I present the following ideas for contracts and international and national business in this paper:

1. International business, which for Argentine law is equal to international legal acts and environments, has experienced changes due to the different circumstances of modern times.

2. The legal characterization in civil law refers to a special way of organizing legal acts toward the creation of legal structures or mechanisms which establish precise effects within the legal system.

3. The difference between bilateral contracts and other ways of creating legal relations within the frame of free will must be established.

4. Enterprise is not a unitary legal concept, but rather an economic criterion. There are legal uses and aspects concerning enterprises. An enterprise, in Latin American law, includes legal elements and is always an organization created to be developed further in the markets.

5. There is an ample diversity of legal systems which may be applied to international business, that go beyond the national and the private international law sphere. The following should also be considered: uses and practices, substantive international law, integrational law, interblock law, and the World Trade Organization (“WTO”) laws. The Convention on Contracts for the International Sale of Goods (“CISG”), the Rules to Be Applied to the Documentary Credit, and the

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Incoterms are examples of substantive international laws. The Unidroit Principles have been applied to international contracts, constituting an example of useful soft law to be applied to the creation, development and winding up of multinational business.

6. The State interferes with the freedom of trade and may alter the position of economic agents and the economic outcome of each activity.

While the Earth moves in the universe during its endless translation-rotation at thirty kilometers per second, and completes a circumvolution around the sun in 365 days and six hours, we enter the twenty-first century at such speed. State-of-the-art technology of artificial life advances and, even though, it runs twenty-five years behind genetic engineering, it has formulated the limits of artificial intelligence, which is a particularly dynamic section of the computing science, in Asilomar, a city that is situated in the Californian bay of Monterrey.

Law is a social science; it develops through living structures, which are closer to a fractal concept\(^2\) than to a Euclidian geometric reference. Legal rules, even though they must have harmonic lines, do not remain in the mere aesthetic construction, as repeatedly expressed by many authors. That is why the research of a legal figure generally faces legal realities that do not represent harmonic structures in a Euclidian sense. On the contrary, they offer variations, not only in geometry which could be included in the geometry of organisms, by following the similarity to the fractal geometry.

The legal system begins with language and speech which is then translated into signs. The law is a large system of definitions and concepts, which try to govern an important part of the human behaviour, especially when expressed in subjects’ interactions, together with different systems of practices.

Law is divided into different subsystems, groups of rules and specific regulations. It attempts to be interconnected. Commercial law is developed in the markets. The concept of market, as well as that of enterprise, is both economic and sociologic. There is not only one market; markets represent different spaces of social life, among which subjects, things (isolated objects, groups of things, universalities, assets) and legal relationships arise from conduct, acts, contracts, agreements and self-managing assets systems ("SAS"). The latter are not well

From speech, which is a selection and updating act, the law moves on to the written rules, which provide stability, durability and recoverability. Law has its own vocabulary, which must be accurate because it conveys ideas or abstract constructions. Law must be expressed through a system using associative fields. Law is a science and a technique, a social practice that tries to reach an ethical and organizing purpose as regards human society. As expressed by Barthes:3

"the world is full of signs, but not all those signs have the simplicity of the alphabet letters, or of the signs of traffic codes or of the military uniforms; they are infinitely more complex and subtle." "Signs are formed by differences."

A list of self managing assets systems can be made. In present coexisting group and mass societies, users must understand their possible applications, their limits and scopes, and the civil liability reflected among their components.

2. ARGENTINE COOPERATIVE CONSORTIUM

In Argentina, the UTEs are cooperative consortiums whose purpose is transitory, specific and limited, although it must not necessarily be commercial. The purpose of profit is not exclusive of the UTE but is a direct purpose of the venture participant. Due to the insufficient general system of UTEs, the Argentine Congress passed a law creating a cooperative consortium in an attempt to find a different pattern as an alternative to the strict characterization of business organizations which has an excessive amount of mandatory legal provisions.

The cooperative consortium was created by the passing of Act 26005 of 2005 to foster the creation of a kind of joint venture which would be capable of adapting itself to international trade conditions that developing countries wish to fulfill in order to trade with developed countries or countries that are leaving the category of "emerging" countries.

The legal rule states that the cooperative consortium may be constituted by physical or legal persons domiciled or created in the Argentine Republic.

The Act created a common cooperative organization, established to "facilitate, develop, increase or carry out transactions related to the economic activity of its members." The organizations are neither legal persons nor legal subjects, not even companies. They are considered as

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having a contractual nature. Additionally, for us, they are considered to be legal business-organization systems.

The common cooperative organizations were established, at the beginning, to gather companies to form bigger ventures aimed at exporting activities. Today, they are used in an endless number of activities, such as enterprises for exportation. They are open entities with an "operative common fund" that are registered with the Public Commercial Registry.

There is a high degree of regulatory freedom in this kind of legal organization that is managed by all of its members and a representative of the group. It can be seen that there is a high degree of legal flexibility, even in matters related to the responsibility of the companies that form part of the cooperative consortium.

3. THE COLOMBIAN SIMPLIFIED CORPORATION

In our opinion, Colombia has made the best progress in the business-organizations field in Latin America due to its adoption of flexible laws which create greater possibilities for the development of business for smaller companies. These flexible laws are why many foreign investments have been channeled through the Colombian legal system, which appears to be very successful.

The Colombian laws assemble the most advanced trends of the world's business organizational laws and disregards many mandatory legal solutions. In this way, the recent system is considered a paradigm as to the choices made based on free will. It may be created by a sole individual and by a private instrument to be registered with the Public Commercial Registry. The limitation of liability is strong and is not affected by tax or labor laws.

The doctrine of inapplicability of legal personality may be applied in case of fraud or abuse in the use of the legal personality. Indeterminate purpose and indefinite duration are admitted. The most important attainment is its ample freedom in its "organizational system," especially its "internal structure" to take decisions and for the management of the company. To the previously mentioned must be added an additional list of freedoms and flexibilities in Colombian law which make this kind of company a simple vehicle that promotes business, creates companies and fosters investment.

4. LEGAL PERSONALITY AND ITS INAPPLICABILITY

In Rome, during the Empire, appears the idea of the existence of a collective entity of public law, which acts together with the citizens. So, the legal construction that we study and call "legal person," first appears
in the public-law sphere and is then used for religious or professional schools or corporations.

Emperor Justinian made a difference between societas and co-ownership. The former was a bilateral, consensual, perfect, and in good faith contract, by virtue of which two or more persons (socii) were reciprocally bound to contribute to the society either their property or their industry with the purpose of conducting common transactions and obtaining advantages, even though not necessarily assessed in money, as well as to enjoy them in common. Co-ownership or common ownership of property could either be voluntary or not, since they might arise from a legacy or donation.

Since olden days has existed the idea of transforming a group of individuals into a legal unit to develop an activity to carry out a certain purpose.

Halfway through the XIX century, German jurists called legal persons to entities organized by a diversity of individuals, who formed part of those entities to fulfill a specific legal purpose, while in France they were called moral persons to be distinguished from those called civil persons. It was then, when Friedrich Karl Von Savigny conceived the well known theory of fiction, according to which the legal person is an artificial person, whom the law considers a subject having patrimonial rights and legal capacity; and the legal capacity—an essential characteristic of the human being—is extended by the law to those ideal subjects in order to facilitate these organizations of individuals the exercise of the rights and the fulfillment of their obligations derived or inherent to the real and particular aim that these organizations pursued.

Under this point of view, legal persons would only be fictitious and artificial subjects that existed solely for legal ends. That fiction was supported within the legal sphere by a mechanism that permitted obtaining a unique will only for the acquisition and the exercise of the rights of that group.

4. JOSÉ M. CARAMÉS FERRO, CURSO DE DERECHO PRIVADO ROMANO 354 (Perró 1953). Note the difference with the Argentine Company, which always has a profit purpose.

5. JOSÉ IGNACIO NARVÁEZ GARCÍA, TEORÍA GENERAL DE LAS SOCIEDADES 37 (8th ed. 1998).

This idea of legal fiction was adopted in Latin America by Andres Bello in the Chilean Civil Code. The concept was then adopted by the Colombian Civil Code, whose Section 633 defines a legal person as "a fictitious person, able to exercise rights and enter into obligations as well as to be judicially and extra judicially represented." Velez Sarsfield, Authority and Drafter of the Civil Codes of Argentina, Uruguay and Paraguay, also uses this idea and concept of legal persons.

The traditional, simple concept coined in Spain by Girón Tena referred to a legal person as follows: the ability to be a subject, active or passive, of legal relations. The Spanish lecturer has also pointed out that legal person “means the existence of a new legal subject independent from those of the group they compose.”

In Italian Law, Brunetti expresses that in legislation prior to the Codice and under Section 77 of the Commercial Code, every organization was considered as a person. This position is identical to the present situation in Argentina, and is different in Europe, where many business organizations are not considered legal persons.

In present Italian law, corporations, limited partnerships, limited liability companies and cooperative organizations are considered “persons.” Personal companies have, on the other hand, only an asset, self-management autonomous system that is clarified in Regulatory Ministerial Order nº 928 of the Civil Code of 1942, but with important changes.

The asset autonomy granted to the organizations of individuals has a direct relation with the German co-ownership system.

In Argentine law, business organizations are “created” from a meeting of minds and only acquire “regularity” (that is, their typical requirements become mandatory) when the business organization is registered with the Commercial Public Registry (Section 7 of Act 19550 of business organizations).

The Argentine Civil Code establishes which are the legal collective, public and private organizations. Section 33 provides that legal persons may be public or private. Examples of public persons are: (1) the National State, the Provinces, and the Municipalities; (2) autarchic entities; and (3) the Catholic Church. Examples of private persons are: (1) associations and foundations whose principal purpose is the common welfare, that own assets, are capable of acquiring goods according to their by-laws, are not sponsored by the State and are authorized to

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7. García, supra note 5, at 37.
operate; and (2) civil and commercial organizations or entities which, according to the law, have capacity to acquire rights and assume obligations even though express authorization by the State might not be necessary to operate.

In the old Germanic law, which had an associative trend, an individual, by himself, did not mean anything to the law; such an individual was only taken into consideration when belonging to a social group. It was not until the Middle Ages that associations evolved. From being a group of persons, associations began to be recognized by the legal system as autonomous entities different from the individuals that composed them. Through the different communities (represented by peasants, noblemen, church members and craftsmen) humankind developed, and the legal system evolved accordingly.

Along with private communities, public communities also appear (i.e., the Municipality and the Council), which will continue multiplying as a means to obtain what a physically isolated person cannot achieve.

In Central-European law, the Sippe is the basic organization that gathers the purposes of its members—their interests are those of the organization; the will of all its members is the will of the community. In contrast to this idea there is another concept, that of organization, which is applied at the beginning to municipal communities, territorial municipalities, charity and religious associations, and unions or corporations.

The German European Law is permeated by the Roman jurists, as well as by the legal compilers and canonists.

Then, the societas appears as distinguished from the universitas. The societas is only a compulsory relation between individuals; it is neither a legal subject nor an entity able to act. The assets of the societas will be co-owned by all of its members. The universitas, on the other hand, is a clear legal subject—a person different from its members and with independent existence. It has the capacity to act, it has asset-management powers, and it can sue and be sued; it may even have its own credits and debts. It is not liable for the acts of its members, and its existence is independent from the existence or change of its members. The difference between universitas personarum and universitas bonorum appears later on.

The collision and interaction between the Roman and Germanic systems was unavoidable. The present legal systems and their legal provisions arise from these two systems.

Kelsen has pointed out that the concept of legal person arises due to the need of imagining a person with subjective rights and legal

obligations. Legal thought, he continues, is not satisfied by knowing that a human act or omission constitutes a duty or a right. Somebody has to exist that might "have" the duty or the right.

The Argentine Civil Code in Section 39 establishes that members are different—as persons—from the ideal entity, when it states that:

Organizations, associations, etc. will be considered completely different persons from their members. The assets owned by the association are not owned by any of their members and neither of their members nor even all of them are obliged to pay for the organization debts, if they had not expressly undertaken the obligation to pay or to be jointly liable.

The rights of the members arise from the law or the contract, but this should not go against the law. There is a generic responsibility of the "entity," contractual as well as extra-contractual (this latter, within the limits of Section 43 of the Civil Code). The issue of members’ liability is different in the different collective structures.

Legal persons can be sued and their assets foreclosed (Section 42), since they are liable for damage caused to the organization by those that direct or manage it, or by their dependents (Section 43).12 Assets generally are owned by one person and each person has his or her assets. This system is derived from Roman law.

In Argentine law, there are collective assets which are not owned by only one person (common property, undivided inheritance) and other assets that do not have an individual owner, at least for a length of time. (For example, in Argentina, the trust administrations or the mutual investment funds.)

The legal personality implies the existence of the principle of free initiative and of asset autonomy, among others. Due to public-order reasons, the state’s controlling bodies have exercised control over certain legal persons. The concept of legal personality was a judicial construction in Anglo-American law in the case Salomon v. Salomon and Co. Ltd. and in the Supreme Court of Texas ruling in State of Texas v. Standard Oil Company.

In Salomon, the company was a mere vehicle to hide the businesses and, upon insolvency, it was considered that the corporation had been

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12. Civil Code: Section 42—Legal persons may be sued for civil actions, and their assets may be foreclosed.

Section 43—Legal persons are liable for damage caused by those who direct or manage the organization when in office. They are also liable for damage caused by their assistants or things under the provisions established in title “Obligations arisen from illicit acts that are not offenses.”
created to limit the liability of its owners. The court ordered “piercing of the corporate veil” to establish the liability of the company’s members or partners.

In Standard Oil, (1892) we see again a stop to the abuses that, through different strategies, caused damage to third parties and distorted reality.

In Argentina, one of the first petitions to challenge the legal personality of a business organization before the amendments introduced by Act 22903, “the interference with the legal system and its limitations, was sustained in a case which was widely known after knowing, in 1976, the extension of liability solutions that the Supreme Court of Argentina established in the case Cía. Swift de La Plata s. quiebra.”

This issue has been studied in different countries. In Brazil, Tepedino shows us that the question of “disregarding the legal personality” has originated two trends of thought among legal scholars, one being of objective nature and the other following a subjective approach. The author reminds us that in order to accept the disregarding of the legal personality, Requiao demands the existence of fraud or abuse of the law.

Section 50 of the New Brazilian Civil Code (unified to a great extent with the Commercial Code) states:

Em caso de abuso da personalidade jurídica, caracterizado pelo desvio de finalidade, ou pela confusão patrimonial, pode o juiz decidir, a requerimento da parte, ou do Ministerio Público quando lhe couber intervir no processo, que os efeitos de certas e determinadas relações de obrigações sejam estendidos aos bens particulares dos administradores ou sócios da pessoa jurídica.

16. Id. at 138, n.5. That is to say, the fraudulent manipulation of a legal person. The Brazilian courts have dealt with this issue in cases of alimony, child support, abuse or fraud, assets commingling and others.
17. Translated into English—“In case of abuse of legal capacity, characterized by deviation of the end, or by patrimonial confusion, the judge can decide, at the request of the party, or of the Prosecutor’s Office, if asked to intervene, that the effects of certain determined responsibility obligations be extended to the personal assets of the administrators or partners of the legal entity (juridical person).”
Apart from the papers and essays of those who studied the question of “disregarding the legal personality,” Argentine Act 22903 of 1983, which amends the Business Organization Act, established new provisions intended to modify the limitation of the direct liability of the business organization’s operators in cases where the legal provisions are applied in order to deceive others.\(^{18}\)

In Argentina, the system is developed in a paragraph of Section 54 of the Business Organizations Act 19550:

Inadmissibility of legal personality. The conduct of an organization which is intended to cover up purposes that are beyond that of the business, and is intended to be used to infringe the law, the public order or the good faith to violate the rights of third parties shall be attributed directly to the members or the controlling companies which allowed such conduct and who will be jointly liable for the damage caused.

Therefore, the legal personality is not “intervened” or “dismissed,” but rather a different legal effect is applied. This effect is the inadmissibility of the legal personality. The liability is extended to the members or the controlling companies that allowed the illegal conduct set forth in the legal provisions.

The Argentine law makes reference to the “acts” of the company, that is to say, to its activities and to the legal acts arising therefrom. The activities and the acts may be internal or external.

Some legal provisions are broad (infringement of the laws, of the public order) and some are more restrictive. The violation of the principle of good faith must be referred to an act (which must also be detrimental); the good faith is a concrete principle of the law which is specifically applied in commercial law.\(^{19}\) The infringement of the rights of third parties and the attempt to pursue objectives beyond those contemplated for the organization are more concrete violations to the contract creating the organization.

Konder Comparato\(^{20}\) states that the deviation in the use of the person-corporation breaches the contract and generates the suspension

18. The author participated in the Commission for the drafting of this act.
(rather than the destruction) of the effects of the separation of assets. This occurs, in fact, when the events set forth in Section 54 happen; the legal personality becomes inadmissible.

In Argentina, on the issue of the legal personality, differences existing among legal texts, all of which\textsuperscript{21} generate a feeling of discomfort or frustration in the present way of life. It is this author's opinion that, nowadays, the legal personality and its principles are not very useful. It is also true that legislators know and care little about it, its use is extended in different directions, and there are diverse interpretations by courts.

Argentine private law (i.e. civil and commercial law) has the same problems that Latin American law has—the lack of updating of legal provisions in view of new business scenarios. We believe that the limitation or not of liability is more related to the kind of organization than to the personality. It is necessary to analyze in depth whether it is necessary to keep the concept of “legal personality” or replace it.

5. Asset Self-Management Legal Organizations

Basedow\textsuperscript{22} draws attention to the interaction of public and private law by using this term in the title of a chapter of a book which is very important and has great influence on the legal system. The above interaction between public and private law is coupled with the extreme hard social reality existing in many parts of the world.

Differing elements are present in a legal relationship—the subjects (individuals or legal persons) and other organizational structures that have no personality; the property (which can be material or immaterial objects); and the “efficiency” element (i.e., “that element which gives rise to the rights throughout the life of such relationship”). All of these elements constitute the “facts” which Vélez Sarsfield mentions in the note to Section 896 of the Argentine Civil Code, explaining what he had studied (or considered) to prepare it.

If the natural or human fact set forth by the law (factum) occurs, and if there is an agreement between such act and the legal definition, the legal effect\textsuperscript{23} shall fatally arise from the statutory point of view. From a different point of view, the question coincides with the growing importance that is given to the freedom of choice, which is not limited to choosing the courts that have jurisdiction and the law which is applicable.

\textsuperscript{21} An example is Spain, with reference to the new system of formation of business organizations of December 2007, see RICARDO CABANAS TREJO, Ricardo, INSCRIPCIÓN Y PERSONALIDAD JURÍDICA 359 (Consejo General del Notariado 2009).

\textsuperscript{22} “El derecho estatal y la economía. El derecho comercial como una amalgama de legislación pública y privada.” See BASEDOW, ET AL., supra note 1.

\textsuperscript{23} Bueres (dir.)—Highton (coord.), Código Civil, t. 2-B, p. 385.
but "also shows a growing material scope that extends to the generation itself of the legal relationships." 24

If the legal presumption arises from a fact or an act, the following may arise: acquisition, modification, transfer, loss or extinction 25 of rights, obligations, or both.

Modern legal texts make reference to the "objective contact" of the contract executed by the parties as the element that determines the applicable law. This contact, which may be legal or economic, "with a State Party of the MERCOSUR" 26 introduces the economic criterion in the legal system regarding the contract type, following the modern trends in this field (e.g., the French system).

The subjects or actors have changed in the markets, and it can be considered that the ancient "entrepreneur—non-entrepreneur—State" trilogy has been replaced as follows:

1. Civil or commercial entrepreneurs who operate in the market through different organizational vehicles: individual ventures and other asset self-management legal organizations. Not all the organizations have legal personality. Nowadays, the Argentine Consumer Protection Law defines them as "suppliers."
2. Consumers.
3. Other independent agents.
4. The State as economy regulator or entrepreneur.
5. Legal Scholars

These market subjects are highly specialized due to the huge increase of activities and to the value and volume traded. Markets have become so diverse and different, sophisticated and complex, that they can only be understood by specialists. 27

Showing the characteristics that have been mentioned would be legal organizational systems that allow an individual or group of individuals (the parties) to manage, administer, represent and dispose of

25. The provision refers to the extinction (section 896 of the Civil Code) but reference can also be made to "loss," which is a different concept and is not synonymous.
26. Cfr. Acuerdo sobre Arbitraje Comercial Internacional del MERCOSUR (argentine law 25.223) in its sections 3 3(b), 3(c), 3(d) and 3(e).
(collectively referred to as manage) assets, which are in whole or in part used for a purpose and a legal cause which unifies, harmonizes and categorizes it as a common pledge for all creditors of such organizations.

Apart from failing to consider all the problematic aspects of the asset self-managing organization, “legal personality” is blurred by its subdivision into a further sub-category which does not serve any useful purpose (“legal subject”), since, apparently, legal subjects have a different meaning (Section 46 of the Civil Code) to that stated as a general rule in Section 39 of the Code.

The importance of this alternative is shown by the existence of multiple options or legal structures that qualify for developing entrepreneurial activities within the field of private law. Entrepreneurial options have to be multiple, flexible, open, and clear (however incomplete, imperfect or contradictory they may be today) as they are framed in the Argentine legal system.

As has already been asserted in an essay published in 2009, there are different elements in the classical legal relationship that has been taught up to these days: the subjects (individuals or legal persons) and other organizational structures that have no legal personality; the assets, and then, the “efficient” element, i.e., “that element which gives rise to the rights throughout the life of the organization till its dissolution.”

6. CONCLUSIONS

This is a radical proposal to Latin America, to replace this “system” of “legal personality,” which is no longer useful and does not in fact represent a true system. The general system theory shows that symbolic or conceptual systems such as the Law, must, like the rest, attempt a harmonization of all its parts, the “whole” and its “integrity.”

The system theory, which is a new paradigm and research tool, compares and unifies the research of both the “real subsystems” that arise from observation or derive therefrom, and the conceptual systems such as logics, mathematics, music, from which symbolic constructions and abstract systems spring.

If reality is a hierarchy of organized integrities, “the image of man will differ from the image created by a number of random physical particles as utmost and “true” reality. The “world of symbols, values, social entities and cultures is something “real” and its inclusion in a

28. Our Argentine System needs to be adjusted to be an updated, coherent and a useful vehicle to develop international business. See RAUL ANIBAL ETCHEVERRY, “NEED TO REFORM THE CIVIL AND COMMERCIAL CODE AND SUPPLEMENTARY LAWS TO PROVIDE CLARITY, ORGANIZATION AND COHERENCE TO THE CIVIL, COMMERCIAL AND SOCIAL ORGANIZATIONAL AND SELF-MANAGING ENTITIES, La Ley, 8/04/2009.

29. LUDWIG VON BERTALANFFY, TEORÍA GENERAL DE LOS SISTEMAS XV, XVI.
corporate business, hard sciences and human sciences, technology and history, natural and social sciences or any other antagonistic formulation.\textsuperscript{30}

Reality shows that there are a lot of systemic legal organizations or “entities” which may or not have personality. All of them, like individual subjects, do not act in isolation, but rather they interact within a community in one or more markets. They can be created or dissolved, they may or not interact with others in groups, according to the reality of the business.

In contrast to these subjects, we find others who are now called “consumers,” which receive, to some extent, the result of the effort of such organizations for the production or exchange of goods or services. The population is considered a consumer and is awarded legal protection.

It is necessary to construct a unified market notion for all these actors to be completed with the rules of each market relating to competition and loyalty laws.\textsuperscript{31} Membership and property are terms that complement each other in collective organizations. The organization of the market would give rise to the virtual formation of a big entity which is given that name irrespective of the number of participants. And there are several markets, like national, regional and international markets.

In the three market ends (the producer, the distributor or intermediary, and the consumer) rest the laws that foster freedom not only of commerce, such as the French law of March 2, 1791, by means of which any person could freely make any trade or exercise an art or profession. It is also established in French law that there is an obligation to respect the freedom of opportunities and loyal competition for any kind of civil or commercial activities.

There is a fourth and decisive actor in each market—the State. With its various degrees of intervention and decentralization, always present in the direct or indirect regulation of the economy rules, and therefore, in the regulation of the markets, the State’s role is twofold. First, it is autonomous when playing the role of an entrepreneur, and then, at the same time, it acts as a public power as it exercises control of the economy.

In the market, and with the four mentioned actors, there appear a series of conducts, legal acts, contracts and other agreements\textsuperscript{32} which

\textsuperscript{30}. \textit{Id.} at XVII.

\textsuperscript{31}. About the competition law, among others, see R. Illescas Ortiz, \textit{La legislación española sobre la competencia y su adaptación a la normativa}, “Derecho de la competencia: la libre competencia”; “Derecho de la competencia: la competencia leal,” op cit, passim.

\textsuperscript{32}. As the author has already stated, it can be seen that there is another concept which goes beyond that of “contract” which has not been completely developed, at least
articulate the production or exchange of goods and services. Some authors make reference to "transactions" which is a word that clearly expresses the customs that go beyond conducts, legal acts and contracts. One cannot think of a limited market strictly devoted to commercial or mercantile acts, conducts, contracts and transactions. A true market allows for the participation of all operators, irrespective of their activity. The market rules must be clear, not abusive and based on ethics.

The self-managing legal organizations are those which operate business. They are those who habitually execute bilateral contracts. They are currently operated by individual persons, on the one hand, and legal organizations, rather than entities, created to manage independent assets, on the other. Irrespective of the fact that the law may consider these latter "legal persons" or not, all of them act or may act in the market developing a single or various activities. They are not contracts, since both legal sub-systems have a different nature.

In this workplace, we can make the following reflections to the readers:

a) They do not constitute a bilateral or exchange relationship, but create a market operative system.

b) They do not constitute a kind of "system or subsystem" built for a purpose other than operating. For example, the "credit card system" which establishes a certain order, a legal organization which allows the possibility or modality of completing different exchange and credit transactions, but which is not considered an "operative entity."

c) The new concept proposed is a legal organizational system capable of creating and developing an order among persons, property and legal relations which allows the administration and disposition of assets either partially or as a whole.

d) This "administration" or "disposition of assets" is evidenced by "legal conduct" which does not need to be embodied in a "person" that operates through conduct, acts, contracts, agreements or covenants, which affect the assets that such

in our legal system. This has generated a wide scope of meaning for "contract." Apart from the contract, there are "transactions" and "covenants," "agreements" and other legal concepts that already exist but have not been defined and systematized by statute. For example, financial or banking transactions.
"system" administers and controls with a higher or lower degree of autonomy.

e) Such system must have a cause, purpose, object, human and business resources, property, legitimacy or legitimization within the legal world.

f) In our opinion, it is not an open system, such as the contract system, which creates bilateral legal relations which may be multiple, but rather, it is a closed system that must always be authorized and structured, at least in its basic principles, by the law, either directly or indirectly.

Nowadays, business among individuals has become scarce and, in fact, there is a tendency towards the unification of private law. Most transactions and contracts are made with the participation of market enterprises or economic operators. It must be understood that an "economic operator" may be an association, a foundation or a trust, which may operate without a direct view of profit, or may be non-profit or profit organizations. All of them must abide by the market rules, and also by the regulatory statutes, even though they apply mutatis mutandis.

It should also be considered that, according to this point of view, the laws generated by the State and the new laws arise from the debate among three parties: the consumer, the enterprise (in a general sense, including individual businessmen that act on their own name or through representatives, the civil, commercial or social organizations that administer assets, and the State itself acting as an entrepreneur) and the State. It should also be taken into account that when we refer to "enterprise" we cannot disregard all those that have a civil, mutual, social, cooperative or charitable purpose, which undoubtedly play an important role in our societies and administer small, medium or large funds.

Internationalization should also be taken into account due to the creation and increasing development of international contracts and globalization, which is a status defined by what it is not rather than by what it is. On the other hand, the need for social awareness emerges as an important issue in these times where there are few people with big

34. Jorge Oviedo Alban, Estudios de derecho mercantil internacional 67 (shows approximations to the definition of international contract).
35. Kenichi Ohmae, El próximo escenario global 23.
fortunes and millions of persons that are socially excluded and live in extreme marginal conditions. It applies to the social responsibility that for-profit organizations\textsuperscript{36} must have and is reflected by a “social balance.”

The right of association is transferred to the acts when an organization of persons and assets that can be lawfully managed is created. An organizational business, thus, shall have, even though it had a minimum activity and risk, an independent action to manage its assets, i.e. an administrative function that includes the possibility of adopting different forms contemplated by the laws of obligations and the real property laws. “Organization form” is a term that indicates the existence of a “system.”

There are “systems” which are complex, multiple or plurilateral which arise in the contractual field (examples are franchises and credit cards) which serve an exchange purpose; and there are other improved systems that allow the independent legal self-management of assets, and thus, fulfill a role of actors or operators in the general, civil, commercial, or socioeconomic markets.

There are multiple forms of organizational business or systems that appear every day for different purposes, such as groups, corporations, partnerships, consortia, civil societies, condominiums, and joint ventures.

If the core of the organizational business administration phenomenon is the joint action of individuals through a “system,” a better effect can be obtained by providing it with controlled freedom adjusted to these modalities, thus creating a flexible organizational method which will guarantee that entrepreneurial activity will be developed adequately in the global economy.

Considering that the law is a subsystem of the whole social system, and considering that we still have unfair or unequal societies in Latin America, it is necessary to follow a continuous improvement policy. The main source\textsuperscript{37} of law in our Roman-Germanic system is the law, and therefore, it is necessary that laws, which shall be the main source of judicial decisions, are clear, coherent and consistent.

We believe that we have reached a full understanding of the organizational entities. As Arendt stated:

\begin{itemize}
\item \textsuperscript{36} José Miguel Embid Irujo, \textit{Perfil jurídico de la responsabilidad social corporativa}.
\item \textsuperscript{37} Regarding sources of law, see, among others, Alf Ross, \textit{Sobre el Derecho y la Justicia} 75.
\end{itemize}
The understanding, insofar as it is different from the correct information and scientific knowledge, is a complicated process which never leads to univocal results. It is a never ending activity, which is always different, and therefore, we accept reality, and come to terms with it, i.e. we try to be in harmony with the world.38

We know that the “legal personality” is an intellectual construction that is deeply rooted in some legal experts. Even though it is an intuitive concept, it is only acceptable for language practical purposes. The philosopher we are quoting is still developing her assertions with memorable ideas: “Sciences can only clarify, but never prove or deny, the preliminary uncritical comprehension from which they start.” No problem can be solved if it is debated at the same level of comprehension in which it has been formulated (Einstein). The upgrade allows us to find solutions which are both valid and durable, which are the aim of any legal system.

According to the Argentine laws in force, the asset self-management legal systems could be expressed in the following manner:

1. Legal Facts.
2. Legal Acts.
3. Contracts.
5. Legal “Systems” intended to facilitate business activities or that are instruments or vehicles to develop the same.
6. Other Legal Systems.

All of the above are variations that arise from the law; the law creates and establishes them, and allows them to choose the opportunity in which they are going to be used by applying the freedom of intention.

An instance of asset self-management could be found, to a lesser extent, in the case of co-ownership or common ownership, but they are always legal mechanisms that allow the administration and management of assets or property. The self-management of assets would be present in a certain “business” or set of acts and contracts having lesser autonomous management (condominiums); it could also adopt more complex forms in order to be considered a legal active market operator (example in Argentina: an administration trust). All these legal organizations have a higher or lesser degree of autonomy in the management of their assets. Said assets support, and at the same time

38. Hanna Arendt, De la Historia a la Acción 29.
provide the legal qualification for, all the acts performed by such organizational structure.

The nineteenth century law was structured on the basis of certain "patches," by building up concepts of genre and species, sentences and structures to regulate human conduct. Each new legal figure brought about several effects, and its inclusion was not always "clean," that is to say, the preceding system was not remodeled in order to strike any contradictions, redundancies or inconsistencies.

A critical analysis of certain constructions of private or common law can lead us to "unfold" certain structures. To do that, however, it is necessary to carry on a deconstruction to be able to construct anew mechanisms or devices that are adequate for the twenty-first century.

We are inescapably facing complexities with "integralities" or "systems" in all fields of knowledge. 39

Our proposal is based on the assumption that there is an implied category of centers or "systems" which are susceptible of being defined by law but for which there are no clear legal definitions. Apart from contracts, and on the basis of legal acts or contracts themselves, asset self-management systems can be created, and collective business, organizations, groupings and networks can be allowed. Some of them are "legal persons" and some not. Such systems could be defined as asset self-management legal organizations or systems. But such denomination should not be derived from court interpretation or the opinion of legal scholars.

A law must be passed to regulate the civil, commercial or social market operators who are, together with the individual entrepreneurs, the necessary counterparties of consumers, whose rights have largely evolved. They could be defined as "asset self-management legal systems" or given any other name that may appear to be more adequate. And such systems, in order to be internally and externally operated directly or indirectly by human beings, deserve a new coherent, consistent, clear and updated legislative regulation that answers the needs posed by the new century. Legislators sometimes create unorthodox legal mechanisms to include in the legislation the new ventures that entrepreneurs generate almost on a daily basis.

What do corporations and associations, groups and collaborative or cooperative business have in common? They are all legal organizational systems, a genre that can start to be defined by resorting to its active systemic structuring nature. All of the legal systems are related to the freedom of an individual to join others to develop jointly certain activities. The plain right to associate, with only one restriction—the

39. BERTALANFFY, supra note 29, at 3.
illegal association—should be a full and unrestricted guarantee not conditioned on fulfillment of a "useful purpose" or "[the pursuit of] the common welfare" (Argentine Constitution and Civil Code). The human right of association, in any form freely chosen (i.e., the right to select and carry on a human group), is part of the general freedom of action and choice of persons.

In the Argentine legal system, the right of association is not sufficiently and explicitly stated in the Constitution and the substantive law. The Supreme Court clarified the issue in its ruling in the ALITT Case, and also stated that its exercise is ample. However, it should not be forgotten that judicial cases are mere legal precedents that solve an issue but are not obviously considered as legislation in force.

With the two examples of substantive law and legal-scholar opinions stated here, it is clear that:

1. The legal personality system is, nowadays in Latin America, a linguistic habit rather than a precise legal regulation.

2. There are numerous legal organizational systems, whether collective or not, which are fit to be used for the administration of assets individually and with a certain degree of autonomy. It would be convenient to structure the same using uniform theories for national and international business.

3. It would be convenient, especially for national and international business, to have flexible systems such as joint ventures, the Small Business Act proposed in Europe, some American legislation such as the Delaware acts, simple systems such as the Japanese Limited Liability Partnership Act (No 40 of 2005), or the Cooperative Consortia of Argentina or the Colombian Simplified Corporations.
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Japanese Corporate Governance: Behind Legal Norms

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_all people are the same. It is only their habits that are different._
Confucius

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INTRODUCTION

Corporate governance may be analyzed from different perspectives, one of them being its legal aspect. However, instead of examining legal rules regarding corporate governance, this paper will analyze the relationship between non-legal norms and corporate governance focusing on the influence that non-legal norms have on the way corporate governance functions in Japan.

Japanese corporate governance has often been the subject of attention of foreign scholars, particularly in debates on the comparative aspects of corporate governance. The main focus is usually on the rules regulating corporate governance and legal reforms affecting those rules. The main bank system, cross-shareholding and long-term employment are usually mentioned as typical features of the Japanese model of corporate governance.

The current literature on Japanese corporate governance often relies on contrasting arguments. Some scholars suggest that it is fundamentally different from Western patterns and its character is determined by the unique Japanese culture. The opposing view disputes this explanation by focusing on economic, legal and political factors, and arguing that these factors are the primary force driving Japanese corporate governance. This bipolar approach is also present in discussions related to other areas.

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of Japanese law and practice, such as various theories concerning the low litigation rate in Japan.\(^3\)

The objective of this paper is to highlight the background of corporate governance in Japan by taking all dominant factors into consideration in light of arguments relied upon by competing theories. This paper will analyze economic, political and legal factors that have contributed to the development of the Japanese model of corporate governance. Particular attention will be given to exploring the world of corporate governance that exists behind the legal norms, focusing primarily on the influence that Japanese social norms have on corporate governance. Such an analysis of the impact of the non-legal norms on corporate governance may provide new insights into the way culture interacts with legal norms in Japan and may contribute to a better understanding of the way in which Japan is currently adapting the system of corporate governance to its evolving business environment.

A broader objective of this paper relates to a general lack of a comprehensive analysis of the effect of non-legal norms on corporate governance in the wider corporate governance literature. This paper suggests that the cultural lens should not be forgotten when attempting to understand how disparate systems of corporate governance work in practice. In this sense, the overall goal of this paper is not just to contribute to Japanese corporate governance literature but to the understanding of corporate governance as a whole.

This paper will first address the basic structure and principle of Japanese corporate governance by giving an overview of both the legal regulation and non-legal norms used in Japanese corporate governance. Then, it will analyze the influences of both the non-legal and legal norms on corporate governance in the light of arguments relied upon by competing economic and cultural theories. The last portion will explore the prospects for changes in the corporate governance in Japan as a consequence of economic decline in recent years, both with respect to the legal regulations and practices based on non-legal norms. Finally, the paper will conclude by evaluating the possible directions of the evolution of Japanese corporate governance in the future.

LEGAL REGULATION OF JAPANESE CORPORATE GOVERNANCE—
UNSUCCESSFUL ADOPTION OF THE AMERICAN MODEL

After Japan opened its doors to the outside world in the mid-nineteenth century, it embarked on a process of modernization, but with a clear strategy to preserve its own values while importing Western technology under the slogan “Japanese spirit, Western skills” (wakon yosai). This approach was buttressed by the Japanese educational system which continued to cultivate traditional values.

Relating to the Japanese legal system, there are two sets of rules in Japan that have co-existed for over a hundred years: (1) legal norms transplanted from the Western legal system, and (2) traditional informal norms. The Japanese legal system is based on legal transplants originally imported from Germany.4 In the post-war period, particularly in the area of corporate law, Japanese law made a distinct move towards the American model.5 The genesis of the Americanization of Japanese corporate law came during the occupation period, when American law heavily influenced major revisions to Japan’s black letter corporate law—which were aimed at implementing a US-style shareholder primacy model. American influence was also dominant after the economic “bubble burst” in the 1990’s.6 In Japan’s post-bubble era, discussions surrounding a new approach to corporate governance often gravitated towards the need to adopt “global standards” in corporate-governance reforms. The idea of adopting “global standards” was typically understood as a thinly veiled disguise for adopting American standards.7

Adoption of the American model into Japanese business culture was unsuccessful. While in the post-war period Japan adopted corporate governance structures and rules based on American corporate law, in practice, they deviated substantially from the American model.8 Dependence on banks for financing, cross-shareholding, as well as the

4. There are several reasons for the choice of German law, related to suitability for Japan. See HIROSHI ODA, JAPANESE LAW 27-29 (Butterworths, 1992).
6. Id. at 101.
long-term employment system, all developed in the post-war period when Japan was supposedly following the American model. Each of these essential features of the Japanese corporate governance model is in clear contrast to the American model. One of the paradoxes of the Japanese model is that during the period when the model was presumably under the influence of American-style black letter corporate law, it actually diverged from the American model. Some commentators described this divergence as a puzzle. This text will attempt to find answers to this puzzle.

NON-LEGAL NORMS AND CORPORATE GOVERNANCE

All states have a set of rules embodied in codes, statutes or court cases that represent the formal legal order. Besides this formal set of rules, there is a separate set of non-legal norms that also play a role in the governance of society. According to Lawrence Friedman, a legal system includes three basic components: (a) structural component, which means “the institutions themselves” such as courts; (b) substantive component, such as ‘laws themselves’ applied by the courts (both substantive and procedural); and (c) cultural component, which refers to “the values and attitudes that bind system together, and which determines the place of the legal system in the culture of the society as a whole.” Legal culture embodied in non-legal norms is most difficult to define, as it is not so visible and accessible compared to other two components.

Legal systems are embedded in particular cultures that have their own value systems. Non-legal norms are usually based on traditional ways of doing things in a society and rely on moral values, such as trust and reputation. In societies where values, language, meaning, traditions and customs are shared, non-legal norms based on personal relationships play a more prominent role. These norms may also play important role in determining the actual implementation of the formal legal rules. They may be of key importance for understanding the law in action, since they determine when, why, where and how people use law and legal institutions. As those norms are stronger and more important in a

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10. In the context of this text, the term “legal norms” is understood as legal rules and standards articulated through formal institutional processes by legislatures, courts and administrative agencies as opposed to the “non-legal norms” understood as rules that evolved through a social custom or tradition without being recognized as legal rules by formal institutions.
society, so will the implementation of formal legal rules be weaker and less effective.

Despite the various debates on comparative corporate governance, there have been remarkably few analyses of the role of non-legal norms in corporate law and practice. Many scholars writing about the legal aspect of Japanese corporate governance are aware of the cultural aspect but for various reasons have limited their analysis to the legal aspect only, or have only vaguely touched upon non-legal norms. The question that has not been sufficiently explored by the literature is: in what way do non-legal norms influence the corporate governance system of individual countries?

The Japanese model of corporate governance, on its surface, resembles many other models. Although there are several differences between the models of corporate governance of the United States and Japan, they still maintain the same basic structure. According to one leading Japanese legal scholar, the Japanese law resembles more the Anglo-Saxon shareholder-value model than the stakeholder model. However, this similarity is just in form. Behind the façade of legal norms that purport to regulate corporate governance, there exists the real world of corporate governance which is governed not only by legal norms, but also by non-legal norms that are in many respects far more important.

An analysis of the Japanese legal regulations of corporate governance, which would be separated from the social realities, is bound to fail in its attempt to fully understand the Japanese corporate governance system. It may only reveal the rules, but not their life in the real world of practice concerning how they are applied, and how they function and shape the Japanese corporate world.

The role of non-legal norms in corporate governance has recently attracted the attention of some legal scholars. Curtis Milhaupt's paper *The Evolution of Nonlegal Rules in Japanese Corporate Governance* is one of those few attempts focusing on the non-legal rules in Japanese

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Milhaupt focuses on non-legal norms—in the sense that they are features of Japanese corporate governance that are not based on law but play a very important role in corporate governance. This paper will look at the issues arising from the link between Japanese culture and Japanese corporate governance, but from a different perspective than Milhaupt, and will provide, in some cases, different conclusions. More specifically, this paper will attempt to explain the background of those non-legal norms, as well as provide a more detailed elaboration on the way they affect functioning of corporate governance in practice.

**CHARACTERISTICS OF THE JAPANESE MODEL**

Japan has adopted Western legal institutions since the Meiji period, but these institutions have not operated in the same manner as in the West. The legal form was adopted from the West, but the way of doing things maintained a distinctive Japanese flavor. Despite its “shareholder model” form, Japanese corporate governance is, in essence, much closer to the “stakeholder model” with particular attention being given to the protection of employees. The idea that companies should be managed dominantly in the interest of shareholders is in contradiction with the prevailing understanding of corporate governance in Japan. While capital is certainly important, the Japanese system gives greater importance to the labor and efforts of employees, since they play a crucial role in the development of a company. In fact, the company and its well-being are the central focus of the Japanese system, and the company comes before both shareholders and employees. So, maybe it is more accurate to say that Japanese system is focused more on the company, rather than on the employees.

The most typical features of the Japanese model of corporate governance include: the main bank system, cross-shareholding, long-term employment, and the close relationship between the business elite and the government. There are competing theories that attempt to

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16. There is a general consensus in the literature that the main bank, *keiretsu* and lifetime employment are the three central features of Japan's post-war system of corporate governance. However, two of the most prominent Japanese corporate governance scholars, Yoshiro Miwa and Mark Ramseyer, have recently published numerous articles and a book which suggest that all of the central features of Japanese corporate governance are “academic myths” (i.e., they do not exist). For an example, see YOSHIRO MIWA & J. MARK RAMSEYER, *THE FABLE OF KEIRETSU* (U. Chi. Press, 2006); Yoshiro Miwa & J. Mark Ramseyer, *The Myth of the Main Bank: Japan and Comparative Corporate Governance*, 27 LAW & SOC. INQUIRY 401 (2002). For a critique of Miwa and Ramseyer's contrarian research—which also supports the general view
explain the character of these features by relying on different rationales, such as economic, legal and political factors on one side, and culture on another. We shall use keiretsu, or cross-shareholding, and long-term employment as case studies to compare the arguments of these theories.

**Concept of Cross-Shareholding**

The structure of a large publicly traded company is traditionally characterized by cross-shareholding (keiretsu), referring to mutual shareholding through which a number of companies are interconnected in a network where each of them holds shares in the other companies. In addition, the shares are also held by banks, life-insurance companies, individual shareholders and foreign investors.

*Keiretsu* literally means “economic line-ups” and includes something more than what is just covered by the concept of cross-shareholding. *Keiretsu* is a structural arrangement of Japanese firms characterized by close business relationships intertwined with long-term commitments among members. There are various types of *keiretsu*, but the main type is the *keiretsu* corporate group (sometimes called “gurupu”), with the main bank at the center.

Normally, the shares held under these ongoing stable shareholding arrangements constitute the controlling portion of the firm’s shares. There is a mutual understanding between the companies that these shares are not to be traded, but to be kept as a safety mechanism. Member companies within a *keiretsu* offer each other preferential treatment in commercial and financial transactions. They may exchange information through the main bank and, in times of crisis, they are expected to help each other.

**Concept of keiretsu** is of crucial importance for understanding the Japanese model. The fact that most of Japanese large companies are taken in this paper that the central features of Japanese corporate governance do indeed exist—see Dan W. Puchniak, *A Skeptic’s Guide to Miwa and Ramseyer’s ‘The Fable of the Keiretsu,’* 12 J. JAPANESE LAW 273 (2007); Dan W. Puchniak, *Perverse Main Bank Rescue in the Lost Decade: Proof that Unique Institutional Incentives Drive Japanese Corporate Governance,* 16 FAC. RIM L. & POL’Y 13 (2007).

17. *Keiretsu* is the term usually used in the English literature to denote cross-shareholding. In Japanese, cross-shareholding is usually called “mochiai” or “kabushiki mochiai,” while the term “keiretsu” refers to the network of companies.

18. Six major *keiretsu* groups are Mitsui, Mitsubishi, Sumitomo, Fuyo, Dai Ichi Kingyo and Sanwa.


20. In Japan, a distinction is made between investment shareholding and mutual shareholding. The first one involves trading on the stock market, while the second means that shares are not traded but are used to cement the relationship and prevent takeovers.
owned by other companies and banks, which are also owned not by classic types of shareholders, but by other companies in the same keiretsu raises the question: who really owns these companies and banks? In a sense, private ownership as an essential ingredient of capitalism is lacking in the Japanese model.

**Concept of Long-Term Employment**

Long-term employment is another typical feature of the Japanese model. Under this system, which is not regulated by any particular law but is based on informal norms and practice, an employee is recruited directly from school or university and is expected to remain in the company’s employ for the length of his or her career. In return, he or she can expect not to be fired or discharged, except under some extraordinary circumstances. The basis of this agreement is the commitment of employers to provide secure employment to their employees in return for loyalty and “lifetime” service. The employer can rely on loyal employees and their dedication to work hard in exchange for the investment in their training. As a part of this system, the promotion of employees within the hierarchy of the company and the wages paid are based on the principle of seniority.

The mandatory retirement (teinen) system is an essential element of long-term employment. Historically, in the post-war period, the retirement age has been 55 years old. However, recent amendments to Japan’s labor law mandate that it now must be 60 or higher. Presently most companies fix the age of retirement between 60 and 65. This system typically applies to workers in major Japanese companies but is far less present in small companies.

Long-term employment does not mean a formal obligation of the company not to dismiss its employees, nor does it mean that the company does not dismiss employees as this happens in practice.

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22. John Haley, a leading Japanese law scholar, has recently expressed the view that Japan’s long-term employment system is the critical feature that defines Japanese corporate governance and makes it unique from other systems of corporate governance around the world. John O. Haley, Career Employment, Corporate Governance and Japanese Exceptionalism (Faculty Working Paper Series, Paper No. 04-04-01, 2004).

23. Act Concerning Stabilization of Employment of Older Persons, Law No. 103 of 2004), art. 8. This Act entered into force on April 1, 2006.

Rather, long-term employment should be understood in the sense that the company will not resort to layoffs unless it is in deep economic crisis and layoffs are the only possible way to keep the company afloat and prevent bankruptcy. Even in times of crisis, such as the oil shock crises, or more recently in the time of “lost decade,” companies used other mechanisms aimed at avoiding layoffs, such as the reduction of overtime and assigning employees to affiliated companies.

Long-term employment, in the sense of spending the whole career in the same company, is not really unique to Japan since such patterns exist in many other countries, as well. However, relying merely on the numbers and statistics to prove that the Japanese model is not different from other long-term employment patterns misses the point. The essence of the Japanese model of long-term employment is not in the numbers, but in its character. There are several elements of the long-term employment system that are typical for Japan, such as the way of recruiting graduates, seniority-based wages, internal transfers based on a rotation system and on-the-job training, which result in firm-specific skills, making it extremely difficult for employees to move to other firms. These features make Japanese long-term employment qualitatively different from the corresponding patterns in most other countries.

ECONOMIC THEORIES

Keiretsu as Protection Mechanism

Economic theories emphasize economic rationales, as well as legal and political factors, as being the key factors in establishing keiretsu. They point out the fact that individual shareholding decreased while the shareholding of financial institutions and corporations increased after the 1950s and particularly in the 1960s and 1970s. In the post-war period, individual shareholding fell from 69.1% in 1949 to 23.9% in 1986, while the ratio of shareholding by financial institutions increased from 9.9% in 1949 to 41.7% in 1986, and the ratio of shareholding by corporations


26. Practice of simultaneous recruiting of new graduates (shinsotsu-ikkatsu-saiyō) and the way of applying for jobs by the students (shūshoku katsudō) seem to be unique to Japan and S. Korea.

27. “Economic theories” is not really an appropriate term, since in this text the theories covered by this term also include theories that emphasize legal and political factors. This term is chosen as a matter of convenience to distinguish all other theories from the theories that emphasize cultural factors.
increased from 5.6% in 1949 to 24.5% in 1986.\textsuperscript{28} This trend was a result of the easing of restrictions on ownership of shares by financial institutions and corporations due to the revision of the Anti-Monopoly Act of 1947.\textsuperscript{29} After the initial period in the 1950’s, when the Anti-Monopoly Act of 1947 prohibited stockholding by companies, things radically changed in the 1960s. Japan became a member of the OECD in 1964, and one of the conditions for membership was the deregulation of its financial market. As the government relaxed the entry of foreign capital into the country, there was a growing concern about possible takeovers of Japanese companies by foreign companies.

As a response to the liberalization of the country’s markets, large Japanese corporations created a defense mechanism by establishing a stable shareholding system with the participation of “friendly companies.”\textsuperscript{30} Following these changes, the Commercial Code was revised to allow the issuance of new shares to companies, leading to the concentration of shareholdings in the hands of banks and corporations and the creation of \textit{keiretsu}, which contributed to the relatively stable and concentrated ownership structure of Japanese companies. Logically, this resulted in a substantial reduction of individual shareholdings as the shares became concentrated in a small group of financial organizations and corporations. Thus, the \textit{keiretsu} was made possible by government action which was behind the regulations allowing shareholdings by companies.

\textit{Long-Term Employment—Development of the Doctrine of Abusive Dismissal}

Economic theories dispute the cultural roots of long-term employment by pointing out the fact that it did not exist as a firmly established system in the time between the two World Wars. The origins of the long-term employment concept date from the early part of twentieth century, when it gradually developed as a business strategy to avoid the high fluctuation of workers that created difficulties for companies, particularly in key industries such as iron and steel.\textsuperscript{31} To

\textsuperscript{29} Act on Prohibition of Private Monopolization and Maintenance of Fair Trade, Law No. 54 of April 14, 1947.
\textsuperscript{31} Reiko Okayama, \textit{Industrial Relations in Great Britain and Japan from the 1880s to the 1920s, in Labor and Management, The International Conference on Business History} 207, 227 (Keiichiro Nakagawa ed., 1979).
solve that problem, companies started to offer incentives designed to encourage experienced workers to stay, such as increased wages based on seniority and hefty retirement allowances for long-term workers.\textsuperscript{32} An ideological justification for the long-term employment relationship developed afterwards, tying it to Confucian notions of reciprocal obligations. At the start, however, long-term employment was, in fact, a new strategy based on rational economic choice by employers.\textsuperscript{33} The system was first institutionalized only in the 1950s and became popular in the 1970s.\textsuperscript{34} The modern long-term employment system was allegedly designed as a result of a compromise entered into between management and unions aimed at overcoming existing labor problems, being a mutually beneficial bargain rather than as a solution imposed by social norms.\textsuperscript{35}

Long-term employment in its present form developed as a result of economic benefits. It contributed to a greater productivity that benefited both the shareholders and management through higher profits, as well as labor through greater employment security. It has also been argued that since long-term employment affects only a portion of employees and is not universal, it cannot be based on culture, because culture assumes a set of norms and practices that are universal.\textsuperscript{36}

Political factors also played a role in the development of long-term employment in Japan. The legal framework that developed during the same period and supported long-term employment was arguably based on a government policy that encouraged the long-term employment practice. The government supported lifetime employment because it contributed to reducing the tensions between employers and employees that in case of escalation could have caused problems to the peace and stability of the State.

In parallel with this development, at about the same time, the Japanese courts developed the doctrine of abusive dismissal. This new legal doctrine was present in a number of cases starting in 1950s, restricting the employer's power to dismiss employees.\textsuperscript{37} This development led legal scholars to emphasize the importance of

\begin{thebibliography}{9}
\bibitem{33} Id. at 159-60.
\bibitem{34} Id. at 153-60.
\bibitem{35} AOKI, supra note 28, at 3-43.
\bibitem{36} NOTTAGE, WOLFF & ANDERSON, supra note 1, at 63.
\end{thebibliography}
restrictions on termination of employment contracts under Japanese labor law as the factor that contributed to long-term employment.38

CULTURAL THEORIES

Keiretsu as Traditional Way of Doing Things

According to the cultural explanation, stable shareholding is related to the Japanese group mentality.39 The cross-shareholding system is deeply rooted in the Japanese group mentality because the Japanese feel more confident in dealing with people belonging to the same group, where trust serves as a bond which is considered to be more important than any legally binding obligation. As a result, Japanese firms have a tendency to “cluster themselves into groupings of affiliated companies that extend a broad spectrum of markets.”40

Cultural theories point out the parallel between the traditional village and the grouping of companies into larger groups of keiretsu with the appropriate subordinate system in which all companies are subordinated to their respective presidents (shacho).41 The traditional village represents a paradigm.42 In a traditional Japanese village, there was a strong bond connecting all the people, and they maintained long-term mutual relationships. For those people, “it was inconceivable to live outside [their village].”43 The sense of depending on each other as members of the community ensures mutual loyalty and provides a sense of security to the members.

Similar considerations exist in the case of keiretsu. If one company has difficulties, it is likely to be assisted by other companies from the same keiretsu (the same as the villagers would help each other in case of calamities); more powerful companies are expected to support smaller ones. The sense of obligation towards the company may be linked with the sense of belonging to a family and the responsibility towards one’s

38. MIWA & RAMSEYER, supra note 16, at 159.
41. Horie, supra note 39, at 1-16.
43. RYUSHI IWATA, JAPANESE STYLE MANAGEMENT: ITS FOUNDATIONS AND PROSPECTS 54 (1982).
own family.\textsuperscript{44} In the same sense, \textit{keiretsu} also represents a kind of family with members that feel close to each other. In this sense, \textit{keiretsu} is not purely an economic concept but a cultural one, as well.

\textit{Long-Term Employment—Company as Family}

In contradiction to economic theories which deny the existence of long-term employment in Japanese tradition, cultural theories rely on the argument that long-term employment, in fact, has its roots in Japanese history. The kinship-based economic unit was established in the Tokugawa period and provided the basis for the long-term employment system, seniority-based status, which became the basis of the modern system of employment in Japan.\textsuperscript{45} In the Tokugawa period, Japanese business entities functioned like family businesses even when the employer would hire outsiders to manage them.\textsuperscript{46} The employees were expected to show loyalty and dedication to the \textit{ie} so that its name would be preserved—"... the employees were trained from their boyhood to serve the \textit{ie} (meaning 'home'), and were expected to climb up the ladder beginning from \textit{detchi} (丁稚—apprentice), through \textit{tedai} (手代—assistant manager), to \textit{banto} (番頭—manager)."\textsuperscript{47} This represented the foundation of long-term employment based on seniority and loyalty to the company.

Japanese corporate culture is often described as a family system, in the sense that the Japanese company is based on the principles of a traditional family. The seeds of this family concept of companies are deeply rooted in Japanese culture, based on obedience, hierarchy and loyalty which all make up important elements of Japanese culture.\textsuperscript{48} Originally, the Confucian ethic of the group was typically applied to relationships in a family, which are traditionally lifetime relationships. The group concept was extended to the traditional \textit{ie} and later on to the firm. \textit{Ie} was abolished as a legal unit by revisions of the Civil Code


\textsuperscript{45} Tokugawa period is a division in Japanese history during which Japan was ruled by shoguns of the Tokugawa family from 1603 to 1868.

\textsuperscript{46} Yoshikawa, \textit{supra} note 44, at 62.


made after World War II. Nevertheless, the concept of ie still exists as an informal norm of the social structure in Japan. Japanese employees often refer to their companies as "uchi" (home) to describe the company where they work.

According to cultural theories, the kaisha (company) symbolizes the organization where people are not united by contractual relationships, but it includes an element of association resembling that of a family. Of course, the kaisha provides income that enables the employees to support themselves and their families, but it also involves an emotional linkage which may also exist in the West, but usually not so deeply rooted as in Japan. "The company is the people" is a common saying in Japan. By characterizing itself as a family unit, the company has achieved a greater level of loyalty between management and employees. Each employee has an attachment to the company as "my company" (uchi no kaisha), so that all of the employees, in a sense, represent the company. If someone does something wrong, there will normally be solidarity between the employees who will try to protect him or her, because what was done was done for the company.

The relationship between an employer and an employee is based on the hierarchical order in line with Confucian teachings. In return for the employees' loyalty and devotion to their duties, the employer is expected to treat them with benevolence. It has been recognized that devotion to the community plays a key role in suppressing individual desires for the common welfare of the group.

Culturalist theories argue that one of the main features of Japanese industrial relations is the identification of employees with the company, related to a group mentality and the need of employees for a sense of

51. CHIE NAKANE, JAPANESE SOCIETY 3 (1973).
52. There has been a substantial number of cover-ups by Japanese companies aimed at protecting their employees. The Mitsubishi cover-up affair was one of the largest corporate scandals in Japanese history. In 2000 it was revealed that one of the Japanese giants, Mitsubishi Motors Corp., had suppressed complaints made by consumers to avoid massive and expensive recalls. Mitsubishi was forced to admit a systematic cover up of defect problems in its vehicles. In 1995 one of Daiwa Bank's bond traders, Toshihide Iguchi, in New York lost $1.1 billion speculating in the bond market. The company was later indicted for not reporting crimes by Iguchi including unauthorized sales of clients' securities to cover losses.
belonging to a peer group. Working in a company is considered to be a part of one’s identity, and by moving to another company, a person feels deprived of an important part of his or her identity. It is often said in Japan that an employee chooses a company, not a profession. Entry into the company is viewed as “being born again into another family.” Personal interrelationships give a feeling of belonging to a group (nakama ishiki) and security to the individual, but they may also result in a feeling of dependence. Community in Japan may be best understood in terms of mutual interdependency and a shared sense of belonging to a community or group. The Japanese people even evaluate each other on the basis of the group they are affiliated with, making them very sensitive about the reputation and prestige of their group.

DUALISM OF LEGAL AND NON-LEGAL NORMS IN JAPAN

The co-existence of non-legal and legal norms emphasizes the confusion and requires that both sets of rules be taken into account simultaneously. In Japan, as well as in some other Asian nations influenced by Confucianism, there is a stronger emphasis on community interests at the expense of individual ones, and more importance is given to moral norms at the expense of legal norms. Regulations of corporate governance represent, to a certain extent, just the façade behind which there exists a world that has its own life and logic far removed from its outside appearance. Consequently, there are two sets of rules in Japan that have co-existed for more than a century, such as the legal system imported from the West and the traditional rules.

ROLE OF LEGAL NORMS

The way in which corporate governance functions in Japan raises the issue of the role of law in Japan, and specifically corporate law. By giving dominant importance to the role of social norms, cultural theories implicitly downplay the importance of law within the society. There is a

55. NAKANE, supra note 51, at 11.
56. ABEGGLEN & STALK, supra note 21, at 200.
57. Sankei Shimada, the executive director of Nissho Iwai Trading Company who committed suicide following Douglas-Graman affair, wrote the famous note before leaping from the building to his death: “The life of the company is eternal. For that immortality we must sacrifice ourselves.”
58. For example, China, S. Korea, Singapore, and Vietnam.
view that law is largely irrelevant to the social and economic organization in Japan. Some scholars even doubt that legal reforms can be effective due to social and cultural constraints.

In contrast, the majority of scholars attach great importance to the role of law. The increase of derivative suits in Japan has been used as an illustration of the relevance of law within the country. The sudden increase in shareholder derivative suits almost immediately after a reduction in the filing fees in the early 1990s, as noted by Mark West, illustrates the importance of these legal rules.

The argument that the number of derivative suits has substantially increased after the lowering of court fees has strong persuasive force. However, this argument should be taken with some reservations. A logical question that may be asked is: would the number of derivative suits be equally high if the court fees were equally low when the law on derivative suits was enacted? The answer might be "no," because the issue of the litigation rate is too complex to be explained by relying only on the amount of court fees. Litigation rates were traditionally low in Japan, and only in recent decades has there been an increase in Japan's litigation rate without changes in the court fees.

This example, which is emphasized as evidence that the law matters, can be seen from the opposite perspective—that the law does not play a very important role and that the rise of derivative suits has received so much scholarly attention because it is a deviation from the norm. In any case, the increase in derivative suits can be at least an illustration of a possible change in traditional attitudes towards law.

The role of law in Japan has not been so visible during a long period despite its existence on the books. Derivative suits remained dormant for several decades after being introduced into Japanese corporate law, despite the fact that many opportunities for such suits existed in response

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61. Philip Lochner, Corporate Japan: Beginning of a New Era, Columbia Conference held on March 23, 2001 (quoted in id. at 198).

62. Between 1950 and 1990 there were fewer than twenty derivative suits. Since the fee for filing derivative suits was reduced by law to the modest amount of 8,000 yen, there has been a huge increase of derivative suits. By the end of 1999, there were 286 derivative suits, ninety-nine of which were filed in 1999 alone.


to various managerial abuses. Similarly, securities laws existed but were not often used in practice, despite widespread insider trading practices and market abuses. Antitrust laws existed but did little to prevent widespread bid-rigging and cartels. The legal infrastructure for hostile takeovers existed, although not well developed, but Japan has remained largely free of hostile takeovers. Recently, however, there have been many court cases concerning hostile takeovers (in terms of proxy fights, inspection of target company’s books, selling out dissenting shares at a fair value, etc). These examples of extended stagnation illustrate the fact that legal transplants need certain time to take root in a new environment.

Despite some skepticism, there should be no doubt that the law plays a very important role in modern Japan. All modern societies are law-driven societies whether they use statutes, decrees, ordinances, administrative guidelines, or whatever. Japan is not an exception. If the law did not matter, why would Japanese legislators spend so much time and energy in revising something that was not relevant? It can be argued that the functioning of corporate governance depends more on practices

65. In contrast to a low rate of general crimes, in Japan there has been a long list of corporate crimes. Here are just a few illustrations: Yamaichi Shoken collapsed in 1997 because of off-the-book debts (“tobashi”), a technique for hiding losses. In one of the largest corporate scandals in Japanese history, in 2000 it was revealed that one of the Japanese giants, Mitsubishi Motors Corp., had suppressed complaints made by consumers to avoid massive and expensive recalls. In 1995, one of Daiwa Bank’s traders, Toshihide Iguchi, in New York lost $1.1 billion speculating in the bond market. Typically, these corporate crimes were not motivated by greediness of managers but by a desire to protect one’s company.

66. Insider Trading Spike Linked to Close Confidants, KYODO NEWS (Sept. 4, 2010), http://search.japantimes.co.jp/cgi-bin/nb20100904a2.html.

67. As of 2008, thirteen lawsuits were still pending over 1990s bid rigging for local government contracts to supply incinerator plants: Builders Settle Damages Suit Over Bid-Rigging, KYODO NEWS (Apr. 4, 2009), http://search.japantimes.co.jp/cgi-bin/nn20090404a6.html.

68. Puchniak claims that there has not been a single successful hostile-takeover bid in the post-war period. Puchniak, The Efficiency of Friendliness, supra note 12, at 195.

69. The greatest attention attracted the famous “Livedoor” case—Nippon Hoso K.K. v. Raibudoa K.K., Appeal from Injunction Against Issuance of Warrants, Tokyo Koto Saibansho [Tokyo High Ct.] Mar. 23, 2005, 1173 HANREI TAIMUZU [HANTA] 125 (Japan). In this case, the court ordered the provisional injunction against the issuance of stock-acquisition rights to a third party, for the reason that the relevant takeover action was not found to be abusive. Another important case was Steel Partners Japan Strategic Fund (Offshore), L.P. v. Bull-Dog Sauce Co., Ltd., 1809 SHOJI HOMU 16 (Sup. Ct., Aug. 7, 2007). In this case, the court recognized that almost all shareholders other than the acquirer had judged that the acquisition of control by the acquirer would be detrimental to the company’s interests and thus the shareholder interests, and affirmed the implementation of the takeover-defense measure.

than on legal rules. On the other hand, even if not vigorously enforced in all situations, the law has an important persuasive effect. The law, itself, cannot change things immediately, but its existence is still important for creating a legal framework that will legitimize one kind of behavior and prohibit others.

Non-legal norms weaken and are replaced by legal norms as a society becomes socially, economically and culturally more advanced. That has already happened in Japan, and this process of change will continue.

ROLE OF NON-LEGAL NORMS

To understand accurately Japanese corporate governance, it is critical to understand the way in which non-legal norms impact the practice of corporate governance. Reasons rooted in the Japanese culture lie behind the way Japan has integrated foreign legal concepts, including those related to corporate governance, such as the separation between ownership and management, the organization of the firm and the way in which management functions. These concepts cannot be fully understood if observed in isolation from the larger context of Japanese social norms.

Long-term employment may be used as an illustration of this notion. One of the explanations for the development of long-term employment is that it is based on economic efficiency. Puchniak in his unpublished doctoral dissertation argued that “(D)espite a myriad of partial explanations for lifetime employment, the most powerful and straightforward explanation for its emergence and longevity has largely been overlooked: lifetime simply makes economic sense.” 71 However, if this is the case, why do we not find such a system in any other country in the West? After all, economic-efficiency theory is normally presumed to be universally applicable. Puchniak’s argument that “lifetime makes economic sense” makes sense in the case of Japan but not at the universal level.

According to Milhaupt, “corporate norms may be the product of interest group dynamics.” 72 This is one possible explanation which has some explanatory weight behind it. However, Milhaupt’s explanation is incomplete as it fails to address why such norms arise in Japan, and whether the emergence of norms such as those related to long-term employment would be possible, for example, in the United States. If yes,

then why is there a lack of such norms in the United States, at least in comparison to their prominence in Japan? If not, then why do such norms exist in Japan and not in the United States? The most persuasive answer to these questions can be found in theories that emphasize the importance of Japan’s social norms. The fact that similar patterns of long-term employment have developed in different situations and under different circumstances indicates the existence of some integrating factor that played a role in the structuring of this system in Japan. Such patterns have not developed in most other parts of the world, at least not in the form this system existed and exists in Japan, which explains the difference.

Social values may influence the choice of particular corporate structures and legal rules out of a larger menu. Those values are deeply embedded in people’s minds and social institutions. As a result, practices that are compatible with social preferences in other areas are more likely to work smoothly in a particular society.

Non-legal norms often play a more significant role in Japanese corporate governance than do formal legal rules. Even though the non-legal norms did not play a direct role in the process of creating cross-shareholding and long-term employment, they certainly had an influence in the process of their acceptance and integration in the Japanese economic model. The nature of cross-shareholding and the long-term employment system are perfectly congruent with Japanese social values, even if concepts were adopted on account of other considerations. The concept of long-term employment and the way it operates are familiar to employees based on their experiences and education outside the company. So, they tend to easily adjust to their new environment due to the well known patterns of conduct that they are accustomed to. In a similar way, cross-shareholding corresponds to the traditional patterns of cooperation in Japan. The fact that the cross-shareholding and the long-term employment system solution perfectly suit the Japanese traditional social norms only enhanced their successful implementation and functioning in practice.

Cultural theories discussing the influence of non-legal norms usually emphasize the importance of Confucianism. However, this argument should be taken with some reservation. Some scholars argue that Confucianism in Japan was used by the Japanese elite as a kind of “cultural engineering” for manipulation and social control to promote the

goals of the elite. According to this view, the metaphor of *kaisha* as a family may have been used to create a sense of family relationship among employees, while the actual reason for this "familistic rhetoric," used in a wider context of a "family state," was to enhance managerial power. Use of the concept of *ie* was aimed at creating an image of culture based on relationships and concealing the real reasons. This kind of argument is more relevant for determining how the culture can be influenced, than how culture actually affects the business environment. Even if these patterns developed as result of a cultural engineering, the cultural explanation still has some weight. The question that can be asked is: why was such cultural engineering not successful or attempted in Western countries, but was successful in South Korea, which shares a similar culture with Japan?\(^77\)

The role of non-legal norms in shaping the Japanese economic model should not be overestimated. Particularly, the theories that emphasize Japanese uniqueness (so-called 'Nihonjinron' theories) should be taken with a grain of salt.\(^78\) While the factor of culture is certainly important in explaining different patterns of behavior, it is also critical not to overstate its importance and to avoid stereotypes.

**DISCREPANCY BETWEEN LEGAL AND NON-LEGAL NORMS**

The formal legal structure governing Japanese corporate governance is similar to the formal legal structure in many other jurisdictions. In Japan, however, there is a substantial gap between legal norms and actual practice.\(^79\) This is a constant in Japan—the formal structure is adopted and then adjusted to the Japanese way of doing things, which continues to function parallel to the formal system.

Examples of this discrepancy between form and practice can be seen in the way of the functioning of general shareholders meetings and the board of directors ("BOD")—both of which demonstrate some idiosyncratic, culturally based features of Japanese corporate governance. The way the BOD and general shareholders' meetings function deviates significantly from the formal rules that regulate them. Under the law, the BOD is charged with monitoring corporate activities

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76. **VAN WOLFEREN, supra** note 48, at 16.
and is vested with the authority to make important managerial decisions. In practice, however, the BOD has not played this role, particularly with regard to the monitoring function. One of the key features (and problems) of corporate governance in Japan is that the BOD is dominated by the very same executives who are in charge of the day-to-day operations of the company. Obviously, this kind of supervision has a flaw, as it makes no sense if the monitors are those same persons that are to be monitored.

Similarly, despite formally being a supreme organ of the company, shareholders' meetings have been relegated in practice to merely formal rituals. Very few shareholders actually attend the meetings. Many shareholders' meetings in Japan typically take less than thirty minutes to present business and financial reports, approve the distribution of profits and elect new directors and auditors. Such general meetings of shareholders often represent just ceremonies of formality and public approval of decisions that have already been made in informal fora.

In order to understand the way of functioning of the company management, it is necessary to understand the process of making decisions and the role of informal ways of decision-making. In Japan, the formal processes are rigid and top-down, involving a kind of ritual formality with importance given to seals, and do not allow much deviation from the established rules. On the other hand, the informal processes are far more flexible and have a very different logic, with great importance given to consensus and collective participation in making a decision. The efforts made to achieve consensus and avoid disputes are incorporated in the way decisions are made. This informal way of making decisions through various forms of meetings and communications is based on personal relations rather than on formal ways of communication. As result, the decisions are often not made at the general meetings of shareholders or the BOD, but at informal places.

Within the keiretsu system there is usually a group of presidents of corporations who make up the so-called “shacho-kai” (Presidents Club), an informal organ which meets regularly. Shacho-kai is an important venue for fostering ties among the companies belonging to the same keiretsu. These meetings have, to a certain extent, a mysterious character since the outsiders do not know what goes on at these meetings, no notes are taken, and no statements are made officially after those meetings. Due to the lack of information, there can be various speculations about the importance of those meetings. Based on available information

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81. Examples include: Mitsubishi Kinyo Kai, Sumitomo—Hakusui Kai, Mitsui—Nimoku Kai, Fuji—Fuyo Kai, and Sanwa—Sansui Kai.
obtained from practitioners, a number of corporate groups, such as Mitsui and Mitsubishi still hold "shacho-kai" regularly to exchange information and strengthen their relationships. Apparently, these bodies never function as a decision-making organ of group companies, though there are differences in the way they function in different corporate groups.

Another important informal body that seems to play an important role in the decision making process is jomukai. Jomukai can be translated as a "meeting of managing directors" and is aimed at supporting the BOD. A few senior directors acting as jomukai or a similar informal management committee actually have the ultimate decision-making power in a company. Decisions made by such bodies are usually final, and the confirmation of such decisions at the meetings of the BOD is purely a formality to satisfy formal requirements. Although these meetings are not a part of Japan's formal corporate governance structure, they serve in practice as an important informal body that discusses the general corporate policy and strategy of the corporation.

This contradiction between legal and non-legal norms in practice reduces, to a certain extent, the power of the formal organs of the company as the real power is exercised in informal ways, largely outside of those organs. If the general meetings of shareholders and the BOD are formally in charge of making key decisions for a company, but decisions are, in fact, being made by the informal bodies and only formally approved by the general meetings of shareholders, then these informal bodies actually represent institutions that are in many respects more relevant than the BOD and the general meetings of shareholders.

The contradiction mentioned above should be taken into account when the issue of convergence is discussed. Gilson makes a distinction between a convergence in form and a functional convergence of corporate governance.$^{82}$ According to him, each system of corporate governance is able to find functional equivalence without formal convergence. Gilson argues that corporate governance will be subject to functional convergence even without a formal convergence of legal rules.$^{83}$ This can be seen from a completely opposite perspective—that there can be a formal convergence without a functional convergence. Japan is a typical example. The choice of an American model does not mean functional convergence, but only a formal one. The legal reforms brought about a formal convergence of rules, while the practices have

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83. See id. at 338.
remained quite different. Those practices are determined dominantly by
the non-legal norms in clear contrast to the legal norms thereby
demonstrating a functional divergence.

PRESENT TENDENCIES

In present Japanese corporate governance, some trends can be
identified as a result of a number of factors, such as social changes,
economic recession, and legislative actions. These are visible in all areas
related to corporate governance.

Keiretsu

The decline of cross-shareholding in Japan seems to have stopped,
and its demise will probably not happen anytime soon. The keiretsu
system may not change significantly, though some changes have
occurred within the system. While banks have reduced their
shareholdings in the companies, the keiretsu will probably retain its
"safety level" that makes hostile takeovers difficult. Although banks
may not be able to re-establish their participation in cross-shareholding,
such obstacles do not exist in the case of firms, and they have been active
in re-establishing "stable shareholdings." According to a Bloomberg
columnist, "the old practice of cross-shareholdings between companies
and takeover defenses made a roaring comeback" as defensive
mechanisms against hostile takeovers, though the level of cross-
shareholding, even after the increase, was still bellow its bubble peak.

These new trends, however, are mainly a result of the interests of
certain actors, rather than being influenced by the social norms. The
main reason for this revival is the fear of hostile takeovers that increased
after the deregulation of mergers and acquisitions in Japan. The new
Corporation Law of 2005 allowed foreign companies some flexibility in
acquiring Japanese target companies by acquiring the company's
shares. However, implementation of the new law was delayed for a
year due to opposition from Japanese companies which feared that the
merger-and-acquisition provisions of the new law might allow hostile

84. William Pesek, Japan 2008 May Put Science Fiction to Shame, BLOOMBERG,
aZluNeKsDOQ&refer=columnist_pesek. On the recent resurgence of cross-
shareholding, see Keisuke Nitta, On the Resurgence of Cross-Shareholding—Data from
the Fiscal 2008 Survey of Corporate Ownership Structure, available at http://www.nli-
According to Nitta, the recent resurgence of cross-shareholding is almost exclusively
result of actions by business firms, while banks remained passive (p. 5-6).
85. 会社法, Law No. 86/2005.
takeovers of Japanese companies by foreign firms. Eventually, these provisions became effective on May 1, 2007, despite the opposition. 86

With respect to ownership structure, they have probably been the most visible changes that have occurred. The shareholdings of banks and insurance companies that have been traditionally management-friendly have substantially declined in the last two decades. 87 During the same period, foreign shareholdings have substantially increased, though more recently some downward trends were also reported. 88

**Long-Term Employment**

After the collapse of the bubble economy in the 1990s, long-term employment has come under pressure as a result of economic recession. Economic decline required Japanese companies to be more flexible in hiring and firing employees than the traditional system allowed. Many companies have decided to lay off a substantial number of employees in the process of restructuring companies while, in the same period, the number of part-time employees has substantially increased. 89 In fact, the largest difference in long-term employment in the last ten years has been the increase in part-time employees. 90 Since Japan has always had part-time employees in large companies, this is a change in scale and not in form.

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87. Stock ownership by banks declined to 4.9% in 2009, from 15.1% in 1997. In the same period stock ownership by financial institutions declined to 32.4% from 41.9%. However, a slight reverse trend is noticeable in the last few years. See generally Tokyo Stock Exchange, *Fact Book*, p. 64 (2010), available at http://www.tse.or.jp/english/market/data/factbook/b7gie60000003o32-att/fact_book_2010.pdf (last visited Feb. 7, 2010).
88. According to Tokyo Stock Exchange *Fact Book*, supra note 87, foreign shareholding in 2009 was 23.6%, down from 28% in 2007. Nitta, *supra* note 84, provides information indicating that after the Lehman collapse in September 2008, there has been a substantial decline of foreign institutional shareholding (from 14.1% in fiscal 2007 to 11.82% in fiscal 2008).
89. According to the Statistics Bureau of the Ministry for Internal Affairs and Communication figures, there were 33.55 million or 65.7% regular employees in Japan in 2010, while non-regular employees numbered 17.55 million, or 34.3% of the total. See Table 1-1 Employee Excluding Executive of Company or Corporation by Type of Employment, http://www.stat.go.jp/english/data/roudoulzuhyou/edt011.xls.
90. The key characteristic of part-time employment in Japan is the fact that the employee is not a regular employee, regardless of the number of working hours. Part-time employees are often hired by a fixed term contract, and they are disposable according to the fluctuation of business. The same is true of other fixed-term employees (often called “kikan-jugyo’in” or “keiyaku-shain”) who may work full time but are definitely non-regular workers.
It has been repeatedly argued that long-term employment is disappearing, or even that it does not exist anymore.\textsuperscript{91} Despite such claims, many employees still believe today that they are employed for the rest of their working life at their company unless something goes very wrong. Although employment customs are said to be changing, there is still a pervasive belief that it is only really morally acceptable to resort to layoffs when the company faces bankruptcy. This informal understanding has been supported in a number of court cases.\textsuperscript{92} Recently some large listed companies have even gradually switched back to traditional long-term employment. This new tendency might be part of the change of corporate strategies regarding human resources, taking into account failure in the merit system.

Although the economy will probably further suffer as a consequence of the global financial crisis that started in 2008, it is unlikely that the long-term system will be abandoned, though it may be further modified. Employment practices will probably remain one important segment of the Japanese model of corporate governance that has not converged with the American model, and it is not likely to converge in the foreseeable future.

\textit{Legal Reform of Corporate Governance}

A sweeping reform of Japanese corporate-governance laws was introduced in 2002. There are several important changes that have been introduced in the existing corporate management structure.\textsuperscript{93} Most of the debate on reforms has revolved around the clash between the American model, which is geared towards placing primary importance on shareholders and relying on external control, and the traditional Japanese model, which is primarily a stakeholder model based on internal control. Under the new Corporation Law which entered into force in May 2006, taking the Company Law outside the Commercial Code,\textsuperscript{94} Japanese corporations are given the option to select from two distinct corporate governance regimes—the Reformed Large Corporation, based on conventional Japanese model, and the New Type Company with committees with an executive officer ("CEO"), based on the American

\begin{footnotes}
\item[91] See Wolff, \textit{supra} note 25.
\item[94] 会社法, Law No. 86/2005.
\end{footnotes}
The biggest innovation was the establishment of a totally new governance structure known as the "Committee System," which was viewed by some scholars as a sign of the Americanization of Japanese corporate governance.96

Outside directors have been in the centre of discussion and legal reforms as an attempt aimed at the improvement of monitoring. The Tokyo Stock Exchange ("TSE") has also regulated participation of independent directors. TSE Securities Listing Regulations (as of March, 2010) by Rule 436-2 provide for obligations of the companies listed at TSE to ensure at least one independent director/auditor (meaning an outside director/auditor prescribed in Article 2(15) and Article 2(16) of the Corporation Law of 2005, respectively) who is unlikely to have conflicts of interest with shareholders.97 Since the TSE Rules leave the choice between directors and auditors, majority companies have opted to appoint auditors, who are not typically independent. The report of the TSE, based on notifications on appointment of independent directors/auditors, published on July 21, 2010, shows that out of the listed companies which submitted ID/A notifications and had already secured ID/A(s), 10.6% submitted notifications containing only independent directors, 70.7% contained only independent auditors, and 18.7% contained both independent directors and auditors. So, the TSE Rules on independent directors/auditors, which declared better protection of shareholders as its goal, seem to be just another façade in the Japanese corporate governance system, as the main goal of having independently minded persons that would protect shareholders is compromised by allowing companies to appoint auditors who are not necessarily independent.

Hostile takeovers were also the subject of legal reforms. In 2005 the Ministry of Economy, Trade and Industry and the Ministry of Justice issued the "Guidelines Regarding Takeover Defense for the Purpose of Protection and Enhancement of Corporate Value and Shareholders’

95. Article 2 of the new Corporation Law provides (Definitions): (10) “Corporation with a Board of Auditors” shall mean a kabushiki kaisha which has established a Board of Auditors or a kabushiki kaisha in which the establishment of a Board of Auditors is required based on the provisions of this Law; (12) “Corporation with Committees” shall mean a kabushiki kaisha which has established a nomination committee, an audit committee and a compensation committee [hereinafter “the committees”].


Common Interests,” aimed at creating rules for takeover defenses. The Guidelines give specific examples of defenses, along with conditions governing their use. In principle, defenses are legitimate if they serve the interest of shareholders, and not if their goal is merely to secure the position of incumbent management. The Guidelines were clearly influenced by American law. However, the way the rules on hostile takeovers function is also determined by business and legal infrastructure, which is quite different between the United States and Japan: the relationship between shareholders and management is very different, the status of independent directors who may play a key role in any hostile takeover attempts is also very different, as well as the role of the courts. It remains to be seen how Japanese courts will cope with this challenging issue.

For the moment, the corporate-governance reforms have not led to radical changes in the board, the presence of outside directors has not yet been adopted as a standard, and stock options and hostile takeovers are still a rarity in Japan. Meetings of shareholders, however, have become more serious, indicating a greater readiness to accommodate the interests of shareholders. There is a growing tendency of individual shareholders attending the annual meetings and becoming more active at those meetings, often asking questions. Asset-management companies and trust banks were more active at this year’s annual shareholders’ meetings by voting against the management proposals. At average, 15% of the management proposals were voted against, in comparison with 10% last year. Those proposals included retirement allowances to directors, nomination of management and proposals for issue of warrants aimed as protection device against hostile takeovers. As a result, the duration of the meetings have also become longer, and in June 2010 the average duration of annual meetings was fifty minutes—seventeen minutes longer than in June 1999.

It is still premature to make predictions about the impact of legal reforms of corporate governance in Japan. Time will tell whether the


99. See Puchniak, supra note 11 at 195.

100. 「株主総会、15％に反対票」 (日本経済新聞・9/24/2010) (at the Annual Meetings of Shareholders, 15% voted against) (Nihon Keizai Shinbun September, 24, 2010).

101. See id.

102. See id.
present legal reforms will end up in failure, just a “formal convergence” without substantially changing the way of doing things, or whether they will bring substantial changes.

FACTORS OF CHANGE

When discussing reasons that lie behind the changes in the Japanese corporate-governance system, several challenging questions may be raised. Why has Japanese corporate governance remained stagnant in the postwar period until the 1980s, and why have legal norms that have been dormant for about forty years suddenly started to be applied? Have the Japanese courts and judges suddenly become aware of the tools they have had in their hands for almost forty years, but have never resorted to using? What is the impact of economic decline on the legal reforms? To answer these questions it is necessary to identify the relevant social, political, economic and legal factors that play a role in these changes.

Social Factors

In recent years, the informal practices of corporate governance based on non-legal norms came under pressure as a result of globalization, which brought about various changes in the Japanese business and social environment. Japan has been gradually transformed, especially in the urban portion of society and among the younger generation, which is naturally more inclined to accept changes and foreign influences. Younger Japanese have ideas about their careers that are different from those of their parents. They are less committed to long-term employment and are more likely to change companies if others offer better conditions. In the process of restructuring, employees and managers have gradually adjusted to the previously painful experiences brought about by mergers. This also indicates the gradual modernization of Japanese society from being family- and group-oriented towards an individual-oriented society that gradually adopts Western standards.

The attitude of the Japanese towards law has also been changing for the past several decades. At the time many legal reforms were being introduced, the readiness to use those legal norms was still lacking. Over

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103. The identification with the company was one cause of the problems with mergers in Japan, and difficulties in full integration between two companies. Dai-Ichi Bank and Nihon Kangyo Bank, which formed Dai-Ichi Kangyo Bank, is often quoted as an illustration of those difficulties, since employees of these two banks continued to identify themselves with their original banks long after the merger and the banks continued to have two separate branches operating side-by-side under the same roof.

time, things have changed as a result of the globalization process at the international level, and the urbanization of Japan at the national level, which resulted in the weakening of social ties in society and a more open attitude to the changes that were coming from the outside world. In particular, after the 1970s, the Japanese became increasingly ready and willing to resort to law as an instrument for dispute resolution. This can be seen from the increase in the number of cases litigated. The relevance of non-legal norms may be decreasing, corresponding to the increased role of the law in Japanese society.

The appearance of some shareholder activists, such as Takafumi Horie (known as "Horiemon"), the founder of Livedor corporation, and Yoshiaki Murakami, an outspoken investment fund manager, is an illustration of the change of attitudes within Japan. Both of them were in the center of a number of highly publicized stories, such as the attempt at a hostile takeover of NBS (Nippon Broadcasting System), which represented a sign of departing from the traditional and accepting the new ways of doing things.

Some non-profit organizations are also active in promoting reforms of corporate governance. One such organization is the Kabunushi (Shareholders) Ombudsman ("KO") which is comprised of lawyers, accountants, academics and shareholders. It aims to reform Japanese management practices to incorporate the views of all shareholders in Japanese companies. In addition, one part of large business also showed readiness to embrace new ways of doing things. A notable example is Sony, which introduced its Shikkoyakuin (Executive Officer) system in 1997 that served as a model for the New Type Company. More recently, there are signs that Japan’s real estate investment trusts (J-REIT) may also become active players in takeovers.

**Political Factors**

The Japanese version of capitalism is, to a certain extent, similar to the planned economy, a kind of controlled capitalism with industrial
policy as an important tool for directing development. In theory, the Japanese model has been described as a "developmental state."\textsuperscript{110} It is based on partnership between politicians, bureaucrats and businesspersons, which is often termed the "iron triangle," comprising big business, the ruling political party, and the bureaucracy. The Diet is considered an extension of the bureaucracy, and Japan is sometimes referred to as a "government of administration" rather than a government of laws.\textsuperscript{111} Some segments of the Japanese government, particularly the Ministry of Finance and the Ministry of Trade and Industry, play active roles in regulating and monitoring the Japanese corporate world. This demonstrates the important role of the political factors in the Japanese economic model.

While in the post-War period, the American corporate governance model was imposed on Japan; in subsequent periods, the Japanese actors designed independently the corporate governance policy. This task was carried out not only by regulating and monitoring activities, but also by exercising influence on the way the regulations are implemented in practice.

As Japan was improving its economic performance, particularly since the 1970s, there was a return to "wakon-yosai" rhetoric in a new form—nihonjinron. These new theories, which were officially endorsed by the Nakasone Government in the 1980s, emphasized Japanese specificity uniqueness as a positive model for a Japanese road towards modernity and its global outreach.\textsuperscript{112} While the key elements of the Japanese corporate governance were, in fact, based on a rational choice, they were given a cultural explanation.\textsuperscript{113} This kind of cultural nationalism may be explained by a huge economic success of Japan at that time, which boosted the Japanese pride.

After Japan entered into the so-called 'lost decade' (which turned to be lost decades), political rhetoric changed. In the 1990s, kaikaku (reform) became the new keyword.\textsuperscript{114} Most comprehensive legal reforms of corporate governance were carried out during the mandate of the Prime Minister Koizumi (2001-2006), who supported the idea of embracing the American model, which was supposed to go in parallel

\textsuperscript{110} "Developmental state" is a term used by political-economy scholars to refer to the phenomenon of state-led macroeconomic planning in East Asia in the late twentieth century.


\textsuperscript{112} See Dale, supra note 78, at 213.


\textsuperscript{114} See id. at 32.
with deregulating the corporate sector based on the ideology of neoliberalism.

Things have changed again after defeat of the Liberal Democratic Party ("LDP") in the elections held in 2009. The Democratic Party of Japan ("DPJ") won the elections by using new rhetoric based on social justice and deploring the ideas of "market fundamentalism" promoted by the previous Government. The DPJ introduced several reforms which were based on a stronger social-welfare policy. Some recent developments, such as the Japan Post's offer of permanent employment to 65,000 of its part-time employees, indicate that long-term employment may have a comeback under the new Government. However, the popularity of the DPJ has started to fall already in 2010, resulting in its rather poor performance in elections held in July 2010. These developments on the Japanese political scene will continue to play an important role in designing legal reforms, including those affecting corporate governance.

Economic Factors

There have also been important changes in some economic factors, mainly as result of economic decline. The traditional features of the Japanese corporate model - the keiretsu, the main bank system and long-term employment - all suffered setbacks as a result of the prolonged economic crisis. The shareholdings of stable shareholders significantly declined in the 1990s, while foreign shareholdings increased. Faced with the problem of bad debts, a number of banks had to dispose of substantial parts of their shareholdings. This has affected the monitoring process in companies, so that the monitoring function of shareholders may become stronger as a replacement for the reduced role of the banks as monitors. The crisis has also affected the long-term employment system, so now the Japanese people have learned to live with the new reality where there is no strong guarantee of long-term employment. Economic decline was one of the key factors that pushed legal reforms since 1990s and is likely to continue to do so.

Legal factors

The role of law is becoming more prominent alongside the process of globalization and modernization of Japanese society. Legal reforms relating to Japanese corporate governance have been numerous and often comprehensive, affecting many aspects of corporate governance. Most reforms in Japan have been motivated by the need to change the existing practices. The main factor in the recent reforms was the need for overcoming the economic decline that has continued for over a decade.

The experience with legal reforms in Japan has shown that even if the reforms do not bring immediate changes, they may still bring results at a later stage. Law often serves as a complement rather than a substitute for non-legal norms. That is a sign of a gradual process of reform of a society, which enables a smooth transition from a society governed by social norms towards society governed by legal norms.

An important step towards a greater role of law in Japan has been the establishment of the Justice System Reform Council in 2001. The Council recommended substantial reforms to the Japanese legal system, including changes in legal education and increases in the number of lawyers. As a result of such reforms, it may be expected that the law will play an increasingly important role in coming years.

LIMITATION FACTORS

In Japan, a common opinion is that there is much reform but not much transformation. The impression is that Japanese legislators have undertaken reforms as a kind of fashion in order to show that they make efforts to restructure the existing system to make it more efficient. The extent and effect of these reforms seems to be designed in a way to adjust the existing model in order to preserve it rather than to subject it to a substantial change. Some legal reforms in Japan had only a symbolic effect, while others brought changes only many years after they were introduced. Cultural barriers often posed obstacles or delayed actual change, particularly when cultural factors were aligned with the interests of the business elite. This can be viewed from a different perspective that cultural arguments were used as rhetoric to mask the actual interests of the business elite that opposed the changes.

Despite comprehensive legal reforms, traditional patterns endure, and the fundamental elements of Japanese corporate governance have not changed.117 It is very difficult to implement legal reforms that would transform the stakeholder model into a shareholders model. The social role of corporations is too deeply rooted to be easily changed. Large

117. Haley, supra note 3.
corporations continue to be controlled by the managers who effectively prevent shareholders from exercising control over them. On the other hand, the shareholders traditionally do not show much ambition to interfere with the job of managers.

One of the key elements of the Japanese corporate governance reforms is the introduction of outside directors. Outside directors, however, failed to play a substantial role in monitoring. While outside directors are seen as a potentially powerful new element of monitoring, such expectations may prove to be too optimistic. It makes little sense to have outside directors who are not really independent and have no real power to influence the decision-making processes. Some companies may decide to incorporate outside directors precisely because they do not consider them to be a threat to the management power. On the other hand, having outside directors may be useful to attract institutional shareholders from the US or the UK, as they feel more comfortable to invest in the companies that have outside directors.

Japanese companies may find it difficult to integrate outside directors, at least in the initial period. It is unlikely that Japanese companies will adopt a system in which outside directors will play the dominant role. This would be contrary to Japanese corporate culture, which is inherently biased against the presence of outsiders given the tradition of board members having longstanding and close personal relationships with each other. The opposition to outside directors is, in fact, motivated by the interests of the business elite rather than being determined by cultural factors, even though such attitude fits cultural patterns towards outsiders. Why would powerful senior managers adopt a system that would reduce their power by placing some key decisions under the authority of outside directors? The importance of this aspect of Japanese business culture may prove to be a stumbling block for a system of external control based on outside directors. 118

The opposition to comprehensive reforms that would impose a stricter control over management was obvious during recent legal reforms. The logical question is then: why were Japanese companies given an option to adopt the New Type Company, rather than it being imposed as a mandatory requirement? The flexibility offered by Japanese reforms can be attributed to powerful industry groups led by Keidanren, which supported greater discretion of the management and opposed the initiative for stricter monitoring of management. During the

118. This is illustrated by the extremely small percentage of Japanese companies that have adopted the US-style board structure—which requires a minimum of two outside directors, see Puchniak, supra note 12, at 256-57. See also Peter Lawley, Panacea or Placebo? An Empirical Analysis of the Effect of the Japanese Committee System Corporate Governance Law Reform, 9 ASIAN-PAC. L. & POL’Y J. 105, 112 (2007).
process of adoption of the new Corporation Law, Hiroshi Okuda, the Chairman of Toyota, who also served as the Chairman of Keidanren, expressed a view that reforms in Toyota should go in the direction of strengthening internal control, rather than introducing outside control. Fujio Mitarai, the President of Canon, who replaced Okuda as the Chairman of Keidanren, held identical views, taking the stance that Canon does not need outside directors to achieve more efficient management.

The importance of this attitude of the major part of the business elite should not be underestimated, and it may pose a serious obstacle to more comprehensive changes within the country. Additionally, the harsh court sentences handed to T. Horie and Y. Murakami in 2007 raised questions about the reasons behind the Japanese court’s attitude, which is usually lenient in the case of corporate crimes. These sentences might be interpreted as a warning for those who consider challenging the traditional ways of doing things.

Legal reforms have had a limited impact so far and have not substantially changed existing business practices in Japan. Analysis of the legal reforms made in Japan indicates that, despite adopting some elements of the American corporate-governance system, Japan has retained the most important features of its traditional model. The firm continues to be controlled by its top management, while shareholders are still deprived of effective mechanisms of control over the corporation, so not many things have really changed in practice. No legal reform can easily change the traditional ways of doing things, such as nemawashi. Then, how can the Japanese model converge with the American one when the process of making decisions remains quite divergent? These informal ways are deeply rooted in the Japanese way of doing things and cannot be changed overnight through legislation.

One possible explanation of the slow adoption of legal transplants in the case of Japan and some other countries in East Asia is that the Western law is based on concepts that are, to a great extent, alien to the traditional norms of those societies. This issue is beyond the scope of this paper, but a basic explanation might be helpful for better understanding of the issues discussed here. The main features of

119. See TOYOTA, ANNUAL REPORT (2003) at 32.
120. In order to realize a more streamlined and efficient management decision-making process, Canon has not adopted an outside director system. See CANON, ANNUAL REPORT 6 (2004).
121. T. Horie was found guilty of falsifying the company’s accounts and misleading investors and was sentenced to a two-year, six-month sentence: http://search.japantimes.co.jp/cgi-bin/mn20070319a1.html. Y. Murakami, was sentenced to two years in prison for insider stock trading: http://search.japantimes.co.jp/cgi-bin/nb20070720a1.html.
Western culture that influenced its legal culture are individualism and rationalism. Individualism means that the personal autonomy and rights of individuals must be protected, often against the larger group, the State and society. This idea is in fundamental contradiction with the idea of collectivism and submission of an individual to the community, which is typical for Confucian philosophy. Under the concept of rationalism, conduct of the people should be governed by the rule of reason, meaning an objective standard of conduct based on reality and usefulness. In the Japanese context, rationalism has a different meaning and is related to “giri”—a kind of obligation that arises from a social interaction with other persons. As a consequence of these differences, transplantation of Western law to the Japanese society resulted in a legal system that functioned in Japan in a different way than its Western model.

In societies where social norms are strong, top-down legal reforms must be done very carefully in order to not cause damage to well-functioning markets. In order for real change to occur, there should be a consensus in society that those informal ways are outdated and an agreement on the need to start a new way of doing things. So far, no such consensus and agreement have been achieved in Japan. This has been demonstrated by the contents of the amendments to the Special Act to the Commercial Code (*Shoho-tokurei-ho*) in 2002, which allowed two models of company to exist in parallel; when a consensus cannot be achieved, a compromise is used.

A note of caution is needed when legal norms and principles, as applied in one country, are transplanted into the legal system of another. People often wrongly assume that “if rules are made to resemble each other something significant by way of rapprochement has been accomplished.” In order to have an effective legal transplant, the law has to fit well in the new environment, so that it can be absorbed by the society and implemented into practice. Otherwise, the so-called “transplant effect” may be expected, which means that the law transplanted in this way would not be widely used, at least in the initial period.

**POSSIBLE FUTURE DIRECTIONS**

Japanese attitudes are likely to change as society becomes increasingly commercialized and exposed to the globalization process.

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122. For a detailed explanation of *giri*, see YOSHIKI NODA, INTRODUCTION TO JAPANESE LAW 174-83 (University of Tokyo Press, 1976). See also MERYLL DEAN, JAPANESE LEGAL SYSTEM 17-20 (Cavendish Publishing Ltd., 2002).

Although significant changes in values and attitudes are likely to happen slowly, they carry a potential for change that may undermine the traditional ways of doing things in Japan.

The family-like company will probably continue to exist in Japan, but this kind of concept of a company will most likely become weaker as a result of new trends, including the changing social values and attitudes of the Japanese people. Social changes do not, however, necessarily mean that the informal norms and structures will disappear. In reality, they persist, and no substantial changes have occurred so far.

Increased foreign shareholding needs careful consideration - will it lead to more control over management? While this development may contain a potential for change, it is premature to make predictions. A substantial part of foreign shareholdings is, in fact, in the hands of institutional shareholders who do not show much interest for active participation in management. They would have to join hands with local Japanese shareholders in order to be able to have an impact, and this may not be an easy task.

Probably no substantial change in the direction of the American model will happen as long as the main features of the Japanese business culture remain unchanged. It is unlikely that a majority of Japanese companies will adopt the American model company, and even those companies that have adopted it may soon realize that such a model may not be effective when operating within the traditional Japanese business environment. There will be some adjustments to the Japanese model, but those will probably be more "cosmetic" than radical.

Despite the persistence being demonstrated by the traditional and informal ways of doing things in Japan, it would be misleading to believe that the Japanese corporate culture remains static and inflexible. Over the years, there have been gradual changes aimed at meeting the new trends and challenges brought about by the globalization process and the rapidly changing environment. The changes introduced by the new legal reforms are significant, but the companies may need some time to digest those changes and make necessary adjustments.

Japanese corporate governance may need to make further and real adjustments in order to attract more foreign investors. Companies may, eventually, become increasingly exposed to the impact of the market and may not be able to afford to keep excess employees. As a result, instead of long-term, profit-oriented governance, the short-term governance aimed at improving value of shares may become more important to companies.

Japanese corporate governance is changing in a significant and often unpredictable way. Uncertainty is more about the extent and pace of changes, rather than whether the changes are necessary and in what
direction the changes will lead the Japanese corporate model. Based on
the assessment of various factors of change analyzed above, it can be
expected that in the coming years, the non-legal norms will gradually
weaken at the expense of the increased importance that will be given to
the formal legal norms.

CONCLUSION

Legal regulation of corporate governance in the post-war period in
Japan has been continuously influenced by the American model. In the
same period, the way it functioned in practice significantly deviated from
the American model. This divergence between the legal norms and their
implementation in practice remained largely outside debate on the
Japanese corporate governance.

Discussions on both divergence and convergence usually focus on
legal rules. But such focus is often misplaced because legal rules are
only one segment of a legal system. The law plays a crucial role in
designing the Japanese corporate governance system, but the role of law
cannot be fully understood without considering the social and
institutional aspect of a national legal system, particularly the role of
non-legal norms.

Developments in corporate governance in Japan are too complex to
be explained by a single factor. This author takes a middle way by
recognizing the relevance of cultural, economic, legal and political
factors as major determinants that have shaped Japanese corporate
governance—Japanese corporate governance can be properly understood
only by giving adequate attention to all relevant factors. While economic
interests may have been the driving force behind the adoption of some of
the key features of Japanese corporate governance, such as cross-
shareholding and lifetime employment, they were accepted by all
relevant actors and integrated well in the Japanese corporate world
because those features were well suited for Japanese ways of doing
things. Full understanding of the interaction between social norms on
one hand and economic, legal and political factors on the other hand is
key for understanding the Japanese model; any approach limited to only
certain of these factors could be misleading and incomplete.

An issue that is open to discussion is to what extent the Japanese
legal system has converged on the Western models.124 There is no doubt
that progress has been made in that direction. However, this does not

124. The existence of Western models has been questioned, as corporate governance
models in the West are also undergoing significant changes. See Dan Puchniak, The
Japanization of American Corporate Governance? Evidence of the Never-Ending History
of Corporate Law, 9 ASIAN-PAC. L & POL’Y J. 7 (2007).
mean that, today, the law in Japan plays an identical role as in the West. In the case of corporate governance, a number of issues have to be examined in order to make a proper assessment. For example, do the BOD and Meeting of Shareholders perform their functions in the same way as in the West? Do they strictly follow legal norms, or are they still under the influence of informal bodies and practices, such as *jomukai* and *nemawashi*? Have *keiretsu* and the Japanese pattern of long-term employment ceased to be important features of the Japanese corporate governance? Until clear evidence is produced that such informal bodies and practices have ceased to play an important role in the Japanese corporate governance, the argument that the Japanese model operates in the same way as the West’s will remain questionable.

When discussing the relationship between legal and non-legal norms in the context of changes, one of the key questions is how to measure changes in law and practice. The assumption that the legal model is identical with the actual model used in practice might be wrong. There is a contrast between the law-driven Western model and the relationship-driven Japanese model. Instead of focusing on changes in law, it may be more appropriate to consider changes in actual practice and changes in social norms. But this kind of change may also be more difficult to evaluate. Another difficult task would be to evaluate the link between changes in law and changes in practice. So, it is not surprising that there are substantial differences in opinion about the actual effect of legal reforms on Japanese corporate governance.

Another question is whether, behind the facade of Westernization, Japan had undergone any kind of significant transformation and whether it has accepted the idea of law and justice as they are understood in the West. It can be argued that there is friction between the imported Western legal system on one hand and traditional Japanese morals and values on the other, but it may not be as strong as believed by many foreigners. Japan has made a successful merger of Western concepts of law while preserving its own traditional values. After all, Japan is known for its skills to adopt foreign models and adjust them to its needs.

The corporate model before the newest reforms looked like many Western models; but behind that facade, the actual way of functioning of that model was very much based on the Japanese way of doing things. While the globalization process has an impact on Japanese society and the attitudes of Japanese people, some distinctly different Japanese attitudes will continue to exist. Time will show whether behind the new facade there is also a real change, or if it is just a new facade covering the traditional way of doing things.
Modernizing Latin American Company Law: Creating an All-Purpose Vehicle for Closely Held Business Entities—The New Simplified Stock Corporation*

Francisco Reyes**

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* In the original: Sociedad por Acciones Simplificada or SAS

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I. INTRODUCTION

The wave of corporate governance reforms that has permeated all of the systems of Latin America has not significantly impacted the legislation applicable to closely held companies. This appears to be a misdirected approach since the region’s economic reality is characterized by family control and concentrated ownership. Surprisingly, most legal reforms in this field have targeted agency problems more commonly arising in the context of dispersed equity ownership models. Corporate governance reforms such as mandatory independent directors, auditing committees, and certification of financial statements have become commonplace in securities regulations across the region.\(^1\) Albeit important in improving the legal framework of listed companies, most of these legal reforms disregard the basic underlying agency problem between controlling shareholders and their minority counterparts. Regulatory provisions for non-listed firms impose severe restrictions on private ordering and prevent parties from contracting around cumbersome imperative norms. In fact, provisions concerning all aspects of corporate governance, minority shareholders’ rights, structural changes, mergers, dissolution, and liquidation are overwhelming.\(^2\) These suboptimal anachronistic approaches are justified on the grounds of public policy and defended at any cost by local legal operators.

Company law in most Latin American jurisdictions continues to follow the taxonomy of business associations inherited from the nineteenth century’s French codification movement. The point of

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1. See Colombian Law 964 of 2005 on Securities Regulation; Argentina, Decree 677 of 2001; Brazil, Law No. 10.303 of 2001; Chile, and Law 18.046 of 1981.
2. See Section 224 of Law 6404 of the Brazilian Corporation Law of 1976 and Section 1.036 of the Brazilian Civil Code (Law 10.406 of January 10 of 2002); Sections 223 and 240 of the Mexican General Law of Commercial Companies (Law of August 4\(^{st}\) of 1934) (LGSM); Sections 83, 110 of Law 19.550 of 1972 of Argentina; and Sections 158 and 173 of the Commercial Code of Colombia (Decree 410 of 1971), which provide, for example, the following:

Partners’ board meetings or assembly shall approve with the quorum provided by the by-laws for mergers, or otherwise an early dissolution, the respective undertaking which should cover: 1. The reason for the proposed merger and the manner in which it will take place; 2. Data and figures, taken from the accounting books of the parties involved, which would have served as the basis to determine the conditions of the merger; 3. Breakdown and evaluation of the assets and liabilities of the companies to be absorbed and those of the absorbing concern; 4. An annex explaining the methods for the appraisal and exchange of interests, quotas or shares the transaction will involve; 5. Certified copies of the general financial statements of the contracting parties.

(Colombian Commercial Code of 1971).
departure for these systems can be found in the *Code Civil* and *Code de Commerce* of 1804 and 1807, in which the basic types of companies were included. With the exception of the closely held company (*sociedad de responsabilidad limitada*), the basic business forms already existed in those codes. Accordingly, most countries in the region have regulated four basic types of business associations: (1) Stock corporations (*sociedades anónimas*); (2) Partnerships (*sociedades colectivas*); (3) Limited partnerships (*sociedades en comandita*); and (4) Closely held companies (*sociedades de responsabilidad limitada*). Such business forms generally lack the necessary flexibility to cope with new economic realities due to obsolescence and rigidity. New hybrid business forms, such as the US LLC and LLP appear to be an appealing solution to deal with closely held firms in the region. However, attempts to undertake legal reform in this field must follow a structural transplant approach; namely, it cannot be restricted to the simple adoption of substantive law provisions.

This article is intended to provide an analytical framework for the adoption of a hybrid business form as a model law for closely held firms in Latin America. It is suggested that the advantages of flexibility and freedom of contract make such business forms especially suitable for family-owned firms, start-ups, professional undertakings, and all sorts of small and medium firms within this region.

The introduction, in December 2008, of the *Sociedad por Acciones Simplificada* or SAS (Colombian Simplified Stock Corporation) is an example of a successful, efficiency-minded lawmaking effort in a Civil Law jurisdiction. The SAS is aimed at providing its users with flexibility in its organization and capitalization, complete freedom of contract, and full-fledged limited liability. The Colombian example proves that even in the absence of competition for corporate charters, it is possible to undertake structural transplants of company law with extraordinary results. The enthusiasm with which entrepreneurs have greeted the new legal development is reflected in the high number of

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3. The “SRL” was introduced in Brazil after the Portuguese “sociedade por quotas” of 1905. The same type of business entity was brought to other Latin American countries after the enactment of the Spanish statute of 1927.

4. For a detailed analysis of the main traits of Latin American business forms, see José W. Fernández et al., *Corporate Caveat Emptor: Minority Shareholder Rights in Mexico, Chile, Brazil, Venezuela and Argentina*, 32 U. MIAMI INTER-AM. L. REV. 157 (2001).

5. See Portafolio Economic Journal, *Ventajas de las SAS seducen a empresarios; 82% de las empresas creadas en septiembre fue bajo esta modalidad*, Bogota, Feb. 10, 2010, available at http://www.portafolio.com.co/archivo/documento/DR-4389 (showing that during the last several months, most business people preferred the simplified stock corporation to set up their new companies in Colombia).

SAS formations that occurred after its inception. Within the first twenty-four months after the statute was passed, more than 54,000 simplified stock corporations were created, outnumbering every other form of business association.7

II. PROPOSALS FOR LATIN AMERICAN COMPANY LAW REFORM

A. Publicly Held Corporations

As a general rule, economic growth can be assessed through the measurement of capital market development and the creation of new businesses. However, Robert Cooter has written that a vigorous stock market is not necessarily an essential factor for the economic development of poor countries.8 Using specific examples from economies in transition such as India and China, the author points to the significant growth attained in those countries within the last decade. In determining the manner in which financing has taken place in these jurisdictions, he has noted the relative absence of highly operational systems for publicly traded stocks.9

A brief review of statistical data regarding stock exchanges in Latin America reveals how the stock markets are comparatively depressed as compared with those existing in developed economies (see Table 1). The amount of IPOs and other public offerings is limited, the market capitalization of listed companies is relatively small as a percentage of gross domestic product ("GDP") (see Table 2), and the number of issuers of securities is small.

Under the international benchmark method, a comparison is made between GDPs for the six largest economies in Latin America and market capitalization in each of their national stock exchanges.

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9. Id.
## Table 1: Number of Listed Corporation Per Million Inhabitants

<table>
<thead>
<tr>
<th>Position</th>
<th>Country</th>
<th>Number of listed companies</th>
<th>Population</th>
<th>No. of listed corporations per million inhabitants</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Chile</td>
<td>246</td>
<td>16.134.219</td>
<td>15,24709687</td>
</tr>
<tr>
<td>2.</td>
<td>Perú</td>
<td>221</td>
<td>28.302.603</td>
<td>8,691780046</td>
</tr>
<tr>
<td>3.</td>
<td>Argentina</td>
<td>106</td>
<td>40.927.301</td>
<td>6,010657776</td>
</tr>
<tr>
<td>4.</td>
<td>Colombia</td>
<td>94</td>
<td>44.593.035</td>
<td>5,516565656</td>
</tr>
<tr>
<td>5.</td>
<td>México</td>
<td>335</td>
<td>107.449.525</td>
<td>2,289447068</td>
</tr>
<tr>
<td>6.</td>
<td>Brazil</td>
<td>350</td>
<td>190.078.227</td>
<td>1,294203991</td>
</tr>
</tbody>
</table>

## Table 2: Percentage of GDP Made Up by Market Capitalization

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Chile</td>
<td>246</td>
<td>146.437.000.000</td>
<td>174.000.000.000</td>
<td>119%</td>
</tr>
<tr>
<td>2.</td>
<td>Brazil</td>
<td>350</td>
<td>1.067.472.000.000</td>
<td>710.000.000.000</td>
<td>67%</td>
</tr>
<tr>
<td>3.</td>
<td>Perú</td>
<td>221</td>
<td>92.416.000.000</td>
<td>40.000.000.000</td>
<td>43%</td>
</tr>
<tr>
<td>4.</td>
<td>México</td>
<td>335</td>
<td>839.182.000.000</td>
<td>348.000.000.000</td>
<td>41%</td>
</tr>
<tr>
<td>5.</td>
<td>Colombia</td>
<td>94</td>
<td>153.405.000.000</td>
<td>56.000.000.000</td>
<td>37%</td>
</tr>
<tr>
<td>6.</td>
<td>Argentina</td>
<td>106</td>
<td>214.241.000.000</td>
<td>51.000.000.000</td>
<td>24%</td>
</tr>
</tbody>
</table>

There appears to be an unfortunate coincidence between the wave of corporate-governance reform and the significant decrease in the number of listed firms in all major Latin American jurisdictions (see Table 3, showing the number of firms listed in Latin American domestic stock exchanges). Aside from other macroeconomic factors, a hypothesis can be ventured regarding the increasing costs of compliance (mostly due to multiple requirements of a formalistic nature) without a consistent impact on investor confidence. Therefore, the cost of capital may not have been reduced for publicly held firms.
These data suggest that a listing may not entail a significant reduction in the cost of capital or, worse yet, other factors such as tax evasion (which would have to be reduced after listing due to higher disclosure requirements) represent a negative incentive to list a corporation in a Latin American stock market. Furthermore, the analysis of these and other variables may suggest the reasonableness of shifting the corporate-law agenda towards the improvement of the legal framework for closely held corporations instead of devoting additional resources to the development of a publicly held corporation, the future of which is at best uncertain.

B. Closely Held Corporations

As a general rule, there is no significant innovation regarding closely held corporation statutes in the Latin American region. Outmoded notions such as the lack of single-member companies, a strict ultra vires doctrine, a fixed term of duration, the existence of several formalistic prohibitions supposedly aimed at the protection of shareholders, and a plethora of regulatory provisions better suited for publicly held entities than for small and medium family businesses, are only a few of the features characterizing an anachronistic regime that needs to be reformed.

Probably, the Colombian system in which corporate-law reform has been underway for the last fifteen years, could be a good example of a
shifting from the rigidities of an ancien régime\textsuperscript{10} such as the one described above to a reform agenda prioritizing flexibility, contractual freedom and limited liability. The goals advanced in the recent 2008 act introducing the simplified stock corporation (sociedad por acciones simplificada) match the contemporary policy agenda which gives prevalence to the so-called hybrid business forms, also known as unincorporations.\textsuperscript{11} The adaptability of hybrid business forms which can be used as all-purpose vehicles has led to their introduction in Common Law and Civil Law jurisdictions around the world.\textsuperscript{12}

III. THE MODEL ACT ON SIMPLIFIED STOCK CORPORATIONS FOR LATIN AMERICA

The case for developing new business forms is a strong one in Latin America. Family-owned businesses and closely held companies abound in the region, creating significant demand for entities that allow parties to engage in extensive private ordering. Existing business forms have proven to be inflexible to suit the needs of family-owned and multi-owner firms. However, most Latin American legislators—much like some of their European counterparts—have been reluctant to develop new hybrid vehicles. Increasing entrepreneurial demand for reform has only recently spurred several initiatives within the region. Such statutory enhancements are currently being outmatched by the introduction of a new business form: the Sociedad por Acciones Simplificada (SAS) or Simplified Stock Corporation.\textsuperscript{13} Even though it draws upon the French Société par Actions Simplifiée, this entity closely resembles the hybrid business entities that have been set in place in the United States and the United Kingdom during the last several years. By providing a mixture of corporate and partnership-like components, the SAS allows for significant contractual flexibility, while still preserving the benefits of limited liability and asset partitioning.

\textsuperscript{10} Since the enactment of Law 222 of 1995 (Official Gazette N. 42.156 of December 20\textsuperscript{th} of 1995), concepts such as the single member enterprise were introduced in that countries’ legislation. Additional statutes such as Laws 1014 of 2006 (Official Gazette N.46.164 of January 27\textsuperscript{th} of 2006), 1258 of 2008 (Official Gazette N.47.194 of December 5\textsuperscript{th} of 2008) and 1429 of 2010 (Official Gazette N.47.937 of December 29\textsuperscript{th} of 2010) have continued the flexibilization process.

\textsuperscript{11} See draft legislation for the Colombian SAS, prepared by the author in 2006 and that gave rise to the Colombian law on simplified stock corporations, see Official Gazette N.11, Bogotá, April 11, 2007, at 1-6.


\textsuperscript{13} See Colombian Law 1258 of 2008.
The basic framework for the SAS's Model Act is based upon the following five pillars: (i) Full-fledged limited liability; (ii) Simple incorporation requirements; (iii) Contractual flexibility; (iv) Supple organizational structure; and (v) Fiscal transparency.\(^\text{14}\)

The Model Act on Simplified Stock Corporations for Latin America—crafted after the Colombian example—is not intended to serve as a partial amendment to be introduced to traditional business forms regulated in national codes and statutes.\(^\text{15}\) Instead, it is recommended that its enactment take place on a separate legislation that could be linked to the existing system.\(^\text{16}\) In this manner, the SAS should have to compete with other types of business forms.

A. Flexibility to Regulate Shareholder Relationships

Under the simplified stock corporation model, shareholders acquire broad flexibility to freely regulate their relationships pursuant to a set of enabling provisions containing off-the-rack housekeeping rules that parties can opt out of and replace for tailor-made provisions, if needed.\(^\text{17}\) Therefore, shareholder protection can be achieved through devices of a contractual nature. In this manner, the antagonism between majority and minority shareholders may be ameliorated through \textit{ex ante} negotiations. Agency costs can also be reduced as shareholders are able to satisfy their contracting interests, by setting up specific provisions on the corporate documents. For this purpose, the model act not only proposes enabling provisions but also enhances the enforceability of shareholders' agreements. Through the latter device, it is possible to reach certain equilibrium between stockholders by means of sophisticated mechanisms in which rights and obligations can be crafted to carefully determine \textit{a priori} expectations of all corporate participants. Therefore, clauses setting up drag along or tag along rights, put and call options and buy-out agreements can be included in shareholders agreements. Following the

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15. Such as Commercial Codes and Corporate Law statutes existing in different countries in this region.


17. See \textit{e.g.}, \textit{Model Act on the Simplified Stock Corporation}, § 17, \textit{infra} Annex (stating that "Shareholders may freely organize the structure and operation of a simplified stock corporation in the by-laws. In the absence of specific provisions to this effect, the shareholders' assembly or the sole shareholder, as the case may be, will be entitled to exercise all powers legally granted to the shareholders' assemblies of stock corporations, whilst the management and representation of the simplified stock corporation shall be granted to the legal representative").
incomplete contracts theory, this enhanced freedom of contract complemented by gap-filling through an efficient adjudication process is intended to provide an improved conflict-resolution scenario for shareholders.¹⁸

B. Introduction of Specific Performance

In accordance with the theory of structural transplants,¹⁹ the remedy of specific performance is introduced to allow for the adequate enforcement of these agreements in the event of default. Furthermore, the Model Act incorporates a comprehensive regulation on the abus de droit (abuse of rights) theory, which is extrapolated from the French jurisprudence on Corporate Law.²⁰

Under this theory, shareholders have the ability to bring judicial actions or arbitration complaints, not only on the grounds of abuses of controlling shareholders, but also concerning the same conduct where it has been deployed by minority shareholders, and also in the event of an abuse in symmetrical block shareholdings (i.e., dual ownership on a 50%-50% distribution).²¹ The abuse-of-right action may give rise to damages for the aggrieved party, as well as rescission of the abusive act. Fiduciary duties of care and loyalty can also be applicable to the officers and directors of the SAS. To complete the scenario of corporate-law protections, the Model Act allows for the application of the shadow director doctrine, by means of which any person who intrudes in a positive management activity, without being a legally appointed manager or director, can be disciplined under fiduciary duties as if she were acting in such managerial capacity.²²


¹⁹. Such a concept implies that it is not sufficient for the importation of a rule to merely incorporate into the borrowing country the substantive principles or provisions that work properly in the foreign lending jurisdiction. Along with such substantive norms it is also necessary to incorporate the rules (procedural or otherwise) and factors that cause such provisions to operate properly, including all circumstances that determine its efficiency and enforceability. See Katharina Pistor & Chenguang Xu, Fiduciary Duty in Transitional Civil Law Jurisdictions: Lessons from the Incomplete Law Theory, in GLOBAL MARKETS, DOMESTIC INSTITUTIONS: CORPORATE LAW AND GOVERNANCE IN A NEW ERA OF CROSS-BORDER DEALS 77 (Curtis J. Milhaupt ed., 2003).


²¹. Id.

²². See MODEL ACT ON THE SIMPLIFIED STOCK CORPORATION, § 27, 1, infra Annex (“Any individual or legal entity who is not a manager or director of a simplified stock corporation that engages in any trade or activity related to the management, direction or operation of such corporation shall be subject to the same liabilities applicable to directors and officers of the corporation.”)
C. Piercing the Corporate Veil to Extend Liability to Controlling Shareholder

Even if limited liability is one of the main features of the SAS, the Model Act provides for piercing the corporate veil in order to extend liability to controlling shareholders in the event of fraud or abuse.\(^\text{23}\) Such a procedure has to be brought before a specialized jurisdiction or an arbitration panel that will guarantee a more technical and expedited resolution for aggrieved creditors, as compared to the ordinary systems of adjudication which are handled before civil courts.\(^\text{24}\)

The SAS is as useful for local businessmen as it is for foreign investors. The Model Act seeks to remedy the legislative void existing throughout the region concerning hybrid business forms, as well as reducing transaction costs and providing entrepreneurs with enough flexibility to allow for private ordering in a multi-functional business form, suitable for all kinds of undertakings.\(^\text{25}\)

IV. Specific Aspects of the SAS Model Act

The enabling nature of most of the SAS provisions is particularly relevant, due to the parties' ability to freely draft any clauses that may allow them to neutralize the sort of agency problems that usually characterize non-listed firms.\(^\text{26}\) By exercising this significant contractual freedom, shareholders can stay away from standardized corporate contracts. In this manner, creativity and innovation concerning new corporate structures may be fostered.

A. Nature and Legal Personality

In the first place, the SAS is a business entity that may be created either by the execution of a contract or through the subscription of an
incorporation document by the sole shareholder. 27 This feature is intended to provide investors with a high level of flexibility. The business entity is suitable either for the formation of small, single member corporations or large, multi-owner enterprises including entities forming part of corporate groups. The SAS can be used in any venture, irrespective of the number of shareholders that concur to incorporate it or who subscribe shares at a subsequent stage. 28 In fact, neither the entrance nor the exit of stockholders can affect the continuity of the corporate entity, as long as one person remains as a shareholder. In this way, the antiquated rules setting forth minimum and maximum numbers of shareholders are surpassed completely.

The legal personification of the SAS is produced once the document of incorporation (private or public deed) is filed before the Mercantile Registry. Registration of the simplified corporation has a “constitutive” nature, since it determines the regularity of the business association, the benefits arising from asset partitioning, and limited liability. The SAS is designed to be registered online. Therefore, notarizations and other annoying formalities are altogether surpassed in the SAS scheme.

It is necessary to emphasize that the SAS is not conceived to be listed in a stock market. The SAS is a business association type designed to structure closely held companies. The broad contractual flexibility that allows providing for rules concerning the squeeze out of shareholders, stocks with multiple voting rights, severe restrictions on stock transfers, among others, may be incompatible with the investor protection guidelines that are mandated for listed companies. For the same reasons, the French SAS statute does not allow the possibility of raising resources originating from private savings in the stock market (appellation publique à l’épargne). 29

B. Incorporation and Proof of Existence

The Model Act indicates how the SAS may arise out of a contract or a unilateral act. 30 This approach is intended to supersede the old-fashioned discussion, so frequent in Latin America and even in Continental European countries, concerning the so-called one-person corporation. This significant improvement is immensely useful for structuring corporate groups where total corporate control may be centralized in a single parent corporation.

27. See MODEL ACT, supra note 5, § 5; see also id., infra Annex.
28. Id.
30. See MODEL ACT, supra note 25, §§ 5 & 6; see also id., infra Annex.
Among other things, the Model Act intends to reduce administrative and bureaucratic procedures and formalities necessary for the incorporation of a company. The corresponding provisions are aimed at reducing entry barriers in order to facilitate the creation of new businesses and mitigate the impact of transaction costs. Accordingly, the required procedure to set up a SAS has been reduced to the filing of the formation document in the country’s mercantile registry. Section 5 of the Model Act states that a simplified stock corporation “will be formed by contract or by the individual will of a single shareholder, provided that a written document is granted.” Pursuant to the same provision, the formation document “shall be registered before the Mercantile Registry.”

The SAS Model Act authorizes the parties to set up an unrestricted corporate purpose. (I would say “any lawful purpose.”) This approach is found to be more convenient due to efficiency considerations. Such a characteristic determines a meaningful difference in the economic conception of the stock corporation. Within the unrestricted purpose clause system, managers obtain a higher degree of discretionary authority to run the corporation. There is no need to amend the corporation’s by-laws every time that a new, different business opportunity arises.

It is true that broadening the scope of business activities that the corporation can carry on ameliorates the impact of the ultra vires theory which has permeated most Latin American jurisdictions. Indeed, the traditional “specialty theory,” by means of which the partners have to define ex restricted objects in the foundational documents, has also led to complicated and protracted litigation. The corollary of such specialty theory is closely linked with “ultra vires” concerns, for any act beyond the corporation’s objects is deemed to be null and void. This legal consequence arises from the lack of legal capacity to undertake any activity beyond the purpose clause. As it is obvious within the SAS, parties can opt out this default provision and set up a restricted-purpose clause in the corporate by-laws, defining the specific corporation’s main economic activities that, in turn, will determine the entity’s legal capacity.

31. Id. (This flows naturally from the previous sentence so whatever the professor is citing to in the previous citation—it will be the same citation for this one.)
32. See id.
33. Id.
34. See MODEL ACT, supra note 25, § 5(5); see also id., infra Annex.
35. See id. §§ 5 & 6.
C. Capital Contributions and Shares

One of the most relevant aspects of the new statute has to do with the great flexibility afforded to entrepreneurs that intend to make cash contributions to the firm. The SAS can be funded through a variety of channels, which surpass even the financing mechanisms available for traditional stock corporations. Even if the SAS cannot undertake public issuances of shares due to its nature as an archetypical closely held entity, the flexibility of its capital structure facilitates the process of raising resources from private actors.

Section 10 of the SAS Model Act allows entrepreneurs to freely allocate numerical values to the firm’s authorized, subscribed, and paid-in capital. Furthermore, it allows for payment of the firm’s subscribed capital to take place up to two years after the shares have been initially subscribed. Firms can also issue classes of shares with varying rights. Section 9 allows for capital subscription and payment to be carried out under “terms and conditions different to those set forth under the Commercial Code.” Under Section 10 of the SAS Model Act, firms can also issue “preferred shares with or without vote.” This opens up myriad possibilities for entrepreneurs, who have traditionally been unable to freely determine the rights carried by shares that are issued in closely held firms.

In granting ample flexibility for firms to issue different classes of shares, the SAS Model Act not only favors capital-raising processes but perhaps more importantly, facilitates the administration of corporate affairs by entrepreneurs.

D. Company Organization

Simplifying the operation and organic structure is an important goal of hybrid business forms. Attaining such a goal ameliorates the costs associated with the company’s operation. Accordingly, one of the principal aspects of the SAS legal regime is the creation of a flexible regime, which allows entrepreneurs to opt out of otherwise mandatory provisions. The enabling character of this regulation also gives way to an enormous freedom of organization for the shareholders. Pélin holds that within the regulation of the French Simplified Stock Corporation the combination of freedom of contract with the elements of stock

36. See MODEL ACT ON THE SIMPLIFIED STOCK CORPORATION, § 9, infra Annex.
37. Id.
38. See id. § 10.
39. See id.
40. See id. at § 11.
41. See MODEL ACT, supra note 25, § 5, see also id., infra Annex.
corporations constitutes an unprecedented privilege in that country’s legal system. For any economic agent, the election of the SAS as a business structure corresponds to the desire of increasing the organization’s efficiency by making it suitable to shareholders’ necessities.

The SAS Model Act confers entrepreneurs with complete freedom over the company’s internal organization structure. This is meant to lighten the firm’s bureaucratic burden by reducing to a minimum its mandatory organs. Section 17 of the Model Act establishes in a very clear fashion that the SAS’s structure may be freely defined in its by-laws, to wit: “Shareholders may freely organize the structure and operation of a simplified stock corporation in the by-laws.” In the absence of specific by-law provisions, “the shareholders’ assembly or the sole shareholder, as the case may be, will be entitled to exercise all powers legally granted to the shareholders’ assemblies of stock corporations, whilst the management and representation of the simplified stock corporation shall be granted to the legal representative.”

In this manner, the SAS’s shareholders’ assembly maintains a preponderant role that is reflected in the great variety of powers attributed to it. Therefore, most significant corporate transactions must be authorized by the shareholders duly gathered in the assembly or by the sole shareholder. Specifically, the Model Act, in its Section 37, confers upon the assembly the power to consider and approve the “financial statements and annual accounts” of the company. These documents must be submitted to the business entity’s highest organ by the corporation’s legal representative before the corresponding shareholders’ assembly meeting. The same Section adds that when dealing with corporations with a single shareholder, she will approve all the company’s accounts and will leave a record of such approval in the company minutes dutifully filed in the corporate books.

The by-laws may also create other organs such as the board of directors to carry on part of the activities usually performed by the assembly.

As the corporation’s main governing body, the assembly draws the firm’s policies, adopts structural decisions (conversions, mergers, split-up, winding up, etc.), approves financial statements, distributes profits

43. Id.
44. See MODEL ACT, supra note 25, § 18, see also id., infra Annex.
45. See id. § 17.
46. See id. § 37.
47. Id.
and creates reserves.\textsuperscript{48} As it is the general approach in the Model Act, the cited part of Section 14 is in part a default rule, subject to the parties' will. Therefore, it is viable to allocate some of the corporate powers assigned to the assembly in a different fashion.

\textbf{E. Meetings of the Shareholders' Assembly}

The rules for the operation of the shareholders' assembly also contain meaningful modifications to traditional approaches, as once again the Model Act aspires to decrease unnecessary formalism. To this effect, the proposed changes simplify the existing rules for calling meetings of shareholders, as well as the provisions that govern quorum, majorities, actions without a meeting, etc. This is a very significant change since it removes a series of requirements based on old-fashioned standards, which traditionally paved the way for innumerable lawsuits originating in these purely formalistic aspects.

In order to facilitate the decision-making processes in the SAS, and bearing in mind that it is a useful instrument for foreign investment, the Model Act allows shareholders' assemblies to meet at any specific location, irrespective of its main domicile.\textsuperscript{49} Another manner in which the Model Act seeks to facilitate the operation of shareholders' meetings is through the creation of alternative mechanisms for the adoption of decisions and the simplification of existing mechanisms for this same purpose.\textsuperscript{50} In any event, due to the fact that these rules are enabling rather than mandatory, it will always be possible to stipulate different requirements for actions without a meeting to be effectuated.\textsuperscript{51} Regarding notice of meetings, the parties can set up alternative mechanisms and define, within reasonable limits, the term between the delivery of such notice and the date when the meeting will be held. Section 19 of the cited Act allows for meetings "through any available technological devices or by written consent."\textsuperscript{52} A provision like this clearly foresees the applicability of any available technological means of communication. The utilization of these devices will only increase through time, as local economies and jurisdictions become more

\textsuperscript{48} See \textit{Model Act}, supra note 25, § 20, see also id., infra Annex.

\textsuperscript{49} See id. § 18.

\textsuperscript{50} See id. § 19.

\textsuperscript{51} See Claude Penhoat, \textit{Droit des Sociétés} 303 (AENGDE 5th ed. 1998). Claude Penhoat suggests diverse forms of deliberations within the French SAS structure, including vote cast directly by shareholders who attend the meeting, vote by correspondence, vote by proxy, and any other technique. The same author adds that quorum and majority conditions are freely defined in the by-laws, except for some decisions requiring unanimity. \textit{Id.}

\textsuperscript{52} See \textit{Model Act}, supra note 25, § 19, see also id., infra Annex.
integrated and intertwined. The SAS Model Act also allows for the shareholders to define in the by-laws the corporate organ that will be entitled to formulate the respective notice.\(^{53}\)

The mechanism regarding the waiver of notice to shareholders' meetings constitutes a great innovation in the simplified stock corporation. Under the general regime, omitting the notice of meeting or formulating it inadequately has the potential to disrupt the firm's internal affairs. In practice, the shareholders of a closely held corporation (which are often member of the same family) will not observe the full formalities required for calling meeting of the shareholders' assembly. However, this will not have any adverse effects for the shareholders, as they will in practice have full knowledge of the dealings undertaken in the assembly. Accordingly, it is reasonable to allow them to validate the formerly incurable breach of the formalities for calling meetings of shareholders, through the waiver-of-notice mechanism. So, if for example, after an assembly meeting in which there was a sufficient quorum (though not a universal one) and decisions were taken with the proper majorities, it was established that the absentee shareholders were not dutifully called, this breach in the formalities for calling the meeting can be cured though a simple letter addressed to the corporation's legal representative. For this effect, the only requirement needed is the submission of a written document to the company before, during, or after the corresponding session.

In the same path of creating a more effective and balanced regime for the SAS than the one that exists for other business forms, the Model Act proposes the creation of an implicit validation system for assembly decisions in cases where the notice of meeting given to all or some of the shareholders present at the assembly has been irregular or nonexistent.\(^{54}\) In fact, even if they were not summoned to the assembly, the law presumes that those shareholders attending the corresponding meeting have waived their right of notice. Nevertheless, Section 21 of the SAS Model Act allows present shareholders to demand an appropriate advance notice before the meeting takes place.\(^{55}\) The provision states that "the attendees in a given shareholders' assembly will be deemed to have waived the right of being convened, unless such shareholders make a statement to the contrary before the meeting takes place."\(^{56}\)

In summary, the rigidity of the current regulations in Latin American jurisdictions is attenuated in this subject matter by the

\(^{53}\) See id. § 20.
\(^{54}\) See id. § 21.
\(^{55}\) Id.
\(^{56}\) Id.
introduction of innovative legal rules facilitating shareholders’ effective communication and, furthermore, by allowing entrepreneurs to dispense with unnecessary nullifications and other legal sanctions when no damage exists because of such omission.

V. EMPIRICAL DEMONSTRATION CONCERNING THE COLOMBIAN SAS

The enactment of Colombian Law 1258 of 2008 (Official Gazette N.47.194 of December 5th of 2008), by means of which the Simplified Stock Corporations (SAS by its acronym in Spanish) was created, has been by far the most successful company-law reform in the last several decades. The implementation of the SAS has given rise to a certain degree of competition among the different types of business associations that exist in the country’s commercial legislation. The inception of the new business form allows entrepreneurs to choose between a traditional legal regime characterized by old-fashioned, backward regulations and the new modern corporate type of entity. Certainly, the new business vehicle, which is useful for all purposes, has represented, since the law was enacted, a gradual wither away from the Colombian business-association types existing prior to Law 1258 of 2008. The comparative inferiority of traditional business association types formerly used to structure closely held companies makes their future use unnecessary, given the undeniable practical advantages offered by the SAS. This assertion is evident in light of the exponential growth of the simplified stock corporation in Colombia.

The reaction of the business community to the new regulation on Simplified Stock Corporations has surpassed all expectations. As the graph below shows, the SAS has acquired a level of significant importance within local business associations. The data not only show the impressive acceptance of the SAS during this period, but also the progress made by this company type vis-à-vis the previously existing ones. As a result, while in December 2008 the percentage of SAS only reached 7.42% of the total number of business associations registrations, by August 2010, this company type represented 81.3% of all registered companies. This trend has been consistent during 2010. As Table 4

57. Certainly, previous reforms such as the one introduced by Law 222 of 1995 had a more restricted impact than the SAS. This law constituted only a “patch up” reform to traditional corporate rules contained in the Colombian Commercial Code. Such approach limited the scope of legislative changes that otherwise could have been made under a more progressive orientation.


59. Data for this section (consolidated for the entire country) has been obtained directly from the Confederation of Colombian Chambers of Commerce, CONFECAMARAS.
reflects the percentage of SAS during the first eight months of this year, the percentage of simplified stock corporations has ranged between 70% and 82% of the total amount of new registrations.

Before the enactment of the SAS statute, entrepreneurs were bound to use the traditional types of business associations regulated under the Commercial Code. These business forms were the general partnership, the limited liability company, the limited partnership, and the stock corporation. The statistics show the downfall of these traditional entities, as well as the rise of the SAS. In particular, it is observed that since April 2009, the Simplified Stock Corporation became the favorite company type in Colombia, surpassing even the limited liability company. The latter was, since its inception in 1937 and until that moment, the most widely used company type in Colombia.

Table 4: Evolution of the SAS Compared to Other Company Types (2008-2010)

VI. CONCLUSION

Understanding the underlying economic model in Latin American countries allows for the determination of the most frequent agency problems present in business corporations in the region. Taking into account the high degree of concentrated ownership that prevails across Latin American countries, solutions should be devised in order to
counteract the potentiality for oppression of minority shareholders at the hands of block-holders.

The theory of structural transplants is useful for the introduction of a system that is based upon two pillars. The first pillar is composed of enabling statutes that allow parties to opt out of default legal provisions. Private ordering facilitates the creation of tailor-made rules appropriate for closely held entities. Such freedom of contract contributes to achieving a higher degree of completeness in the corporate contract. The second pillar concerns procedural provisions that are intended to increase the degree of enforcement intensity so that gap-filling by arbitrators, judicial authorities and other entities is facilitated.

The Model Act on Simplified Stock Corporations for Latin America is an attempt to incorporate modern trends into legal systems characterized by a formalistic and backward structure in which regulatory provisions prevail to an overwhelming extent. The extremely successful, empirically measured result of Colombian Law 1258 of 2008 (with more than 54,000 Simplified Stock Corporations created in a short term) clearly suggests that businesspeople prefer flexibility to old-fashioned, misguided paternalism. The widespread adoption of the Model Act would not only allow for a certain degree of convergence in countries that require a higher level of legal integration, but also could foster innovation and foreign investment.
Annex

Model Act on the Simplified Stock Corporation (MASSC)

Chapter I
General Provisions

Section 1. Nature.—The simplified stock corporation is a for profit legal entity by shares, the nature of which will always be commercial irrespective of the activities set forth in its purpose clause.

Section 2. Limited Liability.—The simplified stock corporation may be formed by one or more persons or legal entities.

Shareholders will only be responsible for providing the capital contributions promised to the simplified stock corporation.

Except as set forth in Section 41 of this Act, shareholders will not be held liable for any obligations incurred by the simplified stock corporation, including, but not limited to, labor and tax obligations.

There shall be no labor relationship between a simplified stock corporation and its shareholders, unless an explicit agreement has been executed to that effect.

Section 3. Legal Personality.—Upon the filing of the formation document before the Mercantile Registry [include the name of corresponding company registrar's office], the simplified stock corporation will form a legal entity separate and distinct from its shareholders.

Section 4. Inability to Become a Listed Entity.—The shares of stock and other securities issued by a simplified stock corporation shall be registered within a stock exchange, nor traded in any securities market.

Chapter II
Formation and Proof of Existence

Section 5. Contents of the Formation Document.—A simplified stock corporation will be formed by contract or by the individual will of a single shareholder, provided that a written document is granted. The formation document shall be registered before the Mercantile Registry [include the name of corresponding company registrar's office], and shall set forth:

(1) The name and address of each shareholder;
(2) The name of the corporation followed by the words “simplified stock corporation” or the abbreviation “S.A.S.”;
(3) The corporation’s domicile;
(4) If the simplified stock corporation is to have a specific date of dissolution, the date in which the corporation is to dissolve;

(5) A clear and complete description of the main business activities to be included within the purpose clause, unless it is stated that the corporation may engage in any lawful business;

(6) The authorized, subscribed and paid-in capital, along with the number of shares to be issued, the different classes of shares, their par value, and the terms and conditions in which the payment will be made;

(7) Any provisions for the management of the business and for the conduct of the affairs of the corporation, along with the names and powers of each manager. A simplified stock corporation shall have at least one legal representative in charge of managing the affairs of the corporation in relation with third parties.

No additional formalities of any nature shall be required for the formation of the simplified stock corporation.

Section 6. Attestation.—The Mercantile Registrar [include the name of corresponding company registrar's office] shall attest to the legality of the provisions set forth in the formation document and any amendments thereof.

The Registrar shall only deny registration where the requirements provided under Section 5 have not been met. The decision rendered by the Registrar shall be issued within three days after the relevant filing has been made. Any decision denying registration will only be subject to a rehearing conducted by the Registrar.

Upon the approval of a formation document by the Mercantile Registrar, challenges will not be heard against the existence of the simplified stock corporation and the contents of the formation document will constitute the simplified stock corporation's by-laws.

Section 7. Assimilation to Partnership.—Where a formation document has not been duly approved by the Mercantile Registrar [include the name of corresponding company registrar's office], the purported corporation will be assimilated to a partnership. Accordingly, partners will be jointly and severally liable for all obligations in which the partnership is engaged. If the partnership has only one member, such member will be held liable for all obligations in which the partnership is engaged.

Section 8. Proof of Existence.—The certificate issued by the Mercantile Registrar [include the name of corresponding company registrar’s office] is conclusive evidence as regards the existence of the
simplified stock corporation and the provisions set forth in the formation document.

Chapter III
Special Rules Regarding Subscribed, Paid-in Capital and Shares of Stock

Section 9. Capital Subscription and Payment.—Capital subscription and payment may be carried out under terms and conditions different to those set forth under the Commercial Code or corporate statute [include the name of the relevant Code, Decree, Law or Statute]. In any event, payment of subscribed capital shall be made within a period of two years to be counted from the date in which the shares were subscribed. The rules for subscription and payment may be freely set forth in the by-laws.

Section 10. Classes of Shares.—The simplified stock corporation may issue different classes or series of shares, including preferred shares with or without vote. Shares may be issued for any consideration whatsoever, including in-kind contributions or in exchange for labor, pursuant to the terms and conditions contained in the by-laws.

Any special rights granted to the holders of any class or series of shares shall be described or affixed upon the back of the stock certificates.

Section 11. Voting Rights.—The by-laws shall depict in full detail the voting rights corresponding to each class of shares. Such document shall also determine whether each share will grant its holder single or multiple voting rights.

Section 12. Share Transfers to a Trust.—Any shares issued by a simplified stock corporation may be transferred to a trust provided that an annotation is made in the corporate ledger concerning the trustee company, the beneficial owners and the percentage of beneficial rights.

Section 13. Limitation on the Transferability of Shares.—The by-laws may contain a provision whereby the shares may not be transferred for a period not to exceed ten years, to be counted from the moment in which the shares were issued. Such term can only be extended by consent of all the holders of outstanding shares.

Any such limitation on share transferability shall be described or affixed upon the back of the stock certificate.

Section 14. Authorization for the Transfer of Shares.—The by-laws may contain provisions whereby any transfer of shares or of any given class of shares will be subject to the previous authorization of the shareholders’ assembly, which shall be granted by majority vote or by any supermajority included in the by-laws.
Section 15. Breach of Restrictions on Negotiation of Shares.—Any transfer of shares carried out in a manner inconsistent with the rules set forth in the by-laws shall be null and void.

Section 16. Change of Control in a Corporate Shareholder.—The by-laws may impose upon an incorporated shareholder the duty to notify the simplified stock corporation's legal representative about any transaction that may cause a change in control regarding such shareholder.

Where a change in control has taken place, the shareholders' assembly, by majority decision, shall be entitled to exclude the corresponding incorporated shareholder.

Aside from the possibility of being excluded, any breach of the duty to inform changes in control may subject the concerned shareholder to a penalty consisting of a 20% reduction of the fair market value of the shares, upon reimbursement.

In the event set forth in this article, all decisions concerning the exclusion of shareholders, as well as the determination of any penalties, shall require an approval rendered by the shareholders' assembly by majority vote. The votes of the concerned shareholder shall not be taken into account for the adoption of these decisions.

Chapter IV
Organization of the Simplified Stock Corporation

Section 17. Organization.—Shareholders may freely organize the structure and operation of a simplified stock corporation in the by-laws. In the absence of specific provisions to this effect, the shareholders' assembly or the sole shareholder, as the case may be, will be entitled to exercise all powers legally granted to the shareholders' assemblies of stock corporations, whilst the management and representation of the simplified stock corporation shall be granted to the legal representative.

Where the number of shareholders has been reduced to one, the subsisting shareholder shall be entitled to exercise the powers afforded to all existing corporate organs.

Section 18. Meetings.—Meetings of shareholders may be held at any place designated by the shareholders, whether it is the corporate domicile or not. For these meetings, the regular quorum provided in the by-laws will suffice, pursuant to Section 22 hereof.

Section 19. Meetings by Technological Devices or by Written Consent.—Meetings of shareholders may be held through any available technological device, or by written consent. The minutes of such meetings shall be drafted and included within the corporate records no later than 30 days after the meeting has taken place. These minutes shall
Section 20. Notice of Meeting.—In the absence of stipulation to the contrary, the legal representative shall convene the shareholders’ assembly by written notice addressed to each shareholder. Such notice shall be made at least five days in advance to the meeting. The agenda shall in all cases be included within any notice of meeting.

Whenever the shareholders’ assembly is called upon to approve financial statements, the conversion of the corporation into another business form, or mergers or split-off proceedings, shareholders will be entitled to exercise information rights concerning any documents relevant to the proposed transaction. Information rights may be exercised during the five days prior to the meeting, unless a longer term has been provided for in the by-laws.

Any notice of meeting may determine the date in which the Second Call Meeting will take place, in case the quorum is insufficient to hold the first meeting. The date for the second meeting may not be held prior to ten days following the first meeting, nor after thirty days from that same moment.

Section 21. Waiver of Notice.—Shareholders may, at any moment, submit written waivers of notice whereby they forego their right to be convened to a meeting of the shareholders’ assembly. Shareholders may also waive, in writing, any information rights granted under Section 20.

In any given shareholders assembly and even in the absence of a notice of meeting, the attendees will be deemed to have waived their right of being summoned, unless such shareholders make a statement to the contrary before the meeting takes place.

Section 22. Quorum and Majorities.—Unless otherwise specified in the by-laws, quorum to a shareholders’ meeting will be constituted by a majority of shares, whether present in person or represented by proxy.

Decisions of the assembly shall be taken by the affirmative vote of the majority of shares present (in person or represented by proxy), unless the by-laws contain supermajority provisions.

The sole shareholder of a simplified stock corporation may adopt any and all decisions within the powers granted to the shareholders’ assembly. The sole shareholder will keep a record of such decisions in the corporate books.

Section 23. Vote Splitting.—Shareholders may split their votes during cumulative voting proceedings for the election of directors or the members of any other corporate organ.

Section 24. Shareholders’ Agreements.—Agreements entered into between shareholders concerning the acquisition or sale of shares,
preemptive rights or rights of first refusal, the exercise of voting rights, voting by proxy, or any other valid matter, shall be binding upon the simplified stock corporation, provided that such agreements have been filed with the corporation’s legal representative. Shareholders’ agreements shall be valid for any period of time determined in the agreement, not exceeding 10 years, upon the terms and conditions stated therein. Such 10 year term may only be extended by unanimous consent.

Shareholders that have executed an agreement shall appoint a person who will represent them for the purposes of receiving information and providing it whenever it is requested. The simplified stock corporation’s legal representative may request, in writing, to such representative, clarification as regards any provision set forth in the agreement. The response shall be provided also in writing within the five days following the request.

Subsection 1.—The President of the shareholders’ assembly, or of the concerned corporate organs, shall exclude any votes cast in a manner inconsistent with the terms set forth under a duly filed shareholders’ agreement.

Subsection 2.—Pursuant to the conditions set forth in the agreement, any shareholder shall be entitled to demand, before a court with jurisdiction over the corporation, the specific performance of any obligation arising under such agreement.

Section 25. Board of Directors.—The simplified stock corporation is not required to have a board of directors, unless such board is mandated in the by-laws. In the absence of a provision requiring the operation of a board of directors, the legal representative appointed by the shareholders’ assembly shall be entitled to exercise any and all powers concerning the management and legal representation of the simplified stock corporation.

If a board of directors has been included in the formation document, such board will be created with one or more directors, for each of whom an alternate director may also be appointed. All directors may be appointed either by majority vote, cumulative voting, or by any other mechanism set forth in the by-laws. The rules regarding the operation of the board of directors may be freely established in the by-laws. In the absence of a specific provision in the by-laws, the board will be governed under the relevant statutory provisions.

Section 26. Legal Representation.—The legal representation of the simplified stock corporation will be carried out by an individual or legal entity appointed in the manner provided in the by-laws. The legal representative may undertake and execute any and all acts and contracts included within the purpose clause, as well as those which are directly related to the operation and existence of the corporation.
The legal representative shall not be required to remain at the place where the business has its main domicile.

Section 27. Liability of Directors and Managers.—All Commercial Code [name of the relevant Code, Decree, Law or Statute] provisions relating to the liability of directors and managers may also be applicable to the legal representative, the board of directors, and the managers and officers of the simplified stock corporation, unless such provision is opted out of in the by-laws.

Subsection 1.—Any individual or legal entity who is not a manager or director of a simplified stock corporation that engages in any trade or activity related to the management, direction or operation of such corporation shall be subject to the same liabilities applicable to directors and officers of the corporation.

Subsection 2.—Whenever a simplified stock corporation or any of its managers or directors grants apparent authority to an individual or legal entity to the extent that it may be reasonably believed that such individual or legal entity has sufficient powers to represent the corporation, the company will be legally bound by any transaction entered into with third parties acting in good faith.

Section 28. Auditing Organs.—A simplified stock corporation shall not, in any case, be legally mandated to establish or provide for internal auditing organs [name of corresponding auditing entity, e.g., fiscal auditor, auditing committee, etc.].

Chapter V

By-Law Amendments and Corporate Restructurings

Section 29. By-law Amendments.—Amendments to the corporate by-laws shall be approved by majority vote. Decisions to this effect will be recorded in a private document to be filed with the Mercantile Registry [name of corresponding company registrar's office].

Section 30. Corporate Restructurings.—The statutory provisions governing conversion into another form, mergers and split-off proceedings for business associations will be applicable to the simplified stock corporation. Dissenters’ rights and appraisal remedies shall also be applicable.

For the purpose of exercising dissenters’ rights and appraisal remedies, a corporate restructuring will be considered detrimental to the economic interests of a shareholder, inter alia, whenever:

(1) The dissenting shareholder’s percentage in the subscribed paid-in capital of the simplified stock corporation has been reduced;
(2) The corporation’s equity value has been diminished, or
(3) The free transferability of shares has been constrained.
Section 31. Conversion into Another Business Form.—Any existing business entity may be converted into a simplified stock corporation by unanimous decision rendered by the holders of all issued rights or shares in such business form. The decision to convert into a simplified stock corporation shall be registered before the Mercantile Registry [include the name of corresponding company registrar’s office].

A simplified stock corporation may be converted into any other business form governed under the Commercial Code [include the name of the relevant Code, Decree, Law or Statute] provided that unanimous decision is rendered by the holders of all issued and outstanding shares in the corporation.

Section 32. Substantial Sale of Assets.—Whenever a simplified stock corporation purports to sell or convey assets and liabilities amounting to 60% or more of its equity value, such sale or conveyance will be considered to be a substantial sale of assets.

Substantial sales of assets shall require majority shareholder approval. Whenever a substantial sale of assets is detrimental to the interests of one or more shareholders, it shall give rise to the application of dissenters’ rights and appraisal remedies.

Section 33. Short-form Merger.—In any case in which at least 90% of the outstanding shares of a simplified stock corporation is owned by another legal entity, such entity may absorb the simplified stock corporation by the sole decision of the boards of directors or legal representatives of all entities directly involved in the merger.

Short-form mergers may be executed by private document duly registered before the Mercantile Registry [include the name of corresponding company registrar’s office].

Chapter VI
Dissolution and Winding Up

Section 34. Dissolution and Winding Up.—The simplified stock corporation shall be dissolved and wound up whenever:

(1) An expiration date has been included in the formation document and such term has elapsed, provided that a determination to extend it has not been approved by the shareholders, before or after such expiration has taken place;
(2) For legal or other reasons, the corporation is absolutely unable to carry out the business activities provided under the purpose clause;
(3) Compulsory liquidation proceedings have been initiated;
(4) An event of dissolution set forth in the by-laws has taken place;
(5) A majority shareholder decision has been rendered or such decision has been made by the will of the sole shareholder, and

(6) A decision to that effect has been rendered by any authority with jurisdiction over the corporation.

Whenever the duration term has elapsed, the corporation shall be dissolved automatically. In all other cases, the decision to dissolve the simplified stock corporation shall be filed before the Mercantile Registry [include the name of corresponding company registrar's office].

Section 35. Curing Events of Dissolution.—Events of dissolution may be cured by adopting any and all measures available to that effect, provided that such measures are adopted within one year, following the date in which the shareholders’ assembly acknowledged the event of dissolution.

Events of dissolution consisting of the reduction of the minimum number of shareholders, partners or members in any business form governed under the Commercial Code [include the name of the relevant Code, Decree, Law or Statute] may be cured by conversion into a simplified stock corporation, provided that unanimous decision is rendered by the holders of all issued shares or rights, or by the will of the subsisting shareholder, partner or member.

Section 36. Winding Up.—The simplified stock corporation shall be wound up in accordance with the rules that govern such proceeding for stock corporations. The legal representative shall act as liquidator, unless shareholders appoint any other person to wind up the company.

Chapter VII
Miscellaneous Provisions

Section 37. Financial Statements.—The legal representative shall submit financial statements and annual accounts to the shareholders’ assembly for approval.

In the event that there is a single shareholder in a simplified stock corporation, such person shall approve all financial statements and annual accounts and will record such approvals in minutes within the corporate books.

Section 38. Shareholder Exclusion.—The by-laws may contain causes by virtue of which shareholders may be excluded from the simplified stock corporation. Excluded shareholders shall be entitled to receive a fair market value for their shares of stock.

Shareholder exclusion shall require majority shareholder approval, unless a different procedure has been laid down in the by-laws.
Section 39. Conflict Resolution.—Any conflict of any nature whatsoever, excluding criminal matters, that arises between shareholders, managers or the corporation may be subject to arbitration proceedings or to any other alternative dispute resolution procedure. In the absence of arbitration, the same disputes will be resolved by (include specialized judicial or quasi-judicial tribunal).

The decisions rendered by the tribunal are final and shall not be subject to appeals before any court.

Section 40. Special Provisions.—The legal mechanisms set forth under Sections 13, 14, 38 and 39 may be included, amended or suppressed from the by-laws only by unanimous decision rendered by the holders of all issued and outstanding shares.

Section 41. Piercing the Corporate Veil.—The corporate veil may be pierced whenever the simplified stock corporation is used for the purpose of committing fraud. Accordingly, joint and several liability may be imposed upon shareholders, directors and managers in case of fraud or any other wrongful act perpetrated in the name of the corporation.

Section 42. Abuse of Rights.—Shareholders shall exercise their voting rights in the interest of the simplified stock corporation. Votes cast with the purpose of inflicting harm or damages upon other shareholders or the corporation, or with the intent of unduly extracting private gains for personal benefit or for the benefit of a third party shall constitute an abuse of rights. Any shareholder who acts abusively may be held liable for all damages caused, irrespective of the judge’s ability to set aside the decision rendered by the shareholders’ assembly. A suit for damages and nullification may be brought in case of:

(1) Abuse of majority;
(2) Abuse of minority; and
(3) Abusive deadlock caused by one faction under equal division of shares between two factions.

Section 43. Cross-References.—The simplified stock corporation shall be governed:

(1) By this Law;
(2) By the formation document, as amended from time to time; or
(3) By statutory provisions contained in the Commercial Code [include the name of the relevant Code, Decree, Law or Statute] governing stock corporations.
Promulgation.—This Act shall be effective as of the date of its promulgation, and it repeals any and all statutes, acts, codes, decrees, or provisions of any nature that are inconsistent with this Act.
Global Financial Transactions and Jurisdictional Fragmentation: Inconsistent Decisions by Leading Trans-Atlantic Courts

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INTRODUCTION—LEGAL FRAGMENTATION OF COURTS: USE OF EXTRA-JUDICIAL DIALOGUE TO RESOLVE A CLASH OF DECISIONS

Courts in common-law countries throughout history have been aware that they make law and influence commercial practice. They see their role as extending beyond the adjudication of the particular dispute

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between the immediate parties to the guidance of future activity, and many courts have embraced this task with great responsibility. In this regard, leading courts in the major financial centres make global commercial law. In some recent litigation concerning international financial transactions, national courts have been sensitive to the relevance of other jurisdictions and have expressed a willingness to understand what happens in these jurisdictions. This has been a welcome approach because financial transactions have grown in size and complexity, and the largest and most spectacular of them all tend to be cross-border transactions requiring a resolution that is satisfactory across a number of jurisdictions. In times of economic prosperity, contracting parties are usually ready to re-negotiate and re-structure contracts rather than to litigate; such a general approach changes dramatically when there is the prospect of insolvency of one of the parties or a general economic downturn in an individual country or a global economic downturn.

In equal measure, courts have for generations endeavoured to learn and apply what the commercial industry has done in practice in an endeavour to facilitate commerce, finance and economic prosperity. Frequently the courts and industry work in tandem in this process of mutual education and feedback, but sometimes clashes do occur—when courts overrule a widely held perception of industry practice or when the industry works around court decisions that are considered erroneous.

This article notes the problem of conflicting court decisions that arise from the fragmentation of the legal landscape while the financial industry operates on a more or less integrated global basis via a network of closely linked national and regional financial centres. Additionally, the article focuses on three recent cases decided in the two leading financial centres of London and New York in the aftermath of the recent 


3. See e.g., Law Debenture Trust Corporation Plc v Concord Trust, [2007] EWHC 2255 (Ch) involving an anti-suit injunction; see also AON Financial Products, Inc v. Societe Generale 476 F.3d 90 (2d Cir. 2007) (where the Second Circuit Court of Appeals reversed a trial decision after ISDA submitted an amicus brief. Joanna Benjamin & David Rouch, The International Financial Markets as a Source of Global Law: the Privatisation of Rule-making? 2 L. & FIN. MARKETS REV. 78, 84 n.27 (2008) (the amicus brief pointed out that “The District Court’s errors in this case are of such fundamental nature that they cast significant doubt on the operation of credit default swap contracts. The rulings are directly contrary to the settlement mechanics set forth in ISDA’s standard documentation that is used in this $17.1 trillion market.”).

4. The best known English judge in this regard might be Lord Mansfield, who was called “the father of commercial law in this country” in Lickbarrow v. Mason (1787) 2 TR 63, 73 but there are many more judges that have followed that tradition.

global financial crisis ("GFC"). All three cases arose from pre-GFC transactions that went sour because of the bankruptcy and later collapse of US investment bank Lehman Brothers. One of the cases pitted the provisions of the US Bankruptcy Code against those of the International Swap and Derivatives Association ("ISDA") Master Agreement, one of the most widely used standard form documents in the world. This case, Metavante, is considered one of the most significant decisions concerning the rights of the parties in over-the-counter derivatives following a bankruptcy event of default. The significance of this case is three-fold. First, the decision tested the application the ISDA Master Agreement in the commercially important jurisdiction of New York. Second, within the US, the decision triggered a number of cases that were based on roughly the same facts. Third, in a global setting the decision has opened up a debate on some provisions of the ISDA Master Agreement; one legacy that is certain to remain is the introduction of a sunset clause, of as yet an indeterminate period, to the non-defaulting parties’ right to make a choice as to what to do following the counterparty’s default. The second and third court cases reviewed in this article—actually back-to-back cases—consisted of parallel court actions where the same facts were litigated in London and New York, and the courts reached conflicting decisions. The cases graphically illustrate the effect of legal fragmentation because not only do London and New York share the same common-law background, but both are keenly aware of the need to avoid conflicting court decisions. The New York decision was handed down later than its London counterpart, and the New York judge called for a status conference for resolving the clash between the two decisions. This aspect of dialogue between and among key jurisdictions is a feature of lawmaking that has gained momentum and scope in recent years and has facilitated global financial transactions. Such dialogue occurs horizontally and involves the courts, industry and regulators within the same jurisdiction; it also takes place vertically, progressing from domestic, regional to supranational institutions. The institutional authority of the status conference called for by the judge in

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7. The cases include: LBSF and LBHI v. AIG CDS; The Board of Education of the City of Chicago v. LBSF and LBHI; and Lehman Brothers Commercial Corporation v Norton Gold Fields Ltd. See Andrea Pincus, "The Metavante Ruling—In a Case of First Impression, US Bankruptcy Court Limits ISDA Counterparty Rights Upon a Bankruptcy Event of Default" Energy Trade and Commodities Alert, Alert 09-303 (Dec. 3, 2009).
the US *Lehman Brothers* case, however, is not clear, and the enforceability of any decisions would be problematic.

**Business and Legal Background—Globalized Financial Industry Conglomerates Operating in a Fragmented Legal Landscape**

The global financial crisis of 2007-09 was a graphic reminder of the interconnectedness among world economies that resulted from the steady march of globalisation. It was also a reminder of the ever-present threat of financial distress and insolvency of institutions, even those that appear invincible. A most visible aspect of globalisation and recent global economic prosperity is the global reach of business conglomerates and none more so than the large banks. Banks and other multinational businesses operate through complex corporate groups that are interlinked managerially, operationally, and financially such that a problem that occurs in one member of the group in one jurisdiction may have a global reach. One such bank was Lehman Brothers, reputed to have been the fourth largest US investment bank before its collapse and the largest bankruptcy in history, and whose demise is generally thought to have triggered the most widespread financial crisis since the Great Depression. Some spectacular litigation has already resulted from the sequential filing for bankruptcy by Lehman Brothers Holdings International, Inc., the parent company, and Lehman Brothers Special Financing, the subsidiary, and, on occasion, the issue has been whether the borrower for bankruptcy purposes was the corporate group, the parent company or the individual subsidiary. The demise of Lehman Brothers illustrated the breakneck speed that events can take when trouble brews in some quarter and the multi-jurisdictional nature of litigation arising from one large multinational company. It also illustrated that a distressed company or defaulter need not be poor; indeed the company's overall financial position could be bad while at the same time some of its contracts or subsidiaries are "in the money."

*Business Features of Cross-Border Transactions*

There are a number of business features of cross-border financial transactions that have led to commensurate developments in the law. First, the transactions are huge in size and involve a number of financial institutions. For instance, syndicated loans made to corporate borrowers

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9. Other recent problematic companies that collapsed or were on the brink of doing so include AIG, Enron, Worldcom and Parmalat.

10. This distinction in part explains the different outcomes in the UK case of *Perpetual* and the US case of *Lehman Brothers*, discussed infra.
in leveraged finance deals are structured to appeal to different lenders' or investors' appetites for risk in exchange for a higher risk of loss and will thus be structured in tiers that include senior lenders and subordinated debt, which takes the form of a first lien or mezzanine. This business structure is a recipe for conflict because different types of lenders have different attitudes towards investment. Some take a long-term perspective while others take a short-term perspective. The approach of the two groups to a struggling or defaulting borrower can be quite different, with some lenders prepared to give the borrower some breathing space to trade out of its difficulties, while other lenders would prefer to crystallise a loss and enforce security.

Secondly, the large-sized loans entail large credit risk, and lenders and investors necessarily engage in risk-management products such as credit derivatives and swaps to hedge against the risk of loss. At the same time lenders are managing risk, large corporations are also managing the risks facing them—such as foreign-exchange risk, profit or interest risk, and commodity risk—thus creating a large and vibrant market for derivative products. Thus, a prevalent feature of modern financing is the use of credit default swaps, which are the commonest financial derivatives used to hedge against the risk of loss by transferring the risk to another party. The legal nature of credit default swaps ("CDS") was described in AON Financial Products, Inc. v Societe Generale.:

Simply put, a credit default swap is a bilateral financial contract in which a protection buyer makes periodic payments to the protection seller, in return for a contingent payment if a predefined credit event occurs in the reference credit. Often the reference asset that the protection buyer delivers to the protection seller following a credit event is the instrument that is being hedged.

The court went on to clarify CDSs are different from insurance contracts:

CDS agreements are thus significantly different from insurance contracts. They "do not, and are not meant to, indemnify the buyer of protection against loss. Rather, CDS contracts allow parties to "hedge" risk by buying and selling risks at different prices and

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11. While most derivatives are entered into for speculation and arbitrage, some 10% are used for actual hedging. For the whole spectrum of derivatives and their documentation, see Simon Firth, Derivatives: Law and Practice (London: Sweet & Maxwell, 2010).

12. AON Financial Products, Inc. v. Societe Generale, 476 F.3d 90, 96 (2d Cir. 2007) (citing Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co. of N.Y., 375 F.3d 168, 172 (2d Cir. 2004)).
with varying degrees of correlation."... The terms of each credit swap agreement independently define the risk being transferred.\textsuperscript{13}

Credit risk mitigation techniques are part and parcel of modern investment portfolio management but are also frequently required by the credit-rating agencies that have become a significant feature of the larger financial transactions. Where a corporate group is involved, one technique is the provision of credit enhancement by another member of the group, say the parent company, which guarantees the obligations of its subsidiary. Such an arrangement gives the creditor two entities to look to for the fulfilment of its obligation—the principal debtor and the credit support provider (guarantor), and, by the terms of most financial contracts, the default of the guarantor constitutes the default of the principal debtor as well. Credit-risk mitigation was an important part of the factual matrix in the Lehman Brothers litigation discussed further below.

Thirdly, many loans are actually held by institutional investors and other financial institutions rather than commercial banks, as was traditionally the case. Such providers of funds include sovereign wealth funds, private equity, hedge funds, mutual funds, pension funds, and insurance companies. The non-bank lenders get involved in the loan either at the outset, i.e. primary syndication level, or at the secondary level, where they acquire loan interests by way of purchase from the original lenders. Non-bank lenders have had a tremendous impact on loan markets. First, they see their involvement in a loan as an investment that should produce viable returns on its own merit when compared to other investment instruments, and they will dispose of the loan for alternative forms of investment if the outlay on the loan is not profitable. Non-bank lenders are thus unlike commercial banks that are relationship-driven and tend to hold on to the loan as a market leader in the hope of ancillary services. To be able to compare the loan with other assets, such investors demand asset liquidity, transparent pricing and efficient trading procedures.

The desire of institutional investors to acquire loans and the desire of banks to sell loans have resulted in many loans being sold off to international investors through Collateralised Debt Obligations.

\textsuperscript{13} AON Financial Products, Inc. v. Societe Generale, 476 F.3d 90, 96 (2d Cir. 2007). See also Schuyler K Henderson, Regulation of Credit Derivatives: to What Effect and for Whose Benefit? 8 J. INT'L BANKING & FIN. L. 480 (2009) (discussing further differences between credit default swaps and insurance contracts include 'pure loss rather than speculative loss, different common law/legal standards (absence of subrogation, standards on full disclosure or absence thereof, and different markets and methods of contracting (including MTM [mark-to-market] valuation and regular transfers/novations of CDSs')).
Case law resulting from the global financial crisis has provided judicial descriptions of the key features of these complex transactions that are an established feature of the modern financial landscape.

CDOs are a financial structure at the centre of which a special purpose vehicle ("SPV") issues tranches of debt securities, the performance of which is linked to a portfolio of assets. The SPV may either hold the underlying assets (a "cash CDO") or take exposure to assets such as corporate bonds or asset-backed securities via a credit default swap with a financial counterparty (a "synthetic CDO"). The performance of CDOs is linked or "referenced" to the pool of underlying bonds or securities, the "Reference Pool."

In the case of a synthetic CDO the issuer may (as in the present case) invest the proceeds of issue of the CDOs in a portfolio of high quality, typically AAA-rated assets ("collateral"); those collateral assets are used to generate income to make coupon (interest) payments on the CDOs and, in the case of a default of any of the Reference Pool to which the SPV is exposed, to pay the financial counterparty the loss due under the credit default swap. On each occasion on which one of the assets in the Reference Pool defaults or is subject to some other "credit event" (such as a downgrading of its credit rating), then a payment becomes due from the SPV to the financial institution under the credit default swap. At the same time, the principal and interest due from the SPV to the CDO noteholder is correspondingly reduced. The usual practice is for CDO notes to be issued in different classes, whereby the losses are allocated sequentially commencing with the most "junior" tranche of notes until the original principal amount of such class of notes are written down to zero, and then losses are allocated to the next "higher" tranche of notes, until the entire capital structure is exhausted or the maturity date of the CDO notes occurs. As a consequence junior notes suffer as a result of earlier Reference Pool defaults/other credit events and the less risky "senior" tranches suffer loss only after the underlying classes of CDO notes have been reduced to zero principal value.

A common feature of actively managed CDOs is that one of the parties to the transaction has the right to alter the composition of the Reference Pool. Such a right potentially increases the risk for the holder of the CDO note, particularly if the party with the right to alter...
Finally, the larger financial transactions are typically arranged on the basis of standardised documents that are recommended by leading industry associations such as ISDA (International Swaps and Derivatives Association, Inc), LMA (Loan Markets Association), LSTA (Loan Syndications and Trading Association) and the ICMA (International Capital Markets Association). These associations consult widely with industry practitioners and regulators, and they work in close collaboration with the leading law firms in the world (many of whom are members of the associations). As a result, any decision on a large transaction will be watched closely and has the potential for global impact because many other transactions are based on the same template of documents.

The usual approach taken by English courts (and this is also true for most courts in the leading financial centres) is to enforce the words of the contract negotiated by the parties. The courts hold that risk allocation should be left to the parties, who are typically sophisticated (the clients are sophisticated investors, borrowers or counterparties, and the financial products are sophisticated) and are advised by competent and experienced legal counsel. The courts' role in this regard is usually limited to the application of the words of the contract since consumer issues do not intrude in this area.

FINANCIAL TRANSACTIONS IN THE COURTS

The courts' usual contribution to financial law is the interpretation and application of the law such that the law develops in the same direction as industry practices. From time to time, though, there are occasional divergences between the court decisions and some

16. Granted there are some differences of approach between those that adopt a literal interpretation of the contract and those that are more willing to take into account the context or commercial background. Recent English cases that have taken into account the commercial object of the contract in the interpretation of contracts include Re Sigma Finance Corp [2009] UKSC 2, Re Golden Key Ltd [2009] EWCA Civ 636, Cattles plc v. Welcome Financial Services Ltd. [2009] EWHC 3027 (Ch), and ING Bank NV v. Ros Roca SA [2010] EWHC 50 (Comm). Those that adopted the literary approach include Mills v. HSBC Trustee (Cl) Ltd. [2009] EWHC 3377 (Ch) and Chartbrook Ltd. v. Persimmon Homes Ltd. [2009] UKHL 38.
perceptions in commercial quarters. A court decision that is out of alignment with commercial perceptions is usually followed by debate and refinement of the standard form documentation or corrective legislative action and in that way contributes to the development of the law. One such decision involved the Metavante corporation and Lehman Brothers.

Metavante\textsuperscript{18}

The facts of this case took place between two US business entities, and the transaction was governed by New York law. The case potentially has global implications, however, because it pitted US bankruptcy law and policy against standard terms in the ISDA Master Agreement, which is a form used globally. The Metavante decision concerned straightforward interest rate swap transactions that were entered into in 2007 between the Metavante corporation and Lehman Brothers Special Financing, Inc. ("LBSF") on the basis of the 1992 ISDA Master Agreement. Lehman Brothers Holdings, Inc. (LBHI) was the credit support provider and guaranteed the obligations of LBSF. Under the swap agreement, Metavante was the fixed-rate payer and was required to make quarterly payments based on a fixed interest rate, while LBSF, as the floating rate payer, was required to make quarterly payments based on a floating rate. The payments were netted, and the net payer was required to pay the difference on a scheduled payment date. Under the contract the events of default included the bankruptcy of a counterparty or its credit-support provider;\textsuperscript{19} the right, but not the obligation, of the non-defaulting party to designate early termination upon the occurrence of an event of default;\textsuperscript{20} and the right to withhold performance upon the occurrence of an event of default that was continuing.\textsuperscript{21}

LBHI filed for bankruptcy protection under Chapter 11 of the US Bankruptcy Code on September 15, 2008, followed three weeks later by LBSF's bankruptcy filing on October 3, 2008. Under the ISDA Master Agreement,\textsuperscript{22} each bankruptcy filing was a separate and independent event of default giving rise to Metavante’s right to designate an early termination date, and the trigger of the right to withhold performance as

\textsuperscript{18} In re Lehman Brothers Holdings, Inc., Case No. 08-13555 et seq. (JMP) (jointly administered). The narrative of facts in the text draws heavily from Andrea Pincus, supra note 7.

\textsuperscript{19} See ISDA Master Agreement §5(a)(viii).

\textsuperscript{20} See id. § 6(a).

\textsuperscript{21} See id. § 2(a)(iii)

\textsuperscript{22} See id. § 5(a)(vii).
long as an event of default was continuing.\textsuperscript{23} It was common ground that an early termination would have yielded a multi-million dollar payment to LBSF and that the scheduled payments were substantially in favour of LBSF. Metavante did not designate an early termination of the agreement and instead chose to withhold payment under the individual transactions that remained outstanding.

In May 2009, Lehman Brothers (the debtor and defaulting party) moved to compel performance by Metavante (the non-defaulting party) and claimed payment of all past-due amounts plus default interest. Lehman Brothers essentially based its arguments on US bankruptcy law and policy. First, it argued that while the Bankruptcy Code respected the contractual rights of the non-defaulting party to terminate, accelerate or liquidate its positions in derivatives contracts and net payments, such rights inhered only if the contract was terminated. Second, it was against the legislative intent of the Bankruptcy Code for Metavante to rely on section 2(a)(iii) of the ISDA Master Agreement and choose to keep the contract on foot rather than to promptly terminate it after default. The legislative intention favoured prompt termination so as to permit markets to continue functioning in the direct aftermath of a major player’s collapse. Third, section 2(a)(iii) was an unenforceable \textit{ipso facto} clause in contravention of the Bankruptcy Code.\textsuperscript{24} It was claimed that “Metavante effectively modified the parties’ contract rights by permitting indefinite suspension of performance obligations only because of the financial condition of the debtors and commencement of the bankruptcy cases.”

Metavante, on the other hand, relied on the ISDA Master Agreement and argued that it had the right, but not the obligation, to terminate outstanding transactions and that there was no time limit for making the choice. Secondly, it argued that section 2(a)(iii) “expressly permitted the non-defaulting party to suspend its performance while an event of default was continuing, again with no contractual time limit and no exception for a bankruptcy event of default.” Thirdly, Metavante argued that “the US Bankruptcy Code . . . expressly excepts from the \textit{ipso facto} clause prohibition positions under a swap or master netting agreement, and does so without imposing any statutory time limit.” The key provisions governing payment and delivery of obligations which the court had to apply were the following.

Section 2(a)(i) of the ISDA Master Agreement states:

\textsuperscript{23} See \textit{id.} § 2(a)(iii).
Each party will make each payment or delivery specified in each Confirmation to be made by it, subject to the other provisions of this Agreement.

Section 2(a)(iii) of the ISDA Master Agreement states:

Each obligation of each party under Section 2(a)(i) is subject to (1) the condition precedent that no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing, (2) the condition precedent that no Early Termination Date in respect of the relevant Transaction has occurred or been effectively designated and (3) each other applicable condition precedent specified in this Agreement.

In a bench ruling,²⁵ the court held in favour of the defaulting party (Lehman Brothers) and against the non-defaulting party (Metavante). In a nutshell, the court decided that under United States law a non-defaulting party must make a choice to terminate or not terminate the contract, and the party has a limited time within which to make that choice. But this does not tally with the express wording of the ISDA Master Agreement. The court expressly limited the “enforceability of section 2(a)(iii) of the ISDA Master Agreement and the scope of the US Bankruptcy Code protections for non-defaulting parties to derivative contracts.” The court ruled that, first, each of the respective bankruptcy filings of LBHI and LBSF constituted a separate event of default that triggered Metavante’s right to terminate the transaction. Secondly, the safe-harbour provisions of the US Bankruptcy Code apply only to protect a non-defaulting swap counterparty’s contractual rights solely to liquidate, terminate or accelerate derivative contracts upon the bankruptcy of a counterparty or to offset or net out any termination values or payment amounts or foreclose on collateral. The provisions do not apply where the non-defaulting party fails to terminate, liquidate or accelerate the swap, and they “do not permit the withholding of performance under a swap if the swap is not terminated.” The court explained that

the exceptions to the unenforceability of an ipso facto clause—in this case for executory contracts that are swaps—do not extend to the contractual right to withhold performance under section 2(a)(iii) where such indefinite delay of performance is triggered because of the financial condition of the debtors. Suspension of payments, as

²⁵. There are reports that the court had previously encouraged the litigants to settle their dispute, and the judge was “visibly displeased” by the lack of effort on the part of Metavante to settle the dispute: see Pincus, supra note 7.
opposed to termination, thus amounts to a prohibited modification of the parties’ rights and obligations under the contract.

Lastly, even though there was no contractual or statutory time limit on the right to terminate derivative transactions because of a bankruptcy default, Metavante’s window of opportunity to act promptly under the safe-harbour provisions had passed, and it waived its right to terminate the transactions when it waited more than eleven months after the debtor’s bankruptcy filings before seeking to terminate. The court therefore ordered Metavante to pay the amounts withheld together with default interest in spite of the ISDA section 2(a)(iii), which permitted such withholding in the face of the continuing default by LBSF and LBHI.

There were a couple of unique facts in the Metavante decision that might have swayed the court’s decision against the non-defaulting party. First, Metavante chose to maximise its own benefits from the bankruptcy of Lehman Brothers by failing to net payments, which would have resulted in Metavante’s making substantial payments to Lehman Brothers. Secondly, Metavante chose to ride out the crisis by delaying its decision for some eleven months when the usual commercial expectation was to do it promptly. In this light, the court’s decision was understandable because the court said, in essence, that there was a limit on the extent to which a non-defaulting party could shield behind the literal reading of the ISDA provisions and other transaction documents.

One can pick quite a few areas where the court’s reasoning is not entirely satisfactory. First, for purposes of applying the ipso facto clause, the decision did not make a distinction between the default of the credit support provider (LBHI) and that of the debtor (LBSF), even though there was a time gap between the two. If that distinction were made, one could cogently argue that the trigger for Metavante’s right to modify contractual rights under ISDA section 2(a)(iii) occurred on the earlier bankruptcy and not on the onset of the debtor’s bankruptcy. Secondly, the court did not give clear guidance on how long was too long to wait before a non-defaulting party lost its right to terminate transactions or net payments, or before it would be deemed to have waived its right to terminate. Even though a specific time limit would not have been helpful in light of the variety and complexity of the transactions for which the ISDA Master Agreement is used, the court would have been more helpful had it created a general “reasonable time”

27. It was only in Lehman Bros. v. BNY that the court clarified that the Lehman Brothers companies were to be seen as one corporate family. In Metavante the court saw them as different corporations.
standard or held that there was an implied term in every such contract that the non-defaulting party would act within a reasonable time.\(^{28}\) While such a standard is fluid, it is helpful enough in common-law jurisdictions where courts and parties know how to apply it. It would require the parties and the courts to weigh the relevant factors in each particular transaction such as the volume, complexity, and interconnectedness of the transactions covered by the ISDA Master Agreement; the challenges in obtaining replacement trades from qualified counterparties; and the difficulty of the issues involved in restructuring an entire portfolio of an insolvent counterparty.\(^{29}\)

Arguably, the most noteworthy and controversial aspect of \textit{Metavante}—one with potentially a global reach—was the limit on the enforceability of Section 2(a)(iii) of the ISDA Master Agreement. In refusing to enforce the section in accordance with its terms, the court surprised prevailing orthodoxy, and initial reaction in the media was to say that it was unsafe to do business in the United States. A literal reading of the section appears to suggest that it is open-ended and that it entitles the non-defaulting party to do nothing other than terminate the transactions and crystallise the obligation. The \textit{Metavante} court ruled that in the circumstances of the case, the section did not mean what it said on its face and that the non-defaulting party did not have the choice simply to do nothing indefinitely. The non-defaulting party should have fairly promptly elected to terminate the transactions; having failed to do so, the non-defaulting party was not permitted to terminate or suspend payments until the debtor elected to accept or reject the swap in question. As has been observed, \textit{Metavante} revealed a loophole in the section in that the non-defaulting party can withhold payments indefinitely. The issue is whether the loophole was closed the right way when the court ruled that the section was unenforceable.\(^{30}\)

Comparing \textit{Metavante} with other global authorities, \textit{Metavante} conflicts with \textit{Enron Australia v. TXU Electricity}\(^{31}\) on the right to suspend payments under section 2(a)(iii) of the ISDA Master Agreement.\(^{32}\) \textit{Enron Australia} is generally taken to confirm the non-defaulting party’s right to withhold payments and the general

\(^{28}\) For an argument in favour of an implied term for acting within a reasonable time, see Mark Daley, \textit{Defining the Limits of 32(a)(iii)—Resolving the Section’s Indefinite Applicability}, 24(11) BUTTERWORTHS J. INT’L BANKING & FIN. L 647 (2009).

\(^{29}\) See Pincus, supra note 7.

\(^{30}\) See Daley, supra note 28; see Wilbur F. Forster, Jr., et al., \textit{Court Explores Termination Rights Under Bankruptcy Code Section 560}, PRATT’S J. BANKR. L. 505 (2009).


\(^{32}\) See Pincus, supra note 7, at 5.
enforceability of the section. The court also upheld the contractual right not to designate an early termination to the contract.\textsuperscript{33} There are some crucial factual differences between the two cases, though. In \textit{Enron Australia}, the parties agreed and the court assumed that the ISDA provisions meant what they said—especially that Section 2(a)(iii) was enforceable and that the section did not operate indefinitely.\textsuperscript{34} There were also, however, factors that make a case for similar decisions between the two cases. In \textit{Enron Australia}, the non-defaulting party was also a net payer and therefore had a similar economic interest to that in \textit{Metavante} not to terminate the arrangement. In fact, the period for suspending payment was also much longer, stretching from 2001 to 2005, and still it was assumed all around that the section meant what it said.

\textit{Metavante} is also hard to reconcile with the English case of \textit{Marine Trade SA v. Pioneer Freight Futures Co. Ltd.},\textsuperscript{35} where the enforceability of Section 2(a)(iii) was not in issue and was assumed. In \textit{Marine Trade} the plaintiff relied on the section for purposes of netting payments and recovery by way of restitution for payments made under protest. Like in \textit{Metavante}, the net payments were in favour of the defaulting party, and it was argued that it would be absurd and commercially unreasonable for the defaulting party to keep making gross payments when in fact the defaulting party was owed money after netting all the obligations between the parties. Yet the court observed that this “commercial sense” was not sufficient to gainsay the clear meaning of the contract when the contract was not so unreasonable commercially that the court should override it.\textsuperscript{36} The court noted that the non-defaulting party was perfectly entitled not to elect for early termination and at the same time to insist on gross payment by the defaulting party without any time limit.

On this account, the \textit{Metavante} decision is in the minority.\textsuperscript{37} But this does not necessarily mean that \textit{Metavante} is wrong. On balance, the decision was too drastic to declare the contract unenforceable. On the other hand, commentators agree it would not make commercial sense for the non-defaulting party’s right to withhold payment to be available

\begin{footnotesize}
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\item \textsuperscript{34} See also Daley, \textit{supra} note 28.
\item \textsuperscript{35} Marine Trade SA v. Pioneer Freight Futures Co. Ltd. BVI [2009] EWHC 2656 (Comm).
\item \textsuperscript{36} The court applied the dictum in \textit{Schuler v Wickman Mach. Tools} [1974] A.C. 235, 251.
\item \textsuperscript{37} See also Russell Willings, Derivatives and Insolvency: a British Virgin Islands Perspective on the Metavante Decision and the ISDA Master Agreement 3(1) CORP. RESCUE & INSOLVENCY J. 18 (2010).
\end{itemize}
\end{footnotesize}
indefinitely.\textsuperscript{38} There needs to be a limit on how long a non-defaulting party can withhold payments, and the \textit{Metavante} decision did not clarify how long is too long. In the instant case the court thought that eleven months was too long, and yet in \textit{Enron Australia} the parties and the court did not see any difficulty with four years. Clearly, a rigid timetable is not the answer, and the solution might lie in the adoption of the concept of “reasonable time,” the determination of which would depend on the particular transaction under consideration.\textsuperscript{39}

\textbf{Lehman Brothers—UK Litigation}

The next two cases were based on the same facts and are summarised by the following diagram.

\begin{center}
\begin{tabular}{c c c}
\hline
\textbf{Case} & \textbf{Party} & \textbf{Result} \\
\hline
Lehman Brothers & Non-defaulting party & 11 months withheld \\
Enron Australia & Defaulting party & 4 years withheld \\
\hline
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\textsuperscript{39} The application of the “reasonable time” concept would be similar to that found in the Uniform Customs and Practices for Documentary Credits. \textit{See} Daley, \textit{supra} note 28.
The Perpetual Trustees/Lehman Brothers Litigation

In *Perpetual Trustee Co. Ltd. v. BNY Corporate Trustee Services Ltd.*, an investor sued the collateral trustee to enforce the contract terms that gave the investor priority to the collateral following the default of the swap counterparty. The Lehman Brothers companies (Lehman Brothers International Europe or "LBIE") had set up a special purpose vehicle ("SPV") that issued notes to investors in the form of synthetic collateralised debt obligations. The subscription money obtained from

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investors was used by the SPV to purchase the collateral for the notes. The SPV in turn entered into a credit default swap with Lehman Brothers Special Financing ("LBSF") (the swap counterparty) under which the swap counterparty paid regular amounts to the SPV so that the SPV could service the payments to the noteholders; in exchange, the swap counterparty was rewarded with sums equal to the yield on the collateral. The collateral was charged by the SPV in favour of a trust company to secure the SPV's obligations to its creditors, who included the noteholders and the swap counterparty. The trust deed provided that the rights of the swap counterparty to payments and the collateral would ordinarily have priority over payments to the noteholders, but that the priority would change in favour of the noteholders on the occurrence of an insolvency event by the swap counterparty or credit-support provider. The swap agreement was subject to the ISDA Master Agreement, and all the transactions were governed by English law.

On September 15, 2008, LBHI filed for Chapter 11 bankruptcy protection in the United States. That act constituted an event of default under the swap documentation because LBHI was designated as a credit support provider of LBSF. On October 3, 2008, LBSF also filed for Chapter 11 bankruptcy protection, which also constituted an event of default and triggered a priority switch from the swap counterparty to the noteholders as to entitlement to collateral. The noteholders were not paid, and they gave notice to the trustee to terminate their arrangement and required the trustee to enforce the security. The swap counterparty (LBSF) challenged the noteholders' claim to priority, arguing that it would fall foul of the anti-deprivation rule. The trial judge held that the disadvantage suffered by LBSF did not come within the rule and that the provisions changing priority to collateral were operated before LBSF filed for bankruptcy protection. The Court of Appeal unanimously dismissed LBSF's appeal by first asking if there had been a deprivation of property and by second asking about the timing of the deprivation. It held that the "flip" of priority from the swap counterparty to the

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41. This is the so-called "waterfall flip."

42. While the scope and preciseness of the anti-deprivation rule is subject to debate, the courts agree that the modern rule is based on public policy and says that one cannot contract out of the insolvency regime. See Perpetual, [2009] EWCA (Civ) 1160, citing British Eagle Int'l Air Lines v. Compagnie Nationale Air France [1975] 1 WLR 758, per Cross LJ (HL); Carreras Rothmans Ltd. v. Freeman Mathews Treasure Ltd. [1985] 1 Ch 207, per Gibson J; and Int'l Air Trans.Ass'n v. Ansett Austl. [2008] BPIR 57 (HC). The rule was stated by Cotton LJ in Ex parte Jay that "there cannot be a valid contract that a man's property shall remain his until his bankruptcy, and on the happening of that event shall go over to someone else, and be taken away from his creditors." Ex parte Jay; In re Harrison (1880) 14 Ch D 19 at 26, see also Money Markets Int'l Stockbrokers v. London Stock Exch.[2002] 1 W.L.R. 1150 (Ch D).

43. See Perpetual, EWCA (Civ)1160.
noteholders was not a divesture or transfer of property to the noteholders but merely a change in the order of priorities in which rights were to be exercised in relation to the proceeds of the sale of collateral in the event of default. Furthermore, the court reasoned that it was an agreed feature of the contract documents from inception that the priority right enjoyed by LBSF over collateral was contingent on there being no event of default; the priority right was therefore lost in favour of the noteholders on the occurrence of default. In addition, the court noted that the anti-deprivation rule might not apply where, as in the instant case, the person for whose benefit the deprivation took effect could show that the asset, or the insolvent's interest in the asset, over which the deprivation took effect was obtained by his or her own money. Lord Justice Patten took the simple view that the "flip" was an original feature of the contract and could not possibly be seen as a deprivation of property at the onset of the counterparty's bankruptcy. Secondly, the court held that the switch or "flip" from counterparty to noteholder priority did not violate the anti-deprivation rule because it occurred before, not on or after, liquidation since the alteration of priority was triggered when LBHI filed for Chapter 11 bankruptcy, which was some eighteen days earlier than when LBSF (the credit support provider) filed for bankruptcy under Chapter 11. A deprivation did not fall within the scope of the rule if it occurred before winding up or its equivalent.

As a matter of policy, English courts emphasise the principle of party autonomy. In the High Court, the Chancellor observed that courts should enforce the parties' agreement rather than enforce the anti-deprivation rule on them. In the Court of Appeal, Lord Neuberger M.R. made clear that in "complex and sophisticated contractual arrangements the parties should be expected to know what they were doing, and the courts should be slow to take away their right to freely contract on terms as they see fit." As the Master of Rolls pointed out:

> It is important that, so far as possible, judicial decisions in the insolvency field ensure that the law is clear and consistent. That has always been true, but the need for consistency and clarity is all the greater now that commercial contracts are becoming increasingly complex both in their underlying nature and in their detailed

45. See Perpetual, EWCA (Civ) at 1160.
46. The court and litigants agreed that the filing of Chapter 11 bankruptcy was equivalent to making a winding-up order under English law.
47. See Christopher Harlowe, Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd— the anti-deprivation principle—whose rights are they anyway? 21(3) ENTMT' L. REV. 114, 114-115 (2010). It is important to note that the anti-deprivation principle was only reigned in and not thrown out altogether.
provisions, as is well demonstrated by the contracts in the instant cases... It is also desirable that, if possible, the courts give effect to contractual terms which the parties have agreed. Indeed, there is a particularly strong case for party autonomy in cases of complex financial instruments... and in arrangements involving large corporate groups... in such cases, the parties are likely to have been commercially sophisticated and expertly advised.48

Lehman Brothers—US Litigation

In In re Lehman Brothers Holdings Inc. v. BNY Corporate Trustee Services Ltd.,49 the facts were exactly the same as those in the English counterpart of this case (Perpetual Trustee Co Ltd v BNY Trustee Services Ltd, above) and the swap counterparty, i.e., the debtor, initiated court action in the United States to compel the trustee to disregard the contract documents. The swap counterparty argued that the contractual provisions which required the modification of the scheme for payment priority were unenforceable ipso facto clauses under the US Bankruptcy code because they inappropriately modified the debtor’s interest in a contract solely because of a bankruptcy filing.50 The debtor also argued that any attempt to modify the payment priority would violate the automatic-stay provisions of the Bankruptcy Code51 because it would improperly mark an exercise of control over the property of the debtor’s estate. Finally it argued that so-called safe-harbour provisions of the Bankruptcy Code did not protect the purported modification of payment priority. BNY defended by arguing that the documents were governed by English law and were to be construed in accordance with English law and, under the principles of res judicata and comity therefore, the New York court should defer to the determination of the issues by the English courts. BNY also argued that LBSF could not use its status as a bankruptcy debtor to garner greater rights with respect to the collateral than it possessed before the bankruptcy petition. Furthermore, BNY argued that the payment modifications at issue were the agreed upon mechanisms by which the parties’ transactions were to be liquidated and fell within the safe harbour provisions of the Bankruptcy Code.

The Bankruptcy Court began by justifying its application of United States law at the expense of English law even though the latter had been

48. Per Lord Neuberger of Abbotsbury MR in Perpetual, EWCA (Civ) 1160.
50. Reliance was put on US Bankruptcy Code, 11 U.S.C. §§ 365(e)(1) and 541(c)(B) (2005).
explicitly chosen by the parties as the governing law of the contract documents. The court noted that it was not obliged to recognise a judgment rendered by a foreign court but that it could give *res judicata* effect on the basis of comity. It then observed that the English courts had not taken account of the principles of US bankruptcy law in the earlier proceedings that the trustee wanted enforced. It held that as a general matter "courts will not extend comity to foreign proceedings when doing so would be contrary to policies or prejudicial to the interests of the United States." While recognising that the application of the Bankruptcy Code would yield an outcome directly at odds with the judgment of the English courts, the court articulated the guiding policy:

> Despite the resulting cross-border conflict, the United States has a strong interest in having a United States bankruptcy court resolve issues of bankruptcy law, particularly in a circumstance such as this where the relevant provisions of the Bankruptcy Code provide greater protections than are available under applicable provisions of foreign law.

The court therefore decided not to give "preclusive effect" to the English judgments and proceeded to apply the provisions of the Bankruptcy Code. The bankruptcy court reached different factual and legal conclusions than the English court and applied different law. Key among the differences were these: First, the court held that the priority accorded by the transaction documents to LBSF was a valuable property interest that was entitled to protection as part of the bankruptcy estate. The contract documents that changed priority from LBSF to the noteholders was a modification of that valuable right. Second, the court viewed the Lehman Brothers holding company and the multiple subsidiaries within the corporate group as one integrated enterprise such that the first filing for bankruptcy on September 15 by LBHI was the event that precipitated subsequent related events. The court then noted that the Bankruptcy Code's policy against *ipso facto* clauses prohibits the modification of a debtor's right solely because of an agreement conditioned upon the commencement of a *case* under the Bankruptcy Code and was not limited to the commencement of a *case by or against the debtor*. In the instant litigation, "a case" was commenced by a related entity when LBHI, the corporate parent and credit-support provider, filed for

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53. *Id.*
54. In this regard US law, which requires "modification," is different from UK law, which requires "deprivation."
56. Emphasis in original text.
bankruptcy. The court therefore held that the transaction documents which sought to modify the right to priority of collateral (the "flip") after the first filing constituted an unenforceable ipso facto clause. Similarly, such provisions violated the automatic stay, which was triggered on the filing of the bankruptcy petition, because they sought to deprive the debtor and its creditors of valuable property.

The bankruptcy court's decision stands as the law of the United States. However, there are some internal weaknesses. First, disregard for the choice-of-law provisions and the reasons given for doing so are not convincing. Commercial parties of the level of sophistication that was involved in the Lehman Brothers litigation give careful consideration to choice-of-law and choice-of-jurisdiction matters and address the prospect of insolvency when they make their choice. The very purpose of choosing a particular well known system, such as English law, is to avoid the surprise that may be sprung upon parties by other systems of law, particularly those they know and deliberately avoid, such as the law of New York. The judge seemed to appreciate that the law he applied was different than what the parties envisaged when they entered into contract. He said:

"The English Courts have been most gracious in allowing room for this Court to express itself independently on matters of importance to the administration of the LBHI and LBSF bankruptcy cases. In applying the Bankruptcy Code to these facts the Court recognizes that it is interpreting applicable law in a manner that will yield an outcome directly at odds with the judgment of the English Courts."

Secondly, the bankruptcy court based itself exclusively on US policy in a situation when another jurisdiction was clearly more relevant—the assets that were the subject of contention were located in England. It is a common occurrence in the practice of large financial transactions that a number of entities from multiple jurisdictions will be involved either as lenders, investors, debtors, guarantors, security trustees, custodians, etc., and the contracting parties allocate their legal risks by choice-of-law provisions. The multi-jurisdictional nature of such transactions forces the parties to decide where they want to litigate and under which system of law; courts should facilitate the transactions by respecting the parties' choices. While there is no doubt that US bankruptcy law and policy are important, the parties contracted to be governed by a different bankruptcy regime—the English law bankruptcy regime—and must be taken to have known that the two regimes have

57. An appeal is pending.
different areas of emphasis. A court that disregards the scheme of allocating risks chosen by industry practitioners fails to appreciate the importance of choice-of-law provisions in structured finance.

Thirdly, the court made no attempt to balance domestic policy with the needs of international business or finance. In commercial contracts involving sophisticated businesses, the parties are normally held to their contracts and cannot be seen to contest the documents they signed. The documents create a contractual estoppel whereby the parties are precluded from denying that the obligations they entered into are binding. This is especially so because a leading player, such as Lehman Brothers, was at the forefront of creating and marketing such financial instruments and could not reasonably say that it did not know what it was doing. The court acknowledged the weakness in its approach in a footnote: “The Court recognizes that there is an element of commercial expectation that underlies the subordination argument. LBSF was instrumental in the development and marketing of the complex financial structures that are now being reviewed from a bankruptcy perspective.”

From a broader perspective, the decision declared as unenforceable provisions that are common in structured finance transactions where payments to a swap counterparty are subordinated if the counterparty has defaulted on its obligations. While this might instinctively be seen as a disadvantage to doing business in the United States generally or where the swap counterparty is subject to the US Bankruptcy Code, and while this might at first blush be seen as detracting from the enforceability of subordination provisions generally, it is thought that the impact of the decision might not be widespread and that the decision might be limited to the facts of this case. Furthermore, English law does not have a principle of substantive consolidation that was relied upon by the Bankruptcy Court to treat LBHI and LBSF as the same; the US decision is therefore unlikely to have impact in the UK.

CONCLUSION

The global financial crisis of 2007-2009 illustrated graphically that in the era of globalisation business will cross geographical boundaries—and so will litigation. The crisis also provided fertile ground for litigation that has expanded and clarified the boundaries of existing financial law. It was not surprising in this plethora of court cases that some conflicting decisions were reached in different jurisdictions or that long-standing perceptions were tested.

Whatever the merits or demerits of Metavante, the decision is the law of the United States and must be taken into account by parties wishing to transact business in that country. The decision potentially has impact beyond the United States because it may influence the views of other courts when they interpret the ISDA Master Agreement section 2(a)(iii). In any event, all parties that enter into transactions that are governed by the ISDA Master Agreement must take the decision into account when they decide whether or not to terminate a transaction following the insolvency of a counterparty. The initial impact was that the decision caused uncertainty in derivatives transactions, especially where US counterparties were involved in transactions that adopted the ISDA Master Agreement. Subsequently the Metavante decision was appealed to the United States District Court for the Southern District of New York, and subsequently the Lehman Brothers debtors sought court approval for a settlement deal with Metavante. It has been noted that if the settlement is approved, it would likely forestall a binding precedential judgment by the courts.

English courts have traditionally tried to avoid conflicting decisions with their overseas counterparts, particularly in commercial matters. This was exemplified by Coleman, J. in Lordsvale Finance Plc v Bank of Zambia, in the course of considering a provision concerning default interest rate in a loan agreement:

It would be highly regrettable if the English courts were to refuse to give effect to such prevalent provisions while the courts of New York are prepared to enforce them. For there to be a disparity between the

64. Ken Coleman, Daniel Guyder & John Williams, Allen & Overy, Lehman Moves for Bankruptcy Court Approval of Metavante Settlement (Mar. 2010), available at http://www.allenovery.com/AOWEB/Knowledge/Editorial.aspx?contentTypeID=1&itemID=55295&prefLangID=410 (While the settlement would not be binding on other parties, it would provide guidance to those similarly situated in relation to the Lehman debtors).
law applicable in London and New York on this point would be of great disservice to international banking. 65

It is sometimes inevitable, however, that the law of one country clashes with the principles of another jurisdiction. A case in point is the earlier insolvency case of Bank of Credit and Commerce International, 66 when English law and practice on set-off brushed against the legal principles of other jurisdictions. In that earlier case, English authorities were able to cooperate with other jurisdictions to obtain a satisfactory practical result. Similarly in the US Lehman Brothers case (In re Lehman Brothers Holdings Inc. v BNY Corporate Trustee Services Ltd67), the court was keenly aware that its application of United States law was in direct conflict with the earlier English decision based on the same facts. The court called for a status conference to sort out the difficulties that confronted the parties in the face of a fragmented legal world. The court said:

[T]he Court anticipates that the current ruling may be a controversial one, especially due to the resulting conflict with the decisions of the English Courts. . . . This is a situation that calls for the parties, this Court and the English Courts to work in a coordinated and cooperative way to identify means to reconcile the conflicting judgments. The Court directs that the parties attend a status conference to be held on the next available omnibus hearing date in the Debtor's cases for purposes of exploring means to harmonise the decisions of this Court and the English Courts. 68

The idea of the status conference is appealing, but the power of a court to compel parties to attend or to sanction a non-cooperative party is not so clear.

It bears emphasis that the two conflicting UK and US court decisions that left the trustee caught in the middle of a Trans-Atlantic storm were based on different laws and policy. The anti-deprivation principle in English law focuses on depriving the bankruptcy estate of property while the US ipso facto clause focuses on the modification of contractual relationships. The English insolvency regime is largely pro-creditor and ordinarily upholds commercial contracts, while the US bankruptcy court applied a statute that is largely pro-debtor. English law

65. Lordsvale Finance plc v. Bank of Zambia [1996] 3 All ER 156; Similar sentiments have been known to exist in the United States as well, see AON Financial Products, Inc v. Societe Generale, 476 F.3d 90 (2d Cir. 2007), above.
68. Id. at 423.
emphasises party autonomy, particularly in complex transactions involving sophisticated parties, while bankruptcy law is pre-eminent in the US. The US court applied the principle of substantive consolidation and considered all the Lehman Brothers companies as one group, while English law did not apply such a concept. The English decision was consistent with the ISDA Master Agreement and was therefore welcomed by most commercial entities (invariably not all of them), while the US decision caused consternation in some commercial quarters because it challenged widely held perceptions. It is thought unlikely that US principles would be applied in the UK.

It is not a novel occurrence that a court decision challenges the wisdom of established law and practice as contained in the documents generated in practice. Examples abound stretching back to the early days of the promissory note and the decisions of Chief Justice Holt to more recent cases involving set off and netting and swaps and derivatives. Legal practitioners understand very well that there is always a risk that a document or provision may be declared unenforceable by the courts. This is exactly what is known as documentation risk, a constituent element of legal risk, which is the mainstay of a lawyer’s practice. Practitioners address legal risk in overseas jurisdictions by obtaining legal opinions and routinely advise clients that they cannot be absolutely sure what the courts will do in fact.

A direct clash of court decisions is not necessarily a bad thing. In the history of commercial practice, every setback by the courts has provided an opportunity for further debate and has led to further development of the law and practice. In the short term, legal practitioners may be confused about how to advise clients, but in the long term such clashes lead to debate and further analysis leading to the

69. Commercial law folklore teaches that Chief Justice Holt was hostile to the development of promissory notes and had to be overruled by parliament before the instruments were allowed to develop as a very useful facility for trade.
72. See ROGER MCCORMICK, LEGAL RISK IN THE FINANCIAL MARKETS (Oxford University Press 2006).
73. More recent examples include the two Elliott Associates cases and Aon. Elliott Assoc, LP General Docket No 2000/) R/92 (Court of Appeal of Brussels, 8th Chamber, 26 September 2000) reached an unusual interpretation of the pari passu clause and the court action was initiated in Brussels because it was clear that the New York courts would not agree to that interpretation; see also Elliott Assoc, LP v. Banco de la Nacion 2000 WL 1449862 (SDNY, 29 September 2000). Following the unusual decision in Brussels, the LMA (industry group in Europe) initiated a discussion group to see the implication of the 'new' interpretation; see A MUGASHA, THE LAW OF MULTI-BANK FINANCING: SYNDICATED LOANS AND THE SECONDARY LOAN MARKET 234-234 (Oxford University Press 2007).
development of law and practice. Following significant decisions, standard form contracts are typically updated, new legal opinions issued, and even corrective legislation may follow. It is very clear, therefore, that the courts do influence practice greatly, and any significant decision, however divergent, contributes to the development of the law. It is also clear that industry opinions and commercial practice do influence the law, and in that regard there is a healthy reflexive relationship between the courts and legal practice.

The court decisions discussed in this article illustrate an important aspect of the development of commercial law in the present era. Many financial centres are contributing to the law because of the integration of the global financial market. The majority of the most complex transactions take place in Europe and are particularly centred in London on the one hand, and the United States and particularly in New York on the other hand. There are many nodes in the different geographical regions of the financial market, but the current leadership of the law and transactions is a bi-polar, trans-Atlantic affair that is backed by English law and courts on the one hand, and New York law and courts on the other. In this light, the cooperation between the courts, practitioners and regulators in London and New York on important financial matters such as the interpretation of the ISDA Master Agreement is a service to the global financial industry. This trans-Atlantic cooperation, flagged by chance by the US bankruptcy judge following a curious decision, may be one of the more visible legacies of the Lehman Brothers litigation and may turn out to be the model for future lawmaking, because global transactions and legal fragmentation are here to stay.

POSTSCRIPT

There is ongoing vibrant activity inside and outside the courts regarding all the three key cases discussed in this essay. An appeal from the English case of Perpetual Trustee Company Ltd is expected to be heard in the English Supreme Court during spring 2011. The US case was also appealed. The same litigation in the US is subject to a couple of motions; first, by Lehman Brothers to buy the perpetual notes, and

74. ISDA issued an opinion clarifying the law following Metavante, supra note 6.
75. See, e.g. Enron Australia, supra note 31.
76. Another important legacy may emerge from the requirements of the rating agencies which are still developing their response to the US decision. Blamed for initial overreaction, they presently distinguish between US and non-US entities when they rate counterparties to swap contracts or securitisation structures. See CLIFFORD CHANCE, NEW HORIZONS: LEGAL AND STRUCTURING DEVELOPMENTS FOR THE NEW INTERNATIONAL STRUCTURED DEBT PRODUCTS 66-67 (London, June 2010).
77. This was the subject of a court order on April 22, 2010.
second, by the trustee seeking declaratory judgment to resolve the impasse between the UK and US litigation. If Lehman Brothers indeed purchases the perpetual notes, the basis for the UK and US litigation will be removed and the resolution of the trans-Atlantic conflict in bankruptcy law may not take place.
Financing Insolvency Restructurings in the Wake of the Financial Crisis: Stalking Horses, Rogue White Knights and Circling Vultures

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I. INTRODUCTION

The financing of financially distressed companies is challenging. While additional financing could be provided outside of formal insolvency proceedings, corporate statutes in many jurisdictions prohibit incurring of additional debt while insolvent unless there is notice to, and consent of, creditors. In such circumstances, absent special protection, creditors are reluctant to advance further financing. Where debt is held by multiple creditors, insolvency proceedings are usually necessary to

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prevent a race to the assets and to allow the debtor company a short period in which to determine whether a going concern business plan and financing are possible.

Different jurisdictions place greater or lesser importance on offering a restructuring solution to firms in financial distress in addition to liquidation procedures. Where a restructuring option is available, many, but not all, jurisdictions have realized that any going concern strategy requires a means of financing the business until the appropriate workout plan can be devised, whether it is a restructuring of debt and equity, a going concern sale or a liquidating sale. This financing is called debtor in possession ("DIP") financing in Canada, and post-commencement financing in other jurisdictions; it provides the financing to continue operations during the insolvency proceeding and to cover the costs of insolvency and legal professionals in that proceeding. It is often connected closely to "exit-financing," the capital that will be needed to exit protection under the stay or moratorium provisions of insolvency legislation, and to assist the debtor company in the first period after restructuring.

There are a number of sources of post-commencement financing. They include the sale of some of the debtor's assets or the willingness of suppliers to continue supplying on credit for a limited period. In many jurisdictions, such financing historically came primarily from pre-filing banking and other traditional operating lenders. Pre-filing creditors often have an incentive to continue to lend, based on a desire to preserve ongoing business relations, the need to protect already sunk costs, and the potential for longer term upside credit relationships. In some instances, pre-filing lenders extend financing to ensure that their interests are not trumped by new financing that receives a priority charge. Even where their claims are already covered by their secured charge on the debtor's assets, pre-filing secured creditors may agree to provide DIP financing where they want to ensure that their position is not compromised during the workout process; that the debtor restructures in a manner that maximizes protection of their interests; or to maintain some control over the debtor during the proceedings.

Whether the post-commencement financing lender is a pre-filing creditor or not, it is unlikely to lend absent a secured charge. While some jurisdictions only allow post-commencement financing on as yet unencumbered assets or as a lower priority security interest on already encumbered assets where the value of the encumbered asset is sufficiently in excess of the amount of the pre-existing secured
obligation, in Canada, priority secured charges for DIP financing can extend to already secured assets, if particular pre-conditions are met, such as notice to creditors.

At the height of the financial crisis in 2008 and 2009, forbearance was a primary strategy for not forcing many businesses into insolvency, as manufacturing and other sectors were reeling from the ripple effects of the failure of financial institutions, the collapse of the asset-based commercial paper and mortgage markets, and the overall unavailability of credit. Banks and other lenders would grant extensions of time, renegotiate credit terms, or forbear on exercising their self-enforcement remedies for a specified period. As the worst of the crisis ended and credit continued to be tight, new strategies had to be developed to allow financing of insolvent debtors. This article explores some of those strategies for post-commencement financing, using Canadian insolvency law as illustrative of changes in the credit market. Part II discusses post-commencement financing generally, introducing some of the ongoing policy issues, the challenge of such financing for corporate groups and in cross-border proceedings, as well as recent changes to Canadian statutory language. Part III examines the growing trend of stalking horse proceedings as a mechanism to finance the workout or as a resolution to the debtor's financial distress, including the recent introduction of credit bids. Part IV discusses the impact of the introduction of distressed debt lenders into the insolvency financing market in a number of jurisdictions, and their effect on workout dynamics, including one case of a "rogue white knight." Finally, Part V discusses the impact of credit default swaps and other credit derivatives on the economic incentives in a restructuring proceeding.

II. POST-COMMENCEMENT FINANCING OF INSOLVENT DEBTORS

If there is to be a restructuring aspect to any insolvency law, it must address the issue of post-commencement financing. New finance is often required on a fairly urgent basis to ensure the continued operation of the business while it is determining its future. The UNCITRAL Legislative Guide on Insolvency Law suggests that workout financing can be funded out of the debtor's existing cash flow through operation of a stay and cessation of payments on pre-commencement liabilities; or, where the debtor has no funds to meet immediate cash flow needs, financing may take the form of trade credit extended to the debtor by vendors of goods or services, or through loans or other forms of finance.

2. See discussion in Part III, infra, of the statutory criteria.
extended by lenders.\textsuperscript{3} It observes that post-commencement finance needs to be balanced against the need to uphold commercial bargains; to protect the pre-existing rights and priorities of creditors; to minimize any negative impact on the availability of credit; and to consider the impact on unsecured creditors if remaining unencumbered assets are used to secure new lending, leaving nothing available for distribution if a reorganization were to fail.\textsuperscript{4}

In jurisdictions where court approval is required, the court often engages in a balancing of interests and prejudice between the parties. Secured creditors may be required to make some sacrifice because of the reasonably anticipated benefits for all stakeholders, including employees, trade suppliers and other creditors.\textsuperscript{5} Even on an urgent basis, notice should be given to creditors prior to subordinating their interests, in order to avoid their having to incur the additional costs of seeking to set aside an initial order approving financing. UNICITRAL suggests that the number of authorizations for such financing be kept to a minimum, generally preferring that decision making rest with the insolvency professional rather than with the court.\textsuperscript{6} In Canada, DIP financing requires court approval. While the courts have been fairly consistent in respecting the statutory hierarchy of creditors' claims, they have engaged in a balancing of multiple interests during consideration of financing requests, having regard to the express aims and language of the insolvency statute.\textsuperscript{7}

The courts have cautioned that there should be cogent evidence that the benefit of DIP financing clearly outweighs the potential prejudice to


\textsuperscript{4} Id. at 115.


\textsuperscript{6} UNICITRAL Legislative Guide on Insolvency Law 116 (New York: United Nations, 2005). The Guide notes that although requiring court involvement may generally assist in promoting transparency and provide additional assurance to lenders, in many instances the insolvency representative may be in a better position to assess the need for new finance. Similarly, where secured creditors consent to revised treatment of their security interests, approval of the court may not be required. UNICITRAL suggests that the court will generally not have access to expertise or information additional to that provided by the insolvency representative on which to base its decision. Id.

\textsuperscript{7} Both the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act in Canada have provisions for restructuring and provisions for debtor in possession financing.
the lenders whose position is being subordinated.8 DIP financing requests in initial orders should be confined to what is reasonably necessary for the continued operation of the debtor corporation during a "brief but realistic period on an urgent basis."9 The granting of post-commencement financing may allow a corporation to keep operating in order to retain value while trying to negotiate a workout with creditors. For stakeholders, such as workers, trade creditors, or local governments, it may also result in preservation of their investments, at least for the period that a restructur plan is being formulated.10 According super-priority financing has also been aimed at ensuring compliance with environmental obligations, in the public interest.11 The court, in balancing interests, will weigh the possibility of a going-concern solution that potentially creates long-term upside value for numerous stakeholders, with the risk of further depletion of value that may be able to satisfy claims on a short-term basis.12 This balancing of interest and prejudice is at the heart of most financing judgments. Notwithstanding these potential benefits to all stakeholders, absent careful scrutiny of the terms of the financing agreement, granting access to short-term capital can increase the risk of harm to stakeholders if the terms approved by the court lead to a restructuring plan that prejudices their interests more than a liquidation outcome.

There was a growing practice in the five years preceding 2008 in Canada of arranging DIP financing in an amount far in excess of what the debtor corporation anticipated needing, ostensibly to increase market

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12. Canadian courts have previously held that there are five principles operating in the court’s consideration of applications for DIP financing and priming charges: adequate notice of DIP financing and priming requests, so that creditors can fully assess the impact of DIP financing decisions; sufficient disclosure; timeliness of the request; balancing the prejudice to creditors and other stakeholders; and the principle of granting priority financing as an extraordinary remedy. Courts apply these principles in an effort to find the optimal balancing of prejudice in the exercise of their jurisdiction to grant DIP financing or other priority charges. The court must weigh the likely risks against the likely gains of authorizing such financing; with a view to creating certainty in credit transactions while meeting the objectives of insolvency legislation.
confidence and provide creditors with some assurance that their post-filing claims would be met. However, the size of the DIP facility generated increased up-front fees, higher costs associated with heightened reporting requirements to the DIP lender, and, in some cases, more control elicited as a condition of providing the financing. As the market for DIP financing started to increase, the competition meant that the margin on a DIP facility itself was not that great, but the DIP lender made its real profit on the up-front fees.

Canadian courts have granted "Drip DIPs," that require the debtor to come before the court on notice to creditors each time it seeks to draw down another tranche of funds. The only exposure of the DIP lender is the amount already advanced, and creditors have more information on which to assess their positions as the process unfolds. Gradual release of funds in the first few weeks or months can generate a higher degree of accountability. Where stakeholders are provided with timely information of the financing requirements and the opportunity to provide their views to the court on the necessity of the draw down, it can act as a temper on any managerial slack that has arisen from a generous DIP facility. Drip DIPs frequently are structured so that the debtor can draw down according to an anticipated schedule; hence it is not necessary to come back before the court if there is no deviation from the schedule that would have adverse consequences for other creditors.

Where the lender is a pre-existing secured lender, such as a specific asset secured creditor, the creditor's claim is often unaffected by a reorganization proceeding, and the creditor may not support additional financing as it means delay in realizing on its claim. However, in some cases, subordinated pre-filing lenders may benefit from financing that is aimed at satisfying senior secured claims at the outset or early in the process, as it may enhance their position in the hierarchy of claims.

There is a question of whether post-commencement financing should be granted at all when the circumstances indicate that the financing would consume considerable resources and that the debtor has a questionable ability to successfully negotiate a plan. The court may decline post-commencement financing on a primed basis where the debtor seeks only to prolong the period before an inevitable liquidation, or where there is no possibility for a plan. The challenge is to ensure that such a decision is not premature such that creditors become unwilling to come to the negotiation table. The cases that have declined to grant the

financing have relied in part on the fact that there were not ongoing operations, and employees and trade supply relations to protect during an interim period. For example, the Alberta Court of Queen’s Bench denied the application of a real estate company that had applied for Companies’ Creditors Arrangement Act protection as it was unable to make all of its mortgage payments as a result of the economic downturn and defaults on leases. The application was opposed by the majority of first mortgagees, who wanted to proceed with their foreclosure remedies. The Court concluded that it was not appropriate to grant relief; it appeared highly unlikely that any compromise or arrangement would be acceptable to creditors; the proposed costs were not appropriate given the circumstances; and there were not a large number of employees or significant unsecured debt in relation to the secured debt.

Thus, the policy issues in post-commencement financing can be summarized as the need to appropriately balance the interests of all creditors against the potential for a successful restructuring, with a view to the costs and benefits arising from the particular form and conditions of the proposed financing agreement. These policy issues arose first in the courts’ exercise of their discretionary decision-making concerning DIP financing, and are now the subject of new Canadian legislative provisions.

A. Codification of DIP Financing in Canadian Insolvency Legislation

DIP financing in Canada was initially hotly contested based on jurisdictional grounds, given the previous lack of statutory language; however, it became widely endorsed by the courts as a measure to “keep the lights on” during the period of negotiations for a restructuring plan.

With the amendments to Canadian insolvency legislation effective September 2009, the court’s authority to authorize such financing was codified in both the Bankruptcy and Insolvency Act ("BIA") and Companies’ Creditors Arrangement Act ("CCAA"), both statutes articulating criteria for assessing requests for financing on a primed basis.

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UNCITRAL has recommended that an insolvency law should specify that the court may authorize the creation of a security interest having priority over pre-existing security interests if specified conditions are satisfied, including that existing secured creditors are given the opportunity to be heard by the court; the debtor can prove that it cannot obtain the finance in any other way; and the interests of the existing secured creditors will be protected.\(^{19}\)

The Canadian criteria have some similarities, but do not require the debtor to establish that it can find no other financing, and do not require the pre-filing secured creditor to be fully protected. The factors that the court is to consider include, but are not limited to: the period during which the company is expected to be subject to restructuring proceedings; how the business is to be managed during the proceeding; whether management has the confidence of the debtor’s major creditors; whether the loan would enhance the prospects of a viable compromise or arrangement being made; the nature and value of the company’s property; whether any creditor would be materially prejudiced as a result of the charge; and the monitor’s views.\(^{20}\) The monitor in *CCAA* proceedings is a court-appointed officer that assists the court and parties in the restructuring process, and it can provide an impartial view of the need for, and efficacy of, any DIP financing requests.

The new statutory criteria for DIP financing essentially codify the tests used previously by Canadian courts but offer greater transparency for creditors and other stakeholders that are not repeat players in proceedings. The court is not restricted to consideration of only these factors,\(^{21}\) nor is it required to give them equal weight and consideration.\(^{22}\) The court has approved post-commencement financing with a corresponding charge where necessary to ensure that the business enterprise of the debtor would continue to operate as a going concern while it undergoes restructuring, having regard to the potential material prejudice to creditors, the preservation of employment and the prospects for a successful workout.\(^{23}\) The court has held that even if certain creditors are materially affected by the DIP loan, the court must look to the broader picture, and a compromise that the creditor may have to

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23. Id.
accept can be outweighed by the positive effects of the financing on the total business of the debtor.\textsuperscript{24}

For example, in \textit{Re AbitibiBowater}, the Québec Superior Court approved a DIP financing facility where the benefits of the financing to all creditors, shareholders and employees outweighed the potential prejudice to some creditors.\textsuperscript{25} There was an urgent need for the financing due to a serious lack of liquidity to meet payroll or key suppliers’ deliveries; the term of the financing was relatively short; there was a reasonable prospect of a successful restructuring; and most of the stakeholders and the monitor supported the proposed financing. In stabilizing the continued operations of the debtor, the Court held that the financing potentially added value to the objecting term lenders’ claims and the opportunity to contest future borrowing alleviated in part the prejudice suffered by the term lenders. The Court also observed that in the current credit market, DIP financing would not be available absent a priming charge; however it reduced the amount of the charge for the DIP facility as the Court was not satisfied with the explanation provided to support the amount sought.

How creditors bear the costs of post-commencement financing is an important question. The Canadian court has approved allocation of financing charges based on the following principles: that all secured creditors should contribute to the cost of restructuring; a strict accounting on a cost-benefit basis was impractical and not necessary or desirable for allocation purposes; security arrangements and priorities should not be readjusted as part of this process; the proportion each creditor should be allocated need not be equal; and the allocation should be equitable, rather than equal.\textsuperscript{26} The Court held that while it is unfair to ignore the degree of potential benefit that each creditor might derive, the nature of proceedings under the \textit{CCAA} makes a strict accounting on a cost-benefit basis impractical and ultimately defeating.\textsuperscript{27}

\textbf{B. Corporate Groups and Cross-Border Proceedings}

The challenge for post-commencement financing becomes more acute for debtors operating as a corporate group in multiple jurisdictions. Often the related businesses have highly integrated financial systems and interrelated debt and equity structures, yet the entities are registered in

\textsuperscript{24} Id.
\textsuperscript{25} Re AbitibiBowater Inc. (2009), 58 C.B.R. (5th) 62 (Que. S.C.).
\textsuperscript{26} Re Winnipeg Motor Express Inc, (2009), 2009 CarswellMan 383, 2009 MBQB 204 (Man. Q.B.).
\textsuperscript{27} Id. Where the allocation is \textit{prima facie} fair, the onus is on an objecting creditor to demonstrate that the proposal was unfair or prejudicial. The court relied heavily on the monitor’s expertise and involvement in approving the allocation.
different jurisdictions with different statutory language covering post-commencement financing. The policy issue is whether and to what degree can the assets of the group in one jurisdiction be used as part of the financing in insolvency proceedings to the benefit of group members in another jurisdiction.

Special purpose entities ("SPE") are often created within corporate groups to manage risk in the acquisition and financing of specific assets. Corporate entities often have inter-entity financing arrangements involving loans and guarantees. The supply relationships between the entities may mean that there is short-term debt in the form of receivables granted from one entity to another. A restructuring may not be possible without a highly integrated workout strategy across multiple jurisdictions; and it is the interim financing that may be particularly challenging, given that different jurisdictions have different priorities and different degrees of willingness to allow post-commencement financing. In a number of jurisdictions, a significant method of enterprise group financing is cross-guarantee financing, where each company within a group guarantees the performance of the others. UNCITRAL observes that cross-guarantees can operate to reduce the regulatory burden on companies by granting accounting and auditing relief to related entities, operating as a form of voluntary contribution or pooling in the event that one or more of the companies becomes financially distressed. One advantage of this arrangement is that creditors can focus on the consolidated position for those entities, rather than on the individual financial statements of the wholly owned subsidiaries.

UNCITRAL suggests that insolvency laws should permit an enterprise group member in insolvency proceedings to advance post-commencement finance to other enterprise group members subject to insolvency proceedings; grant a security interest over its assets for post-commencement finance provided to another enterprise group member; and provide a guarantee or other assurance of repayment for post-commencement finance provided to another enterprise group member. The insolvency law should specify that such financing may be provided where it is necessary for the continued operation of, or the preservation of the value of, the enterprise group member; and where any harm to creditors of that group member is likely to be offset by the benefit to be

29. Id. at 29.
30. Id.
31. Id. at 37.
derived from advancing financing or a security interest. There should be appropriate protection for the providers of post-commencement finance and for those parties whose rights may be affected; and there should be fair apportionment of the benefit and detriment associated with the financing among all group members involved. UNCITRAL recommends a balancing of the interests of individual enterprise group members with what is required for the reorganization of the group as a whole. A solvent group member might have an interest in the financial stability of related entities in order to ensure its own financial stability, particularly where it is closely integrated with or reliant on insolvent members for ongoing business activity. UNCITRAL observes that the interest of a group member providing finance may relate more to the insolvency outcome for the group as a whole than to commercial considerations of profit or short-term gains, especially where there is a high degree of reliance between the businesses of the group members. The Nortel Networks case is one such example. Issues include the priority and extent to which inter-group financing should be allowed, the extent to which it encumbers the assets of one entity in furtherance of the restructuring of the entire corporate group, and how both secured and unsecured creditors’ interests are to be assessed in considering the quantum and priority of the financing.

In Canada, one relatively new development is the approval of DIP financing charges that encumber assets of Canadian debtor entities to meet financing needs of related entities in the United States. The genesis of this change is both the increasingly interrelated nature of global business enterprises and the lack of financing during the worst of the financial crisis in 2008 and 2009. The downside risk for such financing is that Canadian creditors that may have had access to the value of those assets may lose that claim. The potential upside is the preservation of the business, jobs and trade relationships, which overall may be more valuable.

For example, in Re InterTAN Canada Ltd., the Ontario Superior Court of Justice approved a DIP financing facility, the terms of which required the debtor to provide security for the borrowings of its US

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32. Id. at 31.
34. Id. at 32.
35. Id. at 32.
36. Id. at 36.
parent in its Chapter 11 filing. The Court expressed concern about inadequate notice to creditors regarding the request to use the debtor's assets as a basis for obtaining finance for a related entity, and observed that if debtors are going to request such extreme relief on an initial application, with little or no notice, it is up to the applicant to establish the evidentiary basis for the requested relief. In the absence of such evidence, parties should have no expectation that the court will grant such extraordinary relief. Justice Morawetz did approve the DIP facility on the basis that the potential upside of a going concern operation was preferable to liquidation, notwithstanding that provisions of the DIP facility effectively transferred assets from the Canadian debtor to another member of the enterprise group. He took into account the prospect of continued going concern operations; the continued employment of over 3,000 individuals; the benefits of continued operation for other third-party stakeholders; the fact that certain creditor groups would be largely unaffected by the CCAA proceedings; and the creation of an unsecured creditors' charge that provided a degree of protection to them.

In Nortel Networks, Canadian and US courts approved a series of agreements between the inter-related Nortel entities that provided the debtors with ongoing funding. The Canadian court held that the scope of review must take account of the complex and interrelated funding agreements that had been developed over a period of years. It was appropriate to place reliance on the views of the monitor who had the benefit of intensive involvement for over a year, and to take account of extensive negotiations among the debtors and creditors. The Court was satisfied that the financing was fair and reasonable, and that the financial stability of the Canadian debtor was in jeopardy and would not improve without the approval of financing.

Cross-border entities and cross-border guarantees extend not only to interim financing but have been used as mechanisms to finance a sale process. For example, the Canadian Court approved a DIP facility in which US debtor entities advanced financing to Canadian debtors. The US debtors were granted a charge over the assets of the Canadian debtor, limited to the amount of inter-company advances. The DIP facility was predicated on the US debtors' carrying out a sales process that would include the marketing of the businesses and assets of both sets of debtors,

39. Re Nortel Networks Corp., 2010 CarswellOnt 1044 (Ont. S.C.J. [Commercial List]).
40. Re Eddie Bauer of Canada Inc. (2009), 2009 CarswellOnt 3657 (Ont. S.C.J. [Commercial List]).
to be subject to approval by both the CCAA court and the US bankruptcy court. Both courts were satisfied that the proposed DIP facility and creation of the inter-company charge were appropriate in the circumstances.

In another proceeding, an extensive process to obtain new debt financing had been undertaken, and the debtors, having thoroughly canvassed the market, did not have any satisfactory alternative financing arrangements available. The Ontario Superior Court approved a cross-border DIP facility that provided that the Canadian debtors would guarantee loans to the US debtors and vice versa.41 The Court was satisfied that the business was fully integrated, making it impracticable in the existing credit environment to secure alternate financing on a stand-alone basis. The Court held that the successful restructuring of the Canadian and US entities appeared to be inextricably intertwined and that financing was needed to continue day-to-day operations.

In granting a motion for DIP financing in another proceeding, the Ontario court was satisfied that secured creditors had received notice; the amount of the facility was appropriate having regard to the debtor’s cash-flow statement; management had the confidence of the major creditors; there was no material prejudice to any of the creditors that would arise from the granting of the DIP charge; and the facility would enhance the prospects of a restructuring.42 The Court held that continued timely supply of US services was necessary to preserve going concern value and that commencement of Chapter 15 proceedings to have the CCAA proceedings recognized as “foreign main proceedings” was a prerequisite to the DIP facility.

III. STALKING HORSE PROCEEDINGS

Given the ongoing problems with credit availability, other means of post-commencement financing have been pursued, including the sale of some of the debtor’s assets. However, these sale processes may raise issues of fairness to stakeholders and the misuse of inside information similar to those raised by mergers and acquisitions outside of an insolvency proceeding. Recently, a number of insolvency proceedings have used various bidding or auction techniques to sell all or part of the enterprise to raise both post-commencement and exit financing. Stalking horse proceedings are one such strategy. The term “stalking horse”

41. Re Smurfit-Stone Container Inc. (2009), 2009 CarswellOnt 391, 50 C.B.R. (5th) 71 (Ont. S.C.J. [Commercial List]). The court approval limited the amount of borrowings under the facility pending further order of both the U.S. and the CCAA court.
42. Re Canwest Global Communications Corp., (2009), 2009 CarswellOnt 6184 (Ont. S.C.J. [Commercial List]).
comes originally from hunters using a horse to serve as a screen as camouflage when they stalked their prey.\textsuperscript{43} In the insolvency context, it is used to signify a situation where the debtor makes an agreement with a potential bidder for a sale of the debtor’s assets or business, and that agreement forms part of a process whereby an auction or tendering process is conducted to see if there is a better and higher bidder that will result in greater returns to creditors. The premise is that the stalking horse has undertaken considerable due diligence in determining the value of the debtor corporation and that other potential bidders can rely, to an extent, on the value attached by that bidder based on that due diligence.

“Stalking horse auction” processes have been used recently in Canadian-US cross-border proceedings, in part as a response to the tightening of credit and the need to generate higher bids for the value of some or all of the assets or business. In an auction, a preliminary bid by the stalking horse bidder is disclosed to the market and becomes the base amount that parties can then outbid, driving up the price and hence the value to meet creditors' claims. The stalking horse bidder in an insolvency proceeding enters the process knowing that it may not be the eventual purchaser. Hence it negotiates a price for its participation and its due-diligence activities, usually in the form of a “break fee,” which it will receive if it is not ultimately successful in its bid for the debtor company. In this sense, it is similar to a white knight in a takeover transaction, in that the size of the break fee must be large enough to be auction-generating and small enough not to be auction-inhibiting.

In \textit{Nortel Networks}, the Canadian and US courts approved a bidding procedure and asset-sale agreement for the purposes of conducting a “stalking horse” bidding process, including a break fee and expense reimbursement.\textsuperscript{44} The hearing was conducted by video conference with the US Bankruptcy Court for the District of Delaware in accordance with the provisions of a cross-border protocol previously approved by the courts. The Canadian court held that it had jurisdiction under the \textit{CCAA} to approve a sales process in the absence of a formal plan of compromise

\textsuperscript{44} Re Nortel Networks Corp. (2009), 2009 CarswellOnt 4467, (2009), 56 C.B.R. (5th) 74 (Ont. S.C.J. [Commercial List]). \textit{See also} Re Eddie Bauer of Canada Inc. (2009), 57 C.B.R. (5th) 241 (Ont. S.C.J.). Previously, the US bankruptcy court has held that it will take the following factors into account in determining whether to approve a break fee: whether the fee correlated with a maximization of value to the estate; whether the request is arm's length; the degree of stakeholder support; whether the proposed fee is a fair and reasonable percentage of the proposed purchase price; any potential chilling effect on the market; the existence of safeguards; and whether there is an adverse impact on any opposing unsecured creditors; Re Hupp Industries, 140 B.R. 191 (Bankr. N.D. Ohio 1992).
or arrangement and a creditor vote, on the basis that the *CCAA* must be
given a broad and liberal interpretation to achieve its objectives. The
Court held that a sale by the debtor that preserved the business as a going
concern was consistent with those objectives. Factors to be considered
included, but were not limited to: is a sale transaction warranted at this
time; will the sale benefit the whole "economic community"; do any of
the debtor's creditors have a *bona fide* reason to object to the sale of the
business; and is there a better viable alternative?

In another proceeding, the Ontario Superior Court of Justice
approved a stalking-horse auction process in a *CCAA* proceeding where
the proposed stalking horse, which was an insider and related party, had
been scrutinized by the financial advisors, the independent committee of
the board and the monitor.45 With respect to a contested break fee, the
Court held that the fee was a business decision that had been considered
by the debtor and key creditor groups and that the amount of the break
fee was consistent with break fees that had been approved in other
proceedings.46 In the circumstances of this case, the court found it
unnecessary to substitute its business judgment for that of the applicants.

Canadian courts have generally supported sealed competitive
bidding processes that allow submission of independent, self-contained
bids, finding that bidders are entitled to fair compliance with such
procedures.47 The courts have supported insolvency professionals
rejecting referential bids on the basis that they would frustrate a sealed
competitive bidding process, as it would create unfairness if a party
could introduce into the sealed bid system elements of a public auction
without any risk of being outbid by another party. Where parties
intended a fixed bid process, the court was satisfied that the receiver's
rejection of a referential bid in favour of another bid was commercially
fair and reasonable in the circumstances and should be accepted.48

Dowdall and Dietrich have argued that stalking-horse proceedings
conducted by the debtor and not a neutral court-appointed officer raise
concerns about the process, in that the stalking horse can exert
considerable control over timelines, making them so tight that other
bidders do not have a meaningful opportunity to undertake their due

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45. Re Brainhunter Inc., 2009 CarswellOnt 8207 (Ont. S.C.J. [Commercial List]),
adopting the tests used in Re Nortel Networks Corp. (2009), 55 C.B.R. (5th) 229 (Ont.
S.C.J. [Commercial List]).
46. Id.
47. Fifth Third Bank v. MPI Packaging Inc., 2010 CarswellOnt 29 (Ont. S.C.J.
[Commercial List]).
48. Id.
diligence. Stalking horse bidders may insist on restrictive terms in respect of who may be treated as a qualified bidder. Management may also have a conflict of interest where they are negotiating key employee retention packages, bonuses or other perquisites; and while these are ostensibly subject to some control in terms of the court’s approval, the tight timeliness may create pressure to approve such plans, even where the court might otherwise have concerns.

These concerns may be difficult to discern where the issues are complex and time is of the essence. However, courts have indicated that they will scrutinize such transactions. In Re Mecachrome International Inc., Justice Gascon of the Québec Superior Court dismissed a motion to approve a plan-funding agreement proposed by the DIP lenders to fund a proposed CCAA plan, under which the DIP lenders would acquire all the shares of the Canadian debtor company in exchange for payment, including some funds to be directed to unsecured creditors to recover approximately 12% of their claims. The Court held that the CCAA is aimed at enabling a debtor company, with the support of its creditors, to weather its financial difficulties and continue to operate in the interests of parties and society in general, and that a plan that is supported by creditors must be achieved at the best cost and under the best possible conditions for the creditors that inevitably suffer the consequences. Here, the fundamental goal of the CCAA in the circumstances was best served by refusing to approve the plan-funding agreement. The Court held that the cumulative effect of the absence of any legitimate and open process to canvass funding proposals; the narrow definition of what constituted a superior proposal under the plan-funding agreement and the lack of flexibility given to the board of directors to qualify a superior proposal as superior; the chilling effect of the high break fee; and the lack of evidence of a value maximizing process, all worked against the objective of a sufficient, transparent and open process. As well, the process contemplated by the proposed funding agreement would usurp the exercise of the right to vote belonging to creditors, and the agreement unnecessarily tied the hands of the Canadian debtor with respect to potential consideration of available alternative solutions that could benefit creditors. The Court held that the funding agreement closely resembled a stalking horse bid process with no real canvassing of the market. While the DIP lenders may have had a head start in any acquisition because of the inclusion of an exclusivity clause of limited

50. Id.
duration in the DIP financing agreement, the Court held that such a clause did not, and could not, have the impact of relieving the Canadian debtors and the monitor of their duties, in terms of fairness, transparency, and openness towards all stakeholders. The Court found that the proposed break fee of 4.5% was too high, the evidence before it suggesting that the average break fee in a merger or acquisition is about 2.9%; and that the debtor had failed to show that the break fee was reasonable or adequately related to the costs of the DIP lender or its risk. The Court noted that while the approval of the monitor is an important factor, it is not decisive in and of itself.52

There is also the issue of the degree to which the DIP financier is, through terms of its facility, determining outcomes in other aspects of the CCAA proceeding. For example, in Re AbitibiBowater Inc., the interim funding was provided on the basis that the funds could not be used towards the payment of special contributions to pension plans; and as a result, the Court concluded that it was necessary to suspend the special contributions to the pension plan.53 While the DIP lender should be able to negotiate the terms of the facility, the courts need to be cognizant of the degree to which such terms will bind the court in future decisions. Tighter credit conditions have given DIP lenders greater leverage and the ability to exert more control. An alternative process that may offer better results for existing creditors is a credit-bid process.

A. Credit Bids

A very recent development in financing workouts of insolvent businesses is the use of credit bidding, which has occurred in cases such as Canwest and White Birch.54 A credit bid allows a creditor to essentially use its debt to bid for the equity of the company, often in a stalking horse process. Although there is no express language in the CCAA that allows credit bidding, as there is in the US Bankruptcy Code, Canadian courts have accepted credit bids as a reasonable means of financing the workout. There are a number of issues raised by this new financing. First, a creditor may have access to considerable information as a result of its position as a senior secured lender; thus, it is important to ensure that any bidding process is fair and transparent in terms of the financial and other disclosures. If the bidding creditor is also the DIP financier, it may pressure the debtor for a truncated process that does not

52. Id.
generate a true market for bids; or it may pressure for a lower value to be attributed to the business, given that pricing is difficult to determine at the point of insolvency. There is an important role for the monitor and the court in ensuring that the process is fair, that information is available that allows competitive bids to come forward, and that any conflicts of interest are controlled as much as possible. While credit bids may offer a helpful alternative to financing a workout, particularly in the tighter post-financial crisis credit market, their further development must be undertaken in a manner that ensures that the integrity of the CCAA process is maintained.

In the Canwest case, the credit bid was topped by a junior lender working in conjunction with other parties, generating increased value. Unlike new parties to insolvency proceedings, pre-filing secured creditors were already privy to confidential information, and generally such lenders are entitled to see other bids and proposals. The challenge was how to create a transparent and fair process that was truly open enough to generate other bids where appropriate. Another case upheld a creditor agreement that had provided for creditor bids, although the judgment did not expressly address the issues associated with credit bids. The Ontario Court approved a sale transaction involving transfer of the business and sale of real property of the applicants in both Canada and the US under a court-approved marketing process.\(^{55}\) The Ontario debtor operated from businesses located in Canada and the United States. The selection of purchaser was based on a thorough analysis of all of the financial and commercial terms presented in all of the bids, and was recommended by the monitor and approved by the first lien lenders steering committee and the independent directors committee.\(^{56}\) A 2007 inter-creditor agreement ("ICA") was found to be binding on the group of companies, including a provision that the first lienholders could credit bid their debt. The Ontario Superior Court of Justice found that by its terms and the definition of "bankruptcy code" in the ICA, the parties recognized that Canadian or US insolvency law might apply. Justice Campbell held that once a process has been put into place by court order for the sale of assets of a failing business, that process should be honoured, excepting extraordinary circumstances. To permit an "invitation" to reopen that process not only would destroy the integrity of the process, but would likely doom the transaction that had been

\(^{55}\) Re Grant Forest Products Inc. (2010), 2010 CarswellOnt 2445 (Ont. S.C.J. [Commercial List]). Objections were raised by the subordinate secured creditor who questioned the jurisdiction of the court to convey real property assets located in the US.

\(^{56}\) Id. The second lien lenders had been consulted, and their views and questions were taken into account in the final selection of purchaser.
achieved. The Court was satisfied that, by operation of the credit agreement, the first lienholders were entitled to exercise their remedies and the Canadian court had jurisdiction to provide the relief requested.

The US caselaw on credit bids is extensive and has highlighted a number of policy issues in respect of this tool for generating post-commencement and exit financing. As Canadian parties develop these strategies, it will be important to study some of the problems that have arisen in the US context in terms of transparency and fairness of the process.

IV. CIRCLING VULTURES AND ROGUE WHITE KNIGHTS

Traditional pre-commencement creditors who offer post-commencement financing are seen to have a stake in the long-term success of the business. However, constraints on credit granting by these institutions have lessened their ability to finance restructuring of insolvent companies. Other sources of financing may not have the same incentives in a restructuring proceeding. Is this shift in incentives a matter that should concern policymakers or the courts?

Distressed debt purchasers, often called vulture funds, have increasingly used strategic purchases to assert control in restructuring proceedings, by buying up debt across multiple classes at a discounted value or buying in sufficient quantity to obtain an effective veto over particular proposals and hence influence the outcome. Generally, Canadian courts have not been concerned with debt purchase transactions that may offer liquidity for trade suppliers, banks and other traditional creditors by creating a market for their devalued claims during insolvency proceedings. Distressed debt purchasers offer creditors an opportunity for early exit and in some cases can lend their expertise to the development of viable business plans. Such lenders may also provide post-commencement financing such that the debtor obtains some

57. Id., which was the product of the marketing process that was not only approved by the Ontario Court but not objected to by any party when it was initiated. The aggregate consideration being paid by the Canadian purchaser for the transferred assets and the U.S. purchasers for the Grant US Partnership assets was $403 million, subject to adjustment. It was urged that the proposed structure would maximize the value of the Grant U.S. Partnership assets.

58. Id. They may then release their security over the assets to be transferred in connection with the exercise of their remedies and by doing so, the security of the second lienholders over the transferred assets would be automatically and simultaneously released. Campbell J. accepted that the effect of the transaction may indirectly be a transfer of US real property assets and the release of a security over them of the second lienholders. The effect of the transaction was such that the claims of local creditors of the business of the US mills remained unaffected.

financial breathing space in which to devise a going-forward strategy to address its insolvency. Canadian courts do not generally distinguish in insolvency proceedings between creditors' claims acquired through normal credit transactions and creditors' claims acquired at a discounted value at the point of a firm's financial distress.

Certain equity sponsors may organize their strategy to shift control early in the process towards their interests. They buy up the debt across classes at a severely discounted value and provide the post-commencement financing under stringent controls. Alternatively, they can buy most of the debt from a single class but purchase that debt through several entities and thus control the vote of the class through the "head count" numbers as well as the total value of claims. This strong creditor position then allows them to put in the equity bid and to be assured that it is accepted across the classes of creditors. While parties are entitled to conduct their affairs to maximize value, this strategy creates new challenges for the court in exercising its supervisory powers in terms of its ability to balance stakeholder interests.

The limited pool of DIP lenders often provides them with considerable bargaining power in negotiations for a post-commencement financing agreement. Given the thinness of the post-commencement financing market, lenders have been able to secure both extremely favourable financing terms, as well as extensive control rights in the provisions of the financing agreement. An example was the Teleglobe DIP financing agreement, in which the DIP lender was expressly given the right to approve any form of order coming before the court. It is a normal practice of a DIP lender to protect its interest, but such control rights can also serve to prevent the debtor from considering strategies or bringing motions that better serve the interests of multiple stakeholders. Canadian courts have endorsed these financing agreements because they have been persuaded that the agreement is the only realistic means for the debtor corporation to keep operating while it attempts to negotiate a viable restructuring plan with its creditors. Often the court is advised that all the jobs will be lost if the DIP agreement is not approved. Control terms in a DIP agreement can create serious risk of prejudice to stakeholders. For example, the DIP lender can threaten to declare default on the agreement if particular motions are brought before the court or if the debtor takes particular positions where creditors bring motions. Other provisions can specify default of the DIP financing agreement if the court makes particular orders. The growth of distressed debt investors in insolvency workouts has created new pressure for timely

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60. *In the matter of the Companies' Creditors Arrangement Act and Teleglobe Inc.* (May 15, 2002), Doc. 02-CL-4528 (Ont. S.C.J. [Commercial List]).
turnaround and workout plans that generate short-term returns on their investments and sometimes little interest in the long-term viability of the business enterprise.61

If the debtor is able to secure capital from existing senior operating lenders, the governance structure may not change, except that the lender imposes more stringent monitoring and, in some cases, control rights on the use of the financing. Governance of the debtor business enterprise plays a significant role in the potential success and, hence, upside value that may be generated by a successful workout, and post-commencement financing has been utilized as a tool in Canada, the US and elsewhere to influence governance.62 Where creditors have confidence in the oversight and management of the debtor corporation and they determine that a going-concern outcome to the insolvency proceeding maximizes value for them, they are likely to provide the DIP facility.63 However, where the party acquiring the distressed debt engages in abuse of its position or lacks good faith in its dealings with parties to an insolvency proceeding, the court may limit the ability of that creditor to veto an outcome to the proceedings, in keeping with the overall objectives of insolvency legislation. Canadian courts may consider the motives and conduct of a distressed debt purchaser where there is evidence of abuse of process or a lack of good-faith dealings.

To date, there have been few judgments that have addressed this type of behaviour. The court has observed that there are different types of vulture funds, some that have objectively concluded that the debtor has value and hence they purchase debt such that there is increased liquidity in the market for those who have a desire to cut their losses, and other vulture funds that are "somewhat more antisocial and may in certain circumstances be said to hold the affected parties to ransom."64 The Court in Curragh held that while legally there is no difference in these claims, the court may question the effect on those traditional creditors who had put 100 cents on the dollar into the situation only to be caught in a credit crunch, and those who have "speculated" at pennies on the pound knowing that the situation is risky.65 In Re Canadian Airlines Corp., the Alberta Court held that the good faith of a distressed investor

61. Id.
62. Id.
63. Existing creditors can often make a decision on post-commencement financing quickly, given that they have already acquired knowledge of the debtor's financial position and may have sector-specific information that has informed previous credit decisions. Hence, they may have lower transaction costs in conducting the due diligence required in post-commencement financing decisions.
65. Id.
may be a factor in considering approval of a CCAA plan.66 There, the creditor continued to purchase a substantial amount of highly distressed debt when it was well aware of the financial deterioration of the debtor in order to leverage its position in the negotiations for a workout. Canadian courts will consider the motives of distressed debt purchasers in weighing the benefits and prejudice in particular restructuring cases.67

Where the DIP lender is not a pre-filing creditor, it may have different timelines in terms of satisfying its claims. As a consequence, the DIP creditor may encourage the debtor corporation to consider liquidation prematurely, when there is still value in the debtor that could accrue to junior secured and unsecured creditors. Similarly, it may press for a going-concern sale to third parties when a sale to existing creditors would satisfy a greater percentage of claims or produce less prejudice to claims overall. A new post-commencement finance lender may have little concern about the outcome of the insolvency proceeding, since its claims are fully protected by the priming charge and it has no pre-filing debt that may be underwater. Given the controls that it extracts in the financing agreement, the post-commencement financing lender may unduly pressure the debtor corporation to consider its interests above those of other creditors. It may also pressure the debtor company to engage in particular bargaining or litigious conduct that unnecessarily prejudices pre-filing creditors and dictates the outcome of bargaining, confident that the size of the facility and the conditions under which it was granted will prevail. Since an objective of Canadian CCAA proceedings is to facilitate a process whereby the debtor is given the opportunity to devise a viable plan of arrangement, the courts should consider the potential prejudice to these objectives where DIP lenders have imposed control rights that prevent directors and officers from decision-making in the interests of the firm and all its stakeholders.68

In Canada, the debtor corporation remains in control during the workout process, as the legislative scheme envisions, but not necessarily the directors and officers, who might be replaced or encouraged to resign. The ability of directors and officers to bargain for the terms of the DIP facility may allow them more room to negotiate overall with

other stakeholders in finding the most appropriate plan of arrangement or compromise. The difficulty is where there is a lack of confidence in governance by the vast majority of creditors, but the DIP facility has the effect of entrenching the directors and officers. In some cases, corporate officers negotiate a specific provision that the debtor cannot change management and that such a change would be considered a default of the DIP agreement. Creditors are not given full access to the terms of the agreement and, thus, do not know of the existence of such terms at the point that the court endorses the DIP agreement. The control issue in respect of DIP lenders has become important because the market for such lenders has been particularly thin since autumn 2008.

Hence, while distressed debt lenders have often provided needed capital, their ability to purchase at a discounted value and their short term profit horizon can sometimes result in workouts that are not aimed at maximizing overall creditor value or at maximizing the overall value of the business enterprise.

A. Rogue White Knights

There is one case that illustrates some of the challenges of these new financing strategies. In Minco-Division Construction Inc., a distressed debt buyer had acquired the debt at a significant discount in order to gain strategic control of the CCAA proceedings, and the Québec Superior Court held that it had jurisdiction to take into account the circumstances under which distressed debt is acquired in insolvency proceedings, especially in situations where the purchaser of such distressed debt is pursuing a hidden agenda, is acting in bad faith, or “tramples on the rights and expectations of others.” Minco-Division Construction Inc. was an owner-developer of a mixed residential and commercial condominium project under construction in Québec, which filed for court protection under the CCAA, owing its creditors more than $32 million. The first ranking Canadian bank granted DIP financing to the debtor, to be used to fund the restructuring process and to maintain and preserve the project. An interim receiver was appointed at the bank’s request, to determine whether it was prepared to fund the sums required to complete construction. Over the course of the restructuring process, the DIP loan grew to approximately $5 million. The debtors had sought a “white knight” to buy out the bank’s interest at a steep discount

69. Id.
in order to allow the debtor to seek permanent financing to fund a plan of arrangement and complete construction of its project. The white knight was found among three shareholders and another party, and the debtor had the expectation that the white knight would support the debtor’s restructuring efforts and not assert claims for the full value of the debt that it had acquired. Disagreement among the principals resulted in the white knight purchasing the rights of the mezzanine lender and numerous construction liens in order to control the class of creditors and defeat the debtor’s restructuring efforts. The Court concluded that no party intended that the white knight would take over the project; rather, its initial role was confined to putting the bank claim in friendly hands while looking for longer term financing to complete the project. The Court held that white knights usually have an interest when intervening to save a debtor from its creditors. 71

In finding that the distressed debt buyer was a “rogue white knight,” the Court held that “threatening to hijack the project and frustrate a plan intended to bring a measure of relief to many creditors, including the purchasers of units, does not square with the good faith conduct required of contracting parties by article 1375 Code civil du Québec (CCQ).” 72 In finding the white knight’s interest to be akin to litigious rights, the Court ordered that the debtor could satisfy and discharge all claims owing to the white knight by paying it, in the context of its plan of arrangement, the amount that the white knight had itself paid to acquire the subject debt claims. 73 The Court further declared that on such payment by the debtors to the white knight, the debtors would be fully discharged in respect of the claims and the white knight would be deemed to have accepted Minco’s plan of arrangement.

Hence on the particular facts of the case, the Québec Court exercised its general authority under insolvency legislation, drawing on

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71. Here, the white knight investor was to have profited from its intervention at least to the extent of 30% or a fifty-fifty basis; instead the white knight used its position to try to take over the debtor on the strength of the giving in payment option contained in the security provisions of the bank claims. It was in this sense that the Court described it as a “rogue white knight.”

72. Id. ¶ 36. Article 1375 specifies that “the parties shall conduct themselves in good faith both at the time the obligation is created and at the time it is performed or extinguished.” In the circumstances, the Court decided to treat the claims of the white knight as if they were “litigious rights” because that was what the parties intended at the time that the bank debt was acquired at a discount. Id. ¶ 40. The Court drew from “litigious right,” which is described in article 1782 CCQ as: “A right is litigious when it is uncertain, contested or contestable by the debtor, whether an action is pending or there is reason to presume that it will become necessary entitling a debtor of such right to be fully discharged by paying to the buyer the sale price, the costs related to the sale and interest on the price . . . per article 1784 CCQ.”

73. Id.
concepts in the Québec Civil Code to prevent an abuse of process by a distressed-debt purchaser in the course of restructuring proceedings. Having regard to the overall legislative objectives, the Court balanced the interests of multiple creditors and limited the effects of the conduct of the rogue white knight by limiting the value of its claims to the purchase price of those claims plus costs of proceedings and interest costs. The white knight did not suffer any financial loss, but it was not able to take advantage of control rights to hijack the debtor’s efforts for a viable workout plan. The judgment in Minco-Division Construction Inc. indicates that where a creditor provides financing to support a debtor’s restructuring and receives a control or veto position in the restructuring process, the court may consider whether the creditor has acted in a manner that is abusive, in bad faith or that is inconsistent with the reasonable expectations of the debtor and other creditors at the time that such funding was agreed upon. The competing consideration—that a party to commercial agreement is entitled to pursue all legal rights that it has acquired in the transaction—was subject to the considerations of abuse, bad faith and inconsistency with reasonable expectations in the context of the insolvency proceeding.

The willingness of the courts to intervene in the effects of commercial transactions when they threaten the policy behind the applicable insolvency legislation will be tested in the treatment of credit derivatives in insolvency proceedings. Like the development of distressed debt markets, credit derivatives alter the economic incentives and motivations of stakeholders in insolvency proceedings so that they are unrecognizable in the traditional model of creditors’ incentives in insolvency proceedings.

V. CREDIT DEFAULT SWAPS AND THE EFFECT ON POST-COMMENCEMENT FINANCING

While a full discussion is beyond the scope of this paper, financing issues in insolvency proceedings cannot ignore the incentive effects of credit default swaps and other credit derivatives on insolvency restructuring proceedings. Credit derivatives are financial instruments that allow parties to manage credit exposure. A credit derivative can be


75. There are numerous kinds of credit derivatives, such as credit default swaps, collateralized debt obligations ("CDOs"), full and index trades, and credit-linked notes. Elizabeth Murphy, Janis Sarra and Michael Creber, "Credit Derivatives in Canadian Insolvency Proceedings, 'The Devil will be in the Details,'" in Annual Review of Insolvency Law, 2006 (Toronto: Carswell) at 187-234. Credit derivatives are classified as
a privately negotiated agreement that explicitly shifts credit risk from one party to the other; or it can be collateralized and housed within a special purpose vehicle that resells debt contracts in various tranches at differing prices, quality and risk. CDO can be cash-flow based, whereby the vehicle issues its own financial instruments to finance purchase of debts of different corporate entities, ensuring a fixed flow of loan repayments that are used to pay investors in the various tranches; or CDO can be synthetic, whereby the entity does not directly purchase debts but, rather, enters into credit default swaps with a third party, creating synthetic exposure to the debt of a number of corporate entities. The most common credit derivative, a credit default swap ("CDS"), is a credit derivative contract in which one party, the "protection buyer," pays a sum of money periodically to the "protection seller," usually referable to the amount of protection provided by the contract. The protection seller’s obligation to pay arises on the occurrence of a credit event, most frequently, the reference entity’s failure to pay, bankruptcy, or restructuring. The reference entity is not a party to the credit default swap. The protection buyer that is a creditor of the reference entity hedges the risk of default by that entity and takes on the risk of default by the protection seller. The protection seller acquires the default risk of the reference entity. Unlike insurance, the amount of compensation that can be claimed under a credit derivative is not related to the actual losses suffered by the protection buyer.

Credit derivatives emerged in the early 1990s as a tool for banks to manage their credit risk in respect of entities in which they had directly invested through their lending activities, diversifying their risk on loan default. In this respect, credit derivatives were initially effective in cushioning the commercial banks’ losses in notable cases such as Enron and Parmalat. The market grew in less than two decades to an estimated $62 trillion in outstanding credit default swaps alone at the end of 2007. However, how such financial products work in practice bumps up against insolvency restructuring regimes that allow for the development of viable business plans that maximize enterprise value, preserve economic activity and save jobs. The existence of credit derivatives may

either single- or multi-name (basket) products. Single-name credit derivatives are targeted on the credit worthiness of a single reference entity. Multi-name products hedge the risk of clustered defaults in a portfolio.


77. Credit derivatives do not require either the protection seller or protection buyer to actually hold an interest in the referenced asset; therefore the protection purchased by the protection buyer can be more than, less than, or completely unconnected to its underlying exposure to the reference entity. The protection buyer need not suffer an actual loss to be eligible for compensation if a credit event occurs.
FINANCING INSOLVENCY RESTRUCTURINGS

perversely affect the motivation and behaviour of stakeholders of a financially distressed entity, and may cause greater complexity and uncertainty in a restructuring proceeding, as the real economic interests of claimants are not transparent.

Commercial banks as operating lenders traditionally had a strong role in monitoring the financial status of debtor companies, particularly in the period leading up to insolvency. However, their hedging of risk through derivatives has reduced the incentive to engage in oversight and monitoring, notwithstanding that they are best placed through loan covenants, access to information and in-house resources to engage in that monitoring. While arguably that hedging of risk freed up capital for other market participants seeking to borrow, the previous reliance that creditors and other market participants often had on banks to engage in such monitoring and the resultant signalling of a firm’s financial health, have diminished considerably. Given the weaker covenants under which some debtor companies have financed their operations in recent years, creditors may be unable to assert control over a debtor until there has been a significant deterioration in its financial position, leading to deferred liquidation or restructuring and consequent lower recovery to creditors. It may no longer be feasible for the bank or other traditional operating lender to take a lead in restructuring negotiations, given that they have little or no remaining economic interest due to their credit default swaps.

On insolvency, one moral hazard is that a creditor that has material holdings of credit derivatives may have economic interests that encourage it to cause a default to occur so that there is a credit event. There are many factors that can affect the motivation and behaviour of stakeholders in an insolvency restructuring, given their economic interests; yet the creditor that has hedged its risk through a credit derivative is arguably in a different position in the restructuring proceeding, as there is a lack of transparency in respect of whether, in fact, there are economic interests at risk. This observation is not to suggest that credit derivatives drive behaviour in all cases; rather, it is a growing phenomenon with the move to cash settlements and growth of the market.

Under physical settlement of a CDS, the single institution from which a debtor company borrowed and believed it had a relationship results now in multiplicity of intermediaries and counterparties as CDS settle. The insolvent company may not even appreciate before commencing a restructuring proceeding that it is a reference entity. Cascading swaps means multiple rapid changes to who holds the claim,
making it difficult for a debtor company to establish who has a claim.\textsuperscript{78} It can suddenly be dealing with literally hundreds of new claimants. Given settlement time lags where the protection seller with each physical settlement becomes the party at the restructuring bargaining table, the company's ability to devise a viable business plan can be hindered. This effect is particularly problematic if there is urgency in devising a plan because of a liquidity crisis or the need to maintain customer goodwill. Physical settlement of multiple CDS has the potential to cause a revolving door effect, making it hard for the company to build consensus and garner requisite support of creditors for a going forward viable business-restructuring plan.\textsuperscript{79}

A number of jurisdictions have granted exemptions for derivatives from stays under insolvency laws because of the important public-policy goal of global financial stability. However, the continued trading of derivatives can cause further financial instability of the market in the name of preserving liquidity and makes restructuring increasingly difficult for particular debtors. In this respect, there is a tension between two broader public-policy goals. On the one hand, Basel II capital rules require the ability to terminate, net and realize on collateral in order to allow institutions to take offsetting transactions into account for capital purposes.\textsuperscript{80} If parties cannot close out, they face exposure on their offsetting trades, which can cause greater financial problems in the market. On the other hand, the move towards rehabilitation in insolvency laws globally is driven by the recognition that liquidation can often leave value on the table that would have meant greater realizations for subordinated secured creditors, unsecured creditors and employees, as well as positive ripple effects in the local economy that can be realized by preservation of economic activity in the community.

Many restructurings are almost completely negotiated before any formal proceedings are taken, the UK being one such jurisdiction where this practice occurs. Yet creditors who may be obliged to assign their claims to protection sellers may not be able to bind their claims to an agreed restructuring plan, removing a valuable public policy tool to preserve economic activity.

Cash settlement of CDS poses different kinds of challenges for restructuring. Unlike insurance, no title to the claim passes, and there is no right of subrogation. With cash settlement, the protection buyer that is a creditor of the insolvent company continues to be the party with the

\textsuperscript{78} Murphy, Sarra & Creber, \textit{supra} note 75, at 10.

\textsuperscript{79} Id.

legal claim, although at a reduced or eliminated financial exposure. The debtor and other creditors have no notice or knowledge of the reduced exposure. If the creditor is fully hedged, there will be little incentive to engage in constructive negotiations for a restructuring plan. This level of disengagement may be problematic for the restructuring. While in some cases there can be an active market for derivatives during a restructuring where credit-derivatives holders are also direct creditors and take an active and constructive role in workout negotiations, the converse can also occur. The financial institution with which the debtor company has had an operating lending relationship may be less interested in advancing further credit in the form of post commencement or exit financing if it has no ongoing financial interest in the debtor. The creditor may actually have over-coverage and thus a negative economic interest, materially benefitting if the restructuring fails. Yet parties to the restructuring currently have no information on the economic interest held by those parties hedged through a credit derivative.

Accordingly, a debtor company may find the creditor that is hedged under a CDS adamant in its refusal to agree to amendments to its credit documentation (such as a payment change or deferral) and changes to covenants that would otherwise trigger a default or obligation acceleration. In addition, protection-buying creditors will be unlikely to consent to the extension of the maturity date beyond the protection period unless a credit event has already occurred or the extension itself qualifies as a credit event. These motivations may complicate the efforts of distressed companies to negotiate arrangements with their creditors at the early stages of distress in an attempt to restructure outside of formal insolvency proceedings. Moreover, a claims-trader creditor may be seen as having a new, speculative and short-term interest in the debtor. Having acquired its position when the debtor company is already in financial difficulty, it is often hedging against the speculative outcome of the restructuring process. Such a creditor, perhaps holding a deciding vote, has little interest in the long-term viability of the company.

Moreover, the normative justification for carving out derivatives from stays under restructuring proceedings is unclear, given the shift from their risk-management function to speculative product. The failure to stay derivatives claims creates a statutory preference for particular creditors, over the claims of traditional secured creditors, employees, trade suppliers, and tort claimants. Considering the general insolvency

81. Where there are cash settled credit default swaps, on occurrence of a credit event, the CDS may be settled by determining the value of the underlying debt instrument through an ISDA-run or similar auction, whereby the protection seller pays the protection buyer for its estimated loss based on the value established in the auction or where a value can be determined based on post-credit-event bids for the debt product.
law goals of transparency, timeliness, and certainty, such exclusion must be revisited. As the bailouts of 2008-2009 illustrated, there is a broader public interest in how the global derivative market is to operate effectively, and adjustments to the system must be made after public-policy discussion among stakeholders broader than industry participants. Interests affected are beyond capital-markets participants, and regulation is needed to ensure that there is transparency in the nature of economic exposure and underlying risk. There should be a public-policy debate on whether there is a need to design new principles to account for the separation of economic and legal interest in the context of insolvency proceedings.

These observations are not to suggest that the market has failed to address some of its flaws itself. CDS protocols and index auctions have helpfully assisted in facilitating cash settlements. The purpose of such protocols is to offer market participants an efficient way to settle credit derivative transactions referencing. The protocol mechanism facilitates industry-wide net settlement of CDS referencing an insolvent entity. While these innovations are important, they address only one aspect of the settlement process. There continues to be a lack of transparency as to who is bearing the ultimate costs of the deficiencies in value when all the CDS settlements are completed. There are also significant issues in respect of central counterparty clearing facilities and the need for regulatory intervention that are beyond the scope of this discussion.

Some jurisdictions have statutorily created unsecured creditors' committees, where representative creditors have a role in the negotiations for an insolvency workout, paid out of the insolvency estate, and such

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82. ISDA Protocols, supra note 3. For example, when Collins & Aikman filed for bankruptcy in 2005, there were concerns that there were not enough deliverable bonds to settle all the existing index-related contracts. To address this issue, the ISDA published the first protocols to amend the existing contracts for index-related trades to cash settlement from physical settlement on a multi-lateral basis, rather than through counterparty-to-counterparty negotiations, and to participate in an auction to determine the cash-settlement price of the defaulted bonds. With the CDS outstanding greater by multiples than the volume of bonds issued, the bonds would have to be bought and sold numerous times in the market to settle the CDS, which would have created pressure to source bonds, raising the price of the bonds higher than the likely recovery value. Hence, the market developed credit event auctions, first to facilitate cash settlement and more recently, to allow for physical settlement on net open positions. Nomura, CDS Recovery Basis, ISDA, 2006.

83. ISDA Auction Process, 2008, http://www.isda.org. The Lehman Brothers Holdings' auction illustrated that the market can price the value of CDS and allow cash settlement for counterparties to CDS trades. The auction set a price and resulted in protection sellers paying ninety-one cents on the dollar to protection buyers. More than 350 organizations adhered to the 2008 Lehman CDS Protocol, which provided a settlement procedure for approximately $6 billion of net CDS exposures; ISDA 2008 Lehman CDS Protocol, id.
committees often have strong normative sway with the court. In some jurisdictions, courts recognize ad hoc committees of creditors for similar purposes. In thinking about the disconnection between economic interest and legal claim, it may be that the price for participation on such committees should be that such creditors are required to disclose the extent to which their economic risk has been hedged, with the court given authority to refuse to let the creditor participate where there is little or no economic interest.

Arguably, there should be mandatory disclosure during a restructuring proceeding of the real economic risks at stake, including disclosure of the amount of debt that has been hedged by creditors that seek to exercise their voting or oversight rights in a restructuring proceeding. Lack of transparency now means that the debtor company and other creditors are not aware of who is bearing the real economic risk of firm failure, inhibiting the potential for a viable business restructuring plan. The court should be granted authority to determine the scope and timing of disclosure, including making determinations in respect of confidentiality, limiting access only to parties in the proceeding, and determining any exceptions, such as for de minimus holdings. The court’s consideration of any restructuring plan should take account of economic interests at stake. This weighing of interest could be accomplished in two different ways: voting on a restructuring plan could be premised on the real economic interests in the firm’s insolvency, or alternatively, legal voting rights could be unaffected, but the court could be granted authority to weigh actual economic interests when considering parties’ positions and exercise of voting rights. It is also helpful to consider amending insolvency-restructuring legislation to include credit derivatives within the mandatory stay of proceedings, except with leave of the court on the basis of unfair prejudice, the standard currently used for other creditors to be exempted from the stay. The court could then exercise oversight of the clearing process in a measured way that assists with the risk-management aspects of the products and slows the speculative market. Such an approach could ensure that derivatives continue to settle where they are not adversely affecting the workout process, but could be stayed where the court was persuaded that the stay would prevent inappropriate conduct or would preserve going concern value pending negotiations for a restructuring plan.

84. See, e.g., Rule 2019 of the US Bankruptcy Code.
85. Sarra, supra note 75, at 8.
VI. CONCLUSION

Post-commencement and exit financing in insolvency proceedings continue to pose significant challenges, both in respect of attracting such financing and in considering how its availability and terms affect other stakeholders and the overall integrity of the insolvency system. While stalking horse proceedings, credit bids and other strategies to generate higher value have been a helpful response to financing in a period of global financial uncertainty and tightened credit conditions, they pose new challenges for other aspects of the insolvency system, such as the need for transparency and fairness; the need to consider multiple stakeholder interests; and the public interest in encouraging viable businesses with workable and fair business plans. The uncoupling of interest that has accompanied credit derivatives and their influence in insolvency proceedings has not yet garnered the attention of governments to date in any meaningful way, and the current extensive reforms proposed in the US and elsewhere have failed to address the issues raised by these products within insolvency restructuring proceedings. Post-commencement and exit financing are critically important to the restructuring goals of insolvency legislation. The challenges posed require considerably more attention over the next period.
INTRODUCTION

The failure of Lehman Brothers is now old news, although it will be a considerable time before the underlying legal issues are fully unravelled. The scale of the task involved in unwinding its affairs is unprecedented. This insolvency is by far the largest insolvency in history: in pure financial terms, Lehman Brothers is estimated to be more than six times the size of Worldcom, which was previously considered the largest corporate insolvency ever.

This article uses the factual and legal background of this complex liquidation as the focus for an examination of the role of public policy in these testing situations, and also for a more general assessment of the legitimate limits to the use of public policy arguments by courts wishing to preserve the reputation of the UK’s commercial laws as “fit for purpose” in the current global economy.

In the Lehman Brothers’ insolvency litigation to date, at least in the UK (and this article restricts itself to the UK jurisdiction), some public policy inputs have passed without comment while others have attracted a

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great deal of debate. There appears to be no middle ground. Where there has been debate, its ferocity is perhaps unexpected: the rules in play are not new; they are tried and tested national insolvency rules. However the scale of this liquidation makes a difference. It ensures that the legal arguments in play are important not only for the immediate practical task of administering the estate, but also for the future reputation and international competitiveness of the UK’s national insolvency regime.

Public policy arises in different guises. It clearly has a role to play in the formulation of national statutory insolvency rules. It is also evident in the historical development of all the common law and statutory property rules which play such a crucial role in insolvency outcomes. And, finally, it is the explicit justification for an insolvency-specific overarching common law rule—the anti-deprivation rule—that effectively puts a higher public value on collective management of the insolvent’s estate than on freedom of contract and party autonomy, at least once the debtor is insolvent. Each of these arenas for public policy engagement is discussed here. The degree of controversy surrounding each is quite different. Broadly speaking, it is accepted that parliament has a right to legislate, even if its efforts attract strong criticism. Judicial lawmaking is seen as quite another matter, however. There is, it seems, a fine and not universally agreed line between the proper adjudication of novel issues and the improper assumption of power to engage in judicial lawmaking. This article describes the role of public policy in each of these various arenas, concentrating on the more controversial end—the limits of judicial intervention on the grounds of public policy.

STATUTORY RULES AND PUBLIC POLICY

Every statute reflects a particular public policy stance. The UK’s statutory insolvency rules are no different. Their objective is to provide a system of rules that determines how innocent parties should be treated when the resources of the insolvent debtor are insufficient to give everyone what they expected. In the UK, as in most developed economies, the baseline legal rule is pari passu—the pain will be shared equally—with the significant exception that pari passu applies only to the debtor’s assets.

The first step in the management of any insolvency distribution, therefore, is to remove from the insolvency pool all those assets that are subject to proprietary claims by third parties. The consequence of this rule—at least as we are commonly minded to think of it—is that proprietary claims and personal claims are distinguished, as are the creditors asserting them. Different countries have different criteria for
what counts as the third parties’ property; in the UK many of those rules are common law and equitable rules. These are considered later.

The second step is to distribute what remains according to the rules set out in the relevant insolvency legislation. Again, different countries have different national policies in respect of the insolvency distributions of the pool that is left.

Parliament has varied these two basic principles only slightly. A summary here does injustice to the detailed rules, but serves to highlight the public policy considerations in play. First, parliament has constrained the privileges of proprietary claimants in two respects: in certain circumstances the proprietary status of claims will not be recognised unless the claim is “perfected” by registration, or public notice is given to those who may be adversely affected by the proprietary claim.1 Secondly, some proprietary interests, even if registered, will not accrue solely for the benefit of the interest holder, but the benefits associated with them will be shared, according to different legislative formulae, either with certain nominated preferred personal claimants,2 or even with the ordinary general unsecured creditors.3 In short, parliament has seen the wisdom of ameliorating the impact of proprietary attributes, so that holders of proprietary interests have their rights qualified in certain respects if the defendant is insolvent. Put another way, the orthodox doctrinal attributes of proprietary interests are forced to give way in the face of the compelling policy concerns that arise in insolvency.

Secondly, even in dealing with the personal claimants, parliament has seen fit to vary slightly the pari passu—“equality is equity”—distribution rules. Personal claimants are categorised as “preferred,” “ordinary” and “deferred” creditors.4 The pool of assets available to pay personal claimants is used first to pay all the preferred creditors, in full if possible, but otherwise pari passu. If there are funds remaining, then the ordinary creditors are paid, again in full if possible but otherwise pari passu. If there is anything left (and there rarely is), then the deferred creditors share pari passu.

These rules are well known, and the point here is not to describe yet again their familiar details, but to reiterate the idea that insolvency law is

1. For example, the requirement to register certain charges. These registration requirements only apply to legal securities (and, within that class, only mortgages and charges, not common law liens and pledges, where the protection is delivered by registration is not seen as necessary since the security holder has possession of the secured asset.) These registration rules do not apply to practical security devices, such as retention of title clauses and Quistclose trusts. Companies Act, 2006, §§ 860, 861.
3. Id. § 176A.
4. Id. §§ 115, 156, 175, 189, 178, 74 and Schedule 6.
largely a matter of policy. In the contest between innocent parties, and the difficult determination of who will win and who will lose, parliament has felt it necessary to intervene for better policy ends. Other regimes are possible—that is obvious from an examination of the different approaches adopted internationally. Indeed, other priorities might well be fairer, but parliament has set out the rules for the time being, and they determine the allocation of losses between innocent parties to the debtor’s insolvency.

Quite predictably, this particular public policy element is never questioned in court. There would be no point. The task facing the court is to apply the existing law, not determine what improvements parliament might have made.

**PROPERTY RULES AND PUBLIC POLICY**

Before these accepted statutory insolvency distribution rules can be applied, there is a preliminary step. Creditors can only be paid out of the debtor’s assets; assets belonging to third parties must be returned to them before the pool is disbursed. In the Lehman Brothers’ liquidation, this first task—determining which assets comprise the insolvent’s own estate, and which assets need to be excluded as legitimately the subject of proprietary claims of others—has proved the most complex. The complexity is exaggerated by the sheer scale of the operation: for example, the balance sheet for Lehman Brothers International (Europe) (“LBIE”) on November 30, 2007, showed debts in excess of $400 billion. But the issues themselves are also complicated: by 2007, the global financial markets had developed a range of tools that had received limited testing in the marketplace and even less testing in the courts.

The rules for determining which creditors have proprietary rights are, by and large, common law and equitable rules, and the arena for debate over the proper framing of these rules—including public policy debate—seems far broader. But even a superficial examination of the cases shows that this debate is usually confined to issues of doctrine and precedent; it is rarely about principle, and never about public policy. Perhaps Lord Millett’s comments in *Foskett v McKeown* say it all: 6

Property rights are determined by fixed rules and settled principles. They are not discretionary. They do not depend upon ideas of what is

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"fair, just and reasonable." Such concepts, which in reality mask decisions of legal policy, have no place in the law of property.

Any number of examples might be chosen to illustrate the absence of public policy argument in these cases. The options open to creditors intent on proving they have a proprietary interest in the debtor's assets are limited: the interest can only be by way of ownership (at law, or in equity via a trust) or security (pledge, legal or equitable mortgage, or charge). Just because the options are limited does not mean that the issues are simple, however. Recall the long run of cases seeking proper interpretation of retention-of-title clauses, or adjudication on the valid creation of trusts, or assessment of whether an arrangement creates a security interest and what form that takes. In all these assessments the contract between the parties is crucial, not the label they use to describe it. Proper characterisation of the agreed rights and obligations is a matter of law, and it is this doctrinal analysis which provides the answer to the creditor's question, "Do I have a proprietary interest?" Public policy does not emerge, or at least not explicitly.  

This can be seen clearly in Lehman Brothers' litigation about "client money" and "client assets" in relation to test cases from amongst the thousands of prime brokerage agreements needing to be unwound. In the face of Lehman Brothers' insolvency, the clients' best argument was that these assets—the client money or client assets (generally securities)—were held by Lehman Brothers or its intermediary on trust for the clients. Assessing the merits of such a claim can be complicated in any event, but it was made even more so in the Lehman Brothers' insolvency because there are no industry standards for prime brokerage agreements; each must be reviewed separately, and each must be read in the light of FSA (UK Financial Services Authority) rules as set out in the FSA's Client Assets Sourcebook ("CASS"). In many cases, the outlook for clients is grim. These agreements are typically skewed in favour of the prime brokers so as to assist market activity; and in any event, the collapse of these brokers had always been assumed to be well nigh impossible.

Consider trusts of "client money." The FSA rules look to be protective. They create a compulsory statutory trust on receipt of the client money, and require prime brokers to hold such money in a segregated account with a bank or a qualifying money market fund. If a

7. It is, of course, impossible to explain the evolution of trusts and securities without conceding some judicial public policy input, including some value judgement about the worth of enforcing the specific contractual or even non-contractual agreements between the parties.

client's fund placed with the Lehman Brothers intermediary is "Client Money" (as defined under the FSA Client Money Rules), and if it can still be identified (either as a segregated pool or by tracing into non-segregated Lehman Brothers' accounts), then the monies are prima facie trust funds and are excluded from the insolvent estate. The "ifs" are significant ones. The FSA Client Money Rules provide for several important exceptions to the definition of "Client Money," and the client itself may agree to terms that exclude the notion of a trust of "Client Money." If the money cannot be classed as Client Money, then it forms part of the debtor's general estate and the relevant clients will—on these grounds—have only personal claims, not proprietary ones.

"Client assets" (usually securities) are assessed in a similar way. The terms of the prime broker agreement are crucial. At one end of the spectrum, some agreements clearly provide for the client's retention of legal or beneficial ownership of the securities. At the other end of the spectrum, and less happily, other agreements clearly provide for outright title transfer of client assets to the Lehman Brothers prime broker. In these latter cases the client has no proprietary claim to its original assets, but only a (now not very valuable) contractual right to require Lehman Brothers to account to it for equivalent assets.

Given the explicit terms of these contracts, the conclusions should come as no surprise to the client. But that is not always the case. The terminology of "securities lending," for example, is apt to suggest that the lender retains its property in the lent securities, and is therefore protected. Often nothing could be further from the truth. Beconwood Securities was a test case in the Australian Opes Prime collapse. There the securities "loan" was on terms that "all right, title and interest in \[the securities\] will pass absolutely from one Party to the other, free from all liens, charges, equities and encumbrances, on delivery or redelivery of the same in accordance with this Agreement." It was perhaps unsurprising, therefore, that the protective "lending" label was held irrelevant given the explicit agreement for an outright transfer.

One further issue merits comment. Sometimes neither statute nor contract suggests that the client has a proprietary claim, but nevertheless

9. Re Lehman Bros. Int'l (Europe) (in admin.), (2010) E.W.C.A. Civ. 917 (noting that client money became subjected to the statutory trust on receipt, not on segregation by the prime broker, so traceable monies that should have been segregated but were not were held on the statutory trust, and also noting that the clients entitled to share in the distribution of the client money pool were all those with the relevant claims, not simply those who had contributed to the pool).

the client can identify monies (or other assets) that it has paid over to the broker under the terms of the brokerage agreement. Can the client have "its" original assets back, in effect waiving the Lehman Brothers' performance obligations in exchange for return of its own initial contractually agreed input? This can sometimes amount to a nice legal question, especially where brokers themselves voluntarily elect to hold client monies (or other assets) in segregated accounts, perhaps to provide alternative protection for a client's position, but generally there is little chance of success with such claims: see, for example, *Re Goldcorp Exchange (in rec)*\(^{11}\) and a myriad of similar cases arising in different factual contexts, although also see *Re Global Trader Europe Ltd (in liq)*.\(^{12}\)

Even that is not the end of the matter. Two practical questions follow the initial doctrinal analysis that the client has a property right. The first is whether the client's property can still be identified. If clients cannot point to particular assets as theirs, then no amount of preliminary doctrinal analysis will deliver the benefits of insolvency protection that are being sought. And, secondly, even if clients can point to particular assets as theirs, it is still necessary to ask whether there are any impediments to getting it back. Sometimes there are. Competing claims provide one common example of a legal impediment to recovery.\(^{13}\)

In short, any successful proprietary claim depends upon the identification of particular assets that can legitimately be described as "the client's," and not "the broker's." It is not enough to show that the broker's pool of assets has somehow been enhanced by the injection of certain now non-identifiable client assets.\(^{14}\)

Perhaps the public policy input at this stage lies precisely in *not* interfering, *not* for example insisting on a mechanism that treats all creditors in precisely the same way. The usual justification for non-interference, even when the outcomes seem unfair, is that it eliminates the risk of tactical use of the insolvency legislation by disaffected creditors. If creditors' rights are unaltered by insolvency, then there is no incentive to destroy viable businesses by tipping faltering debtors into early and unwarranted insolvency. The rule thus avoids economic waste, however fortuitously advantageous (or otherwise) that prohibition turns out to be for the individual creditors concerned.

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Similar difficult doctrinal and policy issues surround the use of security, yet here too the assessment of whether there is a security interest, and its proper characterisation, all follow a strict doctrinal analysis, eschewing policy input. Yet the policy issues are close to the surface. A debtor cannot simply agree that a particular creditor's claim will be preferred on the debtor's insolvency. To do so would clearly offend the policy of equal sharing of losses, or pari passu distribution to creditors. This commitment to equal loss-sharing is so strong that contractual set-off between the debtor and creditor is inoperative on insolvency if it goes beyond the statutory insolvency set-off rules. On the other hand, a debtor is free to agree that his creditor's claim will be preferred to the extent of some security interest granted to the creditor. The policy that prevents one strategy but allows the other is often seen as controversial.

More generally, security is controversial because it permits powerful creditors to protect themselves in a way that works to the double disadvantage of the remaining unsecured creditors: there is a disproportionately depleted pool of assets remaining for distribution. For example, a floating charge over the whole of the debtor's assets and undertakings would, if left untrammelled, give the secured creditor absolute priority to the whole of the pool of assets available for distribution on insolvency. On the plus side, of course, it is well recognised that security assists commercial activity; debtors can obtain credit that would not otherwise be available to them, and can do so with a minimum of transaction costs.

The point to note is the stage at which any public policy argument rears its head. The advantages and disadvantages of the creditors' various possible proprietary interests are consciously weighed in the balance by the legislature, not by the judges—or at least not now, in the C21st; they may have been more interventionist when these proprietary rights were being invented. The judges confine themselves, almost without exception, to applying the statute, or applying common law doctrinal rules to determine questions about creditors' property interests.

**COMMON LAW AND PUBLIC POLICY**

With all this downplaying of public policy, it comes as some surprise, therefore, to find what is sometimes (perhaps unfairly) described as a radically different approach in the application of the common law anti-deprivation rule. The rule can be expressed simply; indeed, its C19th formulation remains apt: "there cannot be a valid

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contract that a man’s property shall remain his until his bankruptcy, and on the happening of that event shall go over to someone else, and be taken away from his creditors.” That is the UK version. The US version, the ipso facto rule, is enshrined in statute. A contractual arrangement which infringes the rule is void. Avoidance will increase the asset pool available for distribution to the debtor’s general creditors. Conversely, if the rule is not infringed, the agreement will operate according to its terms and deliver the intended insolvency advantage to the nominated party.

The rule has been applied by courts since at least the eighteenth century. On its face it looks uncontentious, yet the line between what is permitted and what is not remains surprisingly unclear. Lord Neuberger made this plain in both Perpetual Trustee and Money Markets. The only House of Lords authority is British Eagle.

For present purposes, the proper workings of the rule are not the central issue. The common law anti-deprivation rule is routinely justified on the grounds of public policy, empowering the courts to strike down arrangements where parties seek to contract out of, or evade,
defeat,\textsuperscript{23} or work a fraud on,\textsuperscript{24} the insolvency legislation. The modern (and perhaps also the historical) view is that the rule simply prevents parties from contracting out of the insolvency legislation.\textsuperscript{25} It targets arrangements which seek to implement either a different distribution of the insolvent’s assets from that which would obtain under the legislative rules, or which seek to reduce the pool of assets available for distribution. In shorthand, these different limbs of the anti-deprivation rule can be labelled “the contracting out rule” and “the insolvency-triggered deprivation rule.”

The global financial crisis has led to a number of corporate collapses: \textit{Perpetual Trustee} is not the only modern case to raise the anti-deprivation issue, nor is it the most recent. However it is, to date, the only case to have reached the UK court of Appeal, and serves as a working illustration here.

In \textit{Perpetual Trustee},\textsuperscript{26} the Court of Appeal was asked to strike down a priority flip clause which switched the priority enjoyed over collateral away from a Lehman Brothers credit default swaps counterparty and in favour of third party noteholders (including Perpetual Trustee Co Ltd) in defined circumstances, to the potential detriment of the now insolvent Lehman Brothers counterparty.\textsuperscript{27} The administrators argued that the priority flip clause breached the “anti-deprivation rule” and was therefore void on the grounds of public policy. The Court of Appeal found against the administrators and in favour of the third parties, affirming the judgment of Sir Andrew Morritt, the Chancellor, in the High Court.

In the US Bankruptcy Court, Justice Peck applied the analogous US statutory \textit{ipso facto} rule, perhaps rather more expansively than might have been predicted, and concluded that the priority flip clause offended the rule and was therefore void as a fraud on the creditors.\textsuperscript{28} Both cases were due to go on appeal, but Perpetual Trustee has now settled its claims in both jurisdictions.\textsuperscript{29} The legal issues are clearly important,

\textsuperscript{23} Whitmore, supra note 16, at 215; British Eagle, note 16, at 770 (Lord Morris).
\textsuperscript{24} \textit{Perpetual Trustee (CA)}, supra note 16, ¶ 152 (Patten LJ).
\textsuperscript{25} Id. ¶ 54 (Lord Neuberger).
\textsuperscript{26} Id.
\textsuperscript{27} Id.; see also Butters v. BBC Worldwide Ltd., [2009] EWHC 1954. (The court also addressed the treatment of so-called “unwind costs” between these parties, and determined the outcome of a related appeal which raised the anti-deprivation rule.)
\textsuperscript{28} In re Lehman Brothers Holdings Inc., 442 B.R. 407, 411 (Bankr. S.D.N.Y. 2010).
\textsuperscript{29} In the UK Court of Appeal, two Noteholders were pursuing claims, Perpetual Trustee and Belmont. The Perpetual Trustee claims have been settled, but the Belmont claims remain scheduled for appeal to the Supreme Court in March 2011, see The Supreme Court—Case Details, http://www.supremecourt.gov.uk/current-cases/CCCaseDetails/case_2009_0222.html (last visited Jan. 30, 2011).
given the potential application of the same rule to other structured finance and securitisation deals and the value of the assets in dispute. 30

In the UK Court of Appeal, in upholding the flip clause, the Master of the Rolls, Lord Neuberger, (with whom Longmore LJ agreed) explained his conclusions as follows:

Patten LJ has reached the same conclusion on the simple basis that the "flip," that is, the reversal of the order of priority against a company as the holder of a charge, in favour of another chargee over the same assets, cannot be caught by the rule, even if it operates after the liquidation of the company, at least if such a reversal was an original feature of the company’s charge when it was granted. I have considerable sympathy with that view, which has the merit of simplicity... Further, it is fair to say that the principle of party autonomy supports his view.

However, while that view may well indeed be right, I prefer to rest my conclusion in this case on the more limited ground that, in addition to the facts relied on by Patten LJ, the assets over which the charge exists were acquired with money provided by the chargee in whose favour the “flip” operates, and that the “flip” was included merely to ensure, as far as possible, that that chargee is repaid out of those assets all that he provided (together with interest), before the company receives any money from those assets pursuant to its charge. It seems to me that there may be room for argument that, in the absence of these additional facts, the arrangement in this case would have fallen foul of the [anti-deprivation rule]. ... There is also a danger that the simple analysis adopted by Patten LJ could, in the light of the very limited circumstances in which the court will hold a transaction to be a sham, make it very easy to dress up sale transactions in such a way as to enable the rule to be circumvented. 33

Not only did the Court of Appeal conclude, unanimously, that the anti-deprivation rule had not been breached; it also expressed hesitation in applying the rule at all and a concern not to extend its operation any

30. In the Lehman Brothers insolvency, billions of dollars are said to ride on the outcome of the anti-deprivation litigation: see, e.g., the Decision and Order of the United States District Court, Southern District of New York, Granting BNY Corporate Trustee Services Limited’s Motion for Leave to Appeal (against the decision of Peck J), handed down on 20 September 2010, copy on file with authors (see p 15).


32. Which Lord Neuberger also favoured as a reason for upholding the contractual provision: see Perpetual Trustee (CA), supra note 16, ¶ 58.

33. Perpetual Trustee (CA), supra note 16, ¶¶ 66-67. The reasoning is careful, but the analysis is difficult to defend. See supra note 20.

34. Id. ¶¶ 171-172. See also id. ¶¶ 54, 113, 123. Seemingly confining intervention to “contracting out” provisions. But cf. id. ¶¶ 32 et seq., 152 et seq., 91 et seq.
further.\textsuperscript{35} Equally, in the \textit{Ansett} litigation in Australia, the majority was clearly reluctant to reach a conclusion that might upset the commercially successful and internationally beneficial IATA clearing house scheme.\textsuperscript{36} Other modern cases are similarly cautious.

Certain commentators go further still, suggesting that the rule has no application in a modern insolvency regime: their argument is that the Insolvency Act 1986 ("IA") provides a comprehensive code, and should not be supplemented by the common law or by public policy interventions from judges.

This approach, denying the force of the common law rule, especially because it is based on public policy consideration, seems both flawed and counterproductive. A significant number of judicial precedents support the application of the rule, including \textit{British Eagle}\textsuperscript{37} in the House of Lords. No anti-deprivation case, even the modern ones, has suggested that the rule itself no longer exists; the debate is only ever as to whether the rule applies on the facts. Indeed, the anti-deprivation rule has a long history which was presumably familiar to the framers of the IA 1986 and its predecessors, and was reinforced by the particular statutory approach to protective trusts which implicitly assumes the existence of a common law anti-deprivation rule.\textsuperscript{38} Finally, judicial intervention which simply outlaws contractual evasion of the statutory insolvency distribution regime (and in particular contractual evasion that purports to prefer the contracting parties and effect a deprivation on the non-contracting parties) is surely not especially controversial. \textit{Perpetual Trustee} itself recognised this.\textsuperscript{39}

Yet another line of argument against the common law anti-deprivation rule suggests that contracts should be enforced according to their terms, especially contracts agreed by sophisticated parties with the benefit of legal advice.\textsuperscript{40} This effectively pits one public policy principle against another, and suggests that the principle of freedom of contract and party autonomy should win out against the principle of collective insolvency management. The reasons are not given.

This argument for freedom of contract was advanced in the recent case of \textit{Mayhew},\textsuperscript{41} where a settlement agreement provided that a promised indemnity would terminate if the indemnified party became

\begin{itemize}
  \item 35. \textit{Id.} ¶ 57.
  \item 36. \textit{See, e.g., supra} note 16, ¶¶ 76–79. In this respect, the hesitancy also related to the notion that carefully negotiated contractual arrangements between sophisticated parties should be given their full effect.
  \item 37. \textit{Supra} note 16.
  \item 38. \textit{The Trustee Act}, 1925, c. 19, § 33 (UK).
  \item 39. \textit{Supra} note 16, ¶¶ 32 et. seq, 152 et. seq.
  \item 40. \textit{See, e.g., id.} ¶ 58; \textit{see also id.} ¶¶ 91, 99.
\end{itemize}
insolvent. Sir Edward Evans-Lombe refused to accept the supremacy-of-contract argument, responding that, as a matter of policy, such an approach would enable routine avoidance of the anti-deprivation rule in almost every imaginable case; and, as a matter of precedent, the proposition ran contrary to both modern and older authorities.

But even this does not put the case strongly enough. The principle of freedom of contract might justify a pro-party approach to the interpretation of bilateral arrangements. But the same pro-party approach is quite inappropriate when the arrangement affects the rights of non-contracting third parties. However much the contracting parties wish it, a bilateral arrangement cannot deprive innocent third parties of their legitimate statutory rights: freedom of contract cannot trump the collective management rules enshrined in the insolvency legislation—the only freedom that exists is the freedom of contract within the law.

Looking back at all this detail, what conclusions might be extracted about the role of public policy in the collective management of insolvency? On one view, the role of public policy is steadily diminishing. Historically, there must have been substantial public policy intervention from the courts in order to develop all the different proprietary interests that are now so crucial in determining the proper distribution of the insolvent debtor’s assets. The development was slow, it is true, so no one case marks out a paradigm shift in legal thinking, but the net result is nonetheless dramatic. And yet the analysis in this domain now appears to be based on strict doctrinal analysis without even a nod to public policy. Equally, but less radically, the judges centuries ago must have developed and refined the common law anti-deprivation rule. It still appears to meet a need, and judges (as distinct from counsel) do not question its existence, although their mood is clearly to limit its modern operation as much as possible. Finally, and by contrast, the statutory insolvency rules are roundly embraced; their clear public policy motivation comes from parliament, however, not the courts.

All of this raises very directly the obvious question—what role should public policy play in modern judicial activity? Is it proper to allow judicial resort to public policy? More fundamentally, is resort to public policy the best—or the worst—way to deliver a modern, effective and globally competitive commercial law regime?

42. A similar argument emerged in the litigation of Spectrum Plus Ltd (In Liquidation), Re (2005) UKHL 41, but there too the House of Lords refused to favour the clear intention of the contracting parties in the face of the disadvantage that would thereby be wreaked on non-contracting creditors seeking their due protection under the IA 1986.

43. See supra note 20.
The debate about whether judges allow their decisions to be influenced by public policy is essentially a debate about judicial lawmaking. At one extreme, judges are conceded to be legitimately making the law; at the other, they merely administer it, and should therefore confine their deliberations to a rigorous doctrinal analysis of the relevant statutes or common law precedents.

Between these two positions, the attitude of the English courts to any explicit engagement with issues of public policy has ebbed and flowed. Outright hostility is not uncommon. Mr. Justice Burrough famously remarked in *Richardson v Mellish* that public policy is a "very unruly horse and when once you get astride it, you never know where it will carry you," adding that an argument founded on public policy "leads you from sound law, and is never argued but when all other points fail."

Even in those early days, it seems, the King's Courts understood something of the administrative/legislative power division behind the divine right of kings, the precursor to the more modern principle of parliamentary sovereignty.

And yet it is also conceded that judge-made law is precisely the distinguishing feature of the common law. It is what sets it apart from civil law. Without judicial lawmaking, the common law could not have developed. Beyond public policy it is difficult to imagine what other basis might have guided common law judges in their task. So it is perhaps predictable—indeed more than predictable—that, as well as judicial assertions against the role of public policy, there are often even stronger claims in its favour. In *Egerton v Brownlow*, for example, Lord Chief Baron Pollock described the long history of public policy intervention in this way:

This doctrine of the public good or the public safety, or what is sometimes called "public policy," being the foundation of law, is supported by decisions in every branch of the law; and an unlimited number of cases may be cited as directly and distinctly deciding upon contracts and covenants as the avowed broad ground of the public good and on that alone; and the name and authority of nearly all the great lawyers (whose decisions and opinions have been extensively reported) will be found associated with this doctrine in some shape or

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45. Anthony Lester, *English Judges as Law Makers*, 1993 Pub. L. 269, 270 (1993) (traces this perspective back to the King's Court and concludes that "a monarchical view continues to shape the modern British constitution. The divine right of kings has been replaced by the divine right of the Crown in Parliament.")

other. It is distinctly laid down by Coke (66 a), “nihil quod est inconveniens est licitum.”

Both the pro- and anti-public policy camps must inevitably come together on some matters. At the least controversial end of the scale, both camps will generally concede that there is necessary and inevitable judicial resort to public policy whenever courts are required to apply notional “public standards” in legal tests of “reasonableness,” or “unconscionability,” or “good faith,” or “arbitrariness.” In all these determinations, individual views will frequently differ, and judges cannot be allowed simply to give vent to their own personal biases; they are charged with acting in accordance with public norms. To that extent, public policy becomes an essential element in the exercise of judicial discretion.

But judicial lawmaking often goes well beyond these simple standard-setting exercises that are an inevitable part of judicial decision-making. A conscious resort to arguments from public policy was largely responsible for delivering the sophistication, subtlety, fleetness and dynamism that make the common law (including equity) so attractive internationally. In Davies v Davies, which is a leading early restraint-of-trade decision, it was “considered public policy to assist England to become a nation of traders.”47 In Donoghue v Stevenson, the “neighbour principle” was enunciated for the first time on the basis that there is a “general public sentiment of moral wrongdoing for which the offender must pay.”48 There is no shortage of similar examples: consider the judicially-inspired developments in the field of trusts, fixed and floating charges, assignment of choses in action, interference with contractual rights, equitable relief in cases of mistake or accident, and the rules on frustration and failure of consideration. This list is almost endless.

At times, of course, these judicial efforts were seen to overstep the mark. Then they were reined in, either by the House of Lords (or, now, the Supreme Court) or by parliament. Lord Denning’s term as Master of the Rolls in the 1970s is often seen as the high water mark in this regard. His promotion of the “deserted wives’ equity” in National Provincial Bank v Ainsworth49 was promptly overruled by the House of Lords,50 although later re-enacted in the Matrimonial Homes Act 1976. His new model constructive trust in Eves v Eves51 has not been adopted in subsequent cases, and his early views on equitable mistake are now

47. Davies v Davies (1887) 36 Ch. D 359, 365.
doubted. But his wins far outweigh his losses, and a number of his public policy interventions have stood the test of time: as a result of his judgments, the common law now includes rules on promissory estoppel; tort liability for negligent misstatement; freezing injunctions (Mareva injunctions) and search orders (Anton Piller orders); and of course judicial recognition of the public interest in cricket.

The march has continued. Consider the more recent judicial developments in the law relating to undue influence, unjust enrichment, contract damages, or trusts.

Sometimes the judges downplay their inventiveness; Mr. Justice Neuberger (as he then was) in Murphy v Murphy described his role as refining rather than inventing a new area of law:

In so far as this case involves (as I accept that it does) extending the principle identified in A. v. C., I think that it is perhaps more a case of an existing child developing rather than a new child being born.

But even if this is the case—and the line appears difficult to draw—then the distinction seems to do no more than reflect the truth that the common law and equity proceed incrementally, building up from real examples, until eventually a general principle emerges. In this way, as Lord Neuberger recognised, the cases demonstrate that the law (although Lord Neuberger’s focus was equity alone) “continues, when necessary, to develop, to extend.”

Whether this judicial lawmaking role is an appropriate one is a different question, of course. Going back over three centuries, there have been endless clashes between the views of contemporaries. Sir Owen

62. Id. at 291.
Dixon and Lord Reid, for example, readily illustrate opposing schools of thought on judicial activism. Sir Owen Dixon, writing in 1965, asserted that judicial method should employ “strict logic and high technique,” and that a judge’s decisions should not be subjective or based on political or sociological propensities.64 By contrast, Lord Reid, writing in the early 1970s, roundly dismissed the declaratory theory of common law as a fairytale65 and promoted the importance of common sense and public policy as elements of the judicial armoury, along with legal principle.66

While legal opinion and rigorous jurisprudence find support in each of these two schools, the majority, and probably all civil lawyers, think of the common law quite simply as judge-made law. Lord Goff said that “case law is independent of statute, of itself a source of law,”67 and Sir George Baker P adopted and promoted Lord Reid’s views (outlined above), suggesting that, “in the search for a middle way between certainty and justice, judges must prevent precedent becoming master, and with this in view a court should have regard to common sense, legal principle and public policy in that order.”68

This same approach to judicial lawmaking is also supported by the overwhelming body of academic and extra-judicial commentary. Michael Lavarch, writing in the Australian context, argues that “[p]roposals to return the court to a non-policy role of mere interpretation of laws belong in the realms of legal fiction.”69 And Sir Gerard Brennan says that “[t]oday’s changing world, the courts would forfeit their integrity if they failed to exercise their legitimate jurisdiction to declare the general law in terms which accord with the enduring values of our society.”70 In the same vein, Justice Williams goes so far as to suggest that “[p]ublic policy is the backbone of the common law.”71

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66. Id. at 25; see also infra note 68.
The real debate, however, is put rather more sharply by a number of C21st extra-judicial comments. Lord Neuberger suggests that, in the UK, the capacity for judicial lawmaking is both necessary and beneficial because Parliament has provided too much ill-thought-out legislation in some areas, and has consistently failed to legislate in other arenas which are both controversial and sensitive. In both these situations, he argues, judges have to go further than mere interpretation of legislation and reliance on precedents if they are to deliver sensible results. 72 By contrast, Sir Harry Gibbs (who served on the Australian High Court) was far more reserved. 73

It is sometimes argued that one justification for judicial activism is that the legislature is uninterested in reforming the law and that the judges should therefore assume that task. It has been said that since the legislatures have failed to keep the law in a serviceable state, "the courts have been left with a substantial part of the responsibility for keeping the law in a serviceable state, a function which calls for the consideration of the contemporary values of the community." 74 Lord Reid answered the argument that it is the task of the judges to do what the legislature should have done, but failed to do, by saying that "where Parliament has feared to tread it is not for the courts to rush in." To say that the courts have that role is to confound the distinction between legislative and judicial functions, and in that respect is contrary to constitutional principle. Also the suggestion that the court should formulate a new rule in the light of contemporary values is open to the objection that there is usually a diversity of opinion as to what those values are. . . .

This latter position has a clear ideological basis in the separation of powers and appeals to many in terms of democracy and the rule of law. Lord Evershed noted how the House of Lords (in its judicial capacity) had more than once "emphasised that judicial legislation is apt to be a dangerous usurpation of Parliamentary functions." 75 It also appeals to many on the basis of certainty and predictability, since public policy considerations are not uniform, and judicial assessment of them is likely to be subjective.

72. See Lord Neuberger, supra note 63, ¶ 27.
75. Lord Evershed, Equity is not to be presumed to be past the age of child-bearing, 1 SYDNEY L. REV. 1, 7 (1953).
But arguments about the role of public policy intervention are not confined to this theoretical high-ground. The public policy questions raised by the anti-deprivation rule (which was in issue in the Perpetual Trustee litigation) can be addressed at this high level of theory, and probably were in the C18th when the rule was in its early stages of development. But its modern antagonists need not run their arguments quite so widely. For many, the issue is much narrower: where parliament has legislated to provide a comprehensive national insolvency regime, they suggest there is no room for the operation of a public policy rule injected via common law judicial intervention. In other words, where parliament has spoken, public policy interventions should implicitly be prohibited.

This question reflects the reality that the common law is changing. As Parliament legislates more frequently, and the volume of case law grows, there are fewer gaps that need to be filled, and when these gaps do arise, there is less reason why the judges rather than Parliament should act to fill them. As Lord Neuberger notes:

It was acceptable for the court to invent new Common Law and Equitable rights, remedies and principles in earlier times, when Parliament sat infrequently and for short periods, and when England had not yet moved from monarchy to democracy. In such earlier times there was less of a clear dividing line between the various branches of the state: separation of powers had not yet crossed the mind of either John Locke or Montesquieu. In the 1770s, the Lord Chief Justice was a member of the Cabinet.

Indeed, reduced judicial activity may even align better with many parties’ commercial objectives. In the short term at least, reduced opportunity for judicial interference will leave commercial parties free to arrange their affairs as they wish; and yet if things do go wrong, decreased flexibility in the judicial role may ensure greater certainty from the courts in the decisions which they deliver.

And yet ... is this really the ideal? Will it deliver the type of legal regime that is needed for an effective, functioning modern global democracy?

Party autonomy and legal certainty are undoubtedly attractive, but a short pause for thought about national legal developments over the past century shows how often the needs of the parties are delivered more
rapidly, in a more context-sensitive manner, and more nimbly by incremental changes in the common law than by ad hoc statutory interventions, or by decade-long consultations on major statutory reforms.

Of course there is enormous value in improved legislation and legislative practices. Without this route, law reform and modernisation would be ad hoc, piecemeal and lacking any overarching objective focus. Legislation also has the twin advantages of being motivated by general need, not particular litigants, and delivering its rules by way of succinct principles or clear demands. In a broadly similar way, international conventions, model laws, and legislative guides can provide the means for more rapid and considered global solutions promoting the harmonization and modernization of commercial practices. These “legal technologies” operate supra-nationally, often through the work of bodies such the United Nation Commission on International Trade Law (“UNCITRAL”).

Yet even the very best parliamentary legislation or international convention will fail if it is not administered with a hefty dose of analytical rigour and careful judgement—common sense, legal principle and public policy as Lord Reid put it. This is because no legislator can possibly anticipate all the eventualities, and even if it could, the resulting detail would make the whole legislative enterprise unworkable. More than that, in any package of rules, it is inevitable that some of our most fundamental goals for society will be in direct conflict. Consider the tension between freedom and equality: the more freedom there is, the less equality, and vice versa. If the law supports one goal it loses the other. So when these two goals are in conflict, what is to be done—how is the balance to be played out?

It is impossible to deal with these problems, whether legislative or founded in judicial precedent, unless judges are trusted to exercise discretion. And since their discretion cannot simply be a matter of personal preference, it has of necessity to adopt public policy preferences.

If this is not done, then—pragmatically—we will be left without workable avenues for the delivery of adjustments and modifications to the legal regime. How else, in this climate of codification and increased legislation, and in an environment that is increasingly subject to European, global and comparative influences can a commercially competitive system be served? Are there other alternatives to the judicial policy approach that work better? What is the best mechanism for lawmaking that is attuned to public policy goals?

78. See Lord Reid, supra note 65, at 25.
CONCLUSION

The allure of the law as an antidote to social ills is powerful. However, any legal system has to be judged by its functionality. In the words of Lord Denning: 79

the law . . . has two great objects: to preserve order and to do justice; and the two do not always coincide. Those whose training lies towards order, put certainty before justice; whereas those whose training lies towards the redress of grievances, put justice before certainty. The right solution lies in keeping a proper balance between the two.

In a perfect world, the law would be clear, certain and comprehensible. The reality is some way from this. However the better the courts become at delivering the desirable goal of certainty in the law, the less they are able to keep pace with the speed and need for differentiation in modern social and commercial developments, so the less well they serve the real demands of the community they exist to support. If the common law is to continue to survive and prosper, it needs a mechanism for ensuring flexibility, responsiveness, subtlety and differentiation in the law. How is this flexibility built in, and especially how is it built in by an unelected and unrepresentative minority sitting on the bench in a court of law? If the courts cannot perform this function, then it is necessarily left to the legislature, and almost everywhere the consensus seems to be that this is too slow, too political and too generalised.

This is a difficult issue. Here it is suggested that the goals can be delivered only if judges are trusted to take some decisions with an eye to public policy. This option has its risks, of course, but they seem preferable to an alternative which seems likely to neuter the common law's evolutionary and adaptive power, and lead inexorably to the stultification of the entire common law regime.

79. NORMAN ANDERSON, FREEDOM UNDER LAW 39 (Kingsway Publications 1988).
The collision between an increasing number of multinational arbitrations and an increasing number of multinational insolvencies constitutes the irresistible force meeting the immoveable object. In many countries, an insolvency proceeding overrides most other laws and sweeps into its embrace virtually all legal matters relating to the debtor. Yet international arbitration as embodied in the United Nations Convention has achieved a highly favored state of enforcement around the world.
This paper considers two aspects of the difficulties thus created. First we should determine the best domestic rule to reconcile the conflicting demands of the insolvency system and the international commercial arbitration system. That is, in an international case in which the debtor had committed to arbitration of disputes arising from a contract,

a) Should a pending arbitration be halted, even temporarily, upon the opening of the insolvency proceeding?

b) Should the contractual claims be resolved in arbitration, rather than in the insolvency claims-resolution procedures?

The rule a country adopts to govern those choices may be called the country’s “claims-arbitration” rule. In a cross-border case, the challenge is to develop the proper choice-of-law rule to determine which country’s claims-arbitration rule should apply in a given case. For example, when a court in Country A (often the place of arbitration) is asked to determine what claims-arbitration rule it will apply with regard to a debtor that is in an insolvency proceeding in Country B, should it choose its own claims-arbitration rule or the rule that would be applied by the insolvency court in Country B?4 This issue came before two European courts as to the same debtor, with opposite results.


4. My focus is on insolvency proceedings involving multinational businesses and arbitration clauses and awards that are subject to the New York Convention. See New York Convention, supra note 2, at art. 1. A country might or might not apply a different rule to pre-insolvency arbitration clauses that are purely domestic—that is, that involve only domestic parties and a local place of arbitration. Cf Fotochrome, Inc. v. Copal Co. Ltd., 517 F.2d 512 (2d Cir. 1975) (enforcing arbitration award where arbitration proceeding would have been voided as violating the automatic stay if the place of arbitration had been in the United States). The present subject is sufficiently complex that I will not go into the possible differences in policy considerations as to enforcement in insolvency of a purely local arbitration clause or award, although most of the United States cases I discuss are domestic cases. I addressed the domestic-foreign distinction at length some years ago, and I hope soon to return to it. See Westbrook, Coming Encounter, supra note 3. Fotochrome is an old case, and it might not be applied today. Cf. Societe Nationale Algerienne pour la Recherche, la Production, le Transport, la Transformation et la Commercialisation des Hydrocarbures v. Distrigas Corp., 80 B.R. 606, 613-14 (D. Mass. 1987) (exercising discretion to enforce international arbitration clause where no significant bankruptcy issues were involved).
Elektrim was a Polish company that became involved in a staggering morass of litigation and arbitration throughout the first decade of the new century.\(^5\) Vivendi, a venture partner of Elektrim, launched an arbitration proceeding against the Polish concern in London. Shortly before the first hearing in the arbitration, an insolvency proceeding for Elektrim was opened in Poland. The administrator of the insolvency took the position that Polish insolvency law abrogated the arbitration clause in the contract between the parties, leaving the matter to be resolved in court. Vivendi claimed the status of the arbitration was governed by English law, which would not halt the arbitration. The arbitration tribunal rejected the administrator's request for dismissal of the arbitration and went forward to hold hearings and issue an award. The United Kingdom courts upheld the tribunal, ruling that the European Regulation on Insolvency Proceedings\(^6\) allocated the decision about the arbitration to the law of the country where the arbitration was pending.\(^7\) Under English law the arbitration was permitted to go forward, even though the court recognized that the Polish proceeding was the "main" proceeding under the EU Regulation and that Polish law would hold the arbitration clause extinguished by the insolvency. A second English case, decided since the IACCL conference in Toronto, reached the same sort of result under the Model Law on Cross-Border Insolvency,\(^8\) albeit with a more nuanced approach.\(^9\)

Elektrim was involved in a second arbitration, in Switzerland.\(^10\) The Swiss arbitral tribunal ruled that Polish law controlled and dismissed Elektrim from the multiparty arbitration. The Swiss Supreme Court agreed. While the Polish insolvency rules did not operate directly in Switzerland, under Swiss conflicts principles, the law of the insolvency jurisdiction should control and, thus, the arbitration should be halted as

\(^6\) See EU Regulation, supra note 3.
\(^8\) Model Law, supra note 3.
\(^9\) Cosco Bulk Carrier Co. Ltd. v. Armada Shipping S.A. (In re Armada Shipping S.A.), [2011] EWHC 216 (Ch). See the discussion in note 40 concerning the Armada court's approach.
against the insolvent debtor. Thus, the two cases involving the debtor Elektrim reached opposite results.

Needless to say, it is not for me to opine about the proper interpretation of English law, Polish law, Swiss law, or the EU Regulation. The results just described may or may not have been correct under the relevant laws. My concern is to take the Elektrim cases as hypothetical examples to explore the choice-of-law rules explicitly or implicitly adopted in these cases and to consider which of them would make the best sense from a policy point of view if we were free to amend all applicable laws to produce the best results.

ARBITRATION AND THE INSOLVENCY CLAIMS PROCESS

We should begin by considering insolvency-court rules for adjudicating claims that would normally be subject to arbitration. As we have seen, in Elektrim the court assumed that UK law required that the claims be resolved in arbitration, while the Polish law, applied in Switzerland, sent the parties to the claims process in the insolvency court. These claims-arbitration rules address two questions: shall an arbitration be permitted to commence or go forward after an insolvency proceeding has begun, and if it does, should its results be conclusive and enforceable?

Most national insolvency laws impose a moratorium to halt domestic lawsuits and often arbitrations as well when an insolvency proceeding is brought. Many countries claim their moratorium extends to the debtor’s property all over the world, increasing the importance of being able to identify the claims-arbitration rule that applies.

In most countries, however, there is a dearth of authority determining whether the claim will ultimately be resolved in arbitration, with the award being conclusive in the insolvency case on the merits of the parties’ dispute. Few countries have a statutory rule on this question,

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11. The wisdom of modesty in this regard is illustrated by the fact that the Warsaw Court of Appeals may have overruled a lower court decision that the Elektrim arbitration award was not enforceable in the Polish bankruptcy. See Special Case, supra note 10, at n.41. I do not attempt in this paper to probe further Polish law in that regard.


13. See AM. L. INST., TRANSNATIONAL INSOLVENCY: PRINCIPLES OF COOPERATION AMONG THE NAFTA COUNTRIES 50, n.91 (2003). But see Fotochrome, supra note 4, at 516-17 (requiring in personam jurisdiction over a foreign party before the stay has any effect).
but some common-law countries have begun to generate case law approaches. In the United States, for example, a rule is emerging that usually enforces arbitration clauses against the debtor's bankrupt estate (and therefore against its creditors) but creates certain categories of legal issues where the court may not enforce arbitration. As to these categories (usually "core" cases involving claims peculiar to insolvency), some cases have held that the judicial claims process should be used, rather than the arbitration process, while others have said the court has discretion to choose one or the other, depending on the circumstances. The US cases have shown a disinclination to distinguish between domestic and international arbitration in applying these rules.

In Elektrim, the English court did not discuss the English claims-arbitration rule, but seemed to assume that an arbitration proceeding would routinely be completed and its award enforced despite a party's having entered an insolvency proceeding. On the other hand, Armada, a more recent UK case, adopts a flexible rule somewhat like the United States approach just described.

Powerful policies favor enforcement of arbitration agreements and awards, whether local or international. These policies are especially important in the international arena. The most important benefit of international arbitration is neutrality of forum. That advantage is lost if the counterparty is forced in the case of insolvency to give up its right to neutral arbitration. Another pillar of the policy supporting international

14. The United States is an example of a country that provides for a broad stay of all lawsuits and arbitrations, at least temporarily, unless the court decides to permit them to go forward. See 11 U.S.C. § 362(a) (2006).
17. Id.
19. Oddly, the judgment in Armada does not cite Elektrim, yet the two cases are quite similar in facts and issues presented, despite the inapplicability of the EU Regulation in Armada.
arbitration is the predictability it provides for commercial transactions. The parties to an arbitration clause know it will almost always be given effect, and that quality gives it a great deal of commercial value.

International arbitration policy is embodied in the New York Convention, perhaps the most successful commercial convention of modern times. It is presently in force in some 145 countries and has produced a high level of enforcement around the world. However, in the insolvency area a country has the option of refusing enforcement against the debtor company under the Convention. The Convention offers a defense of "incapacity." To quote a prior work of mine:

Article V(1)(a) authorizes nonenforcement if "[t]he parties to the agreement . . . were, under the law applicable to them, under some incapacity . . . ." Although this exception, on its face, seems to refer to the parties' capacity at the time the arbitration agreement was made, rather than to their capacity at the time of the arbitration proceedings, the background of the provision suggests that the drafters were concerned with ensuring that both parties be properly represented during the arbitration proceeding; therefore, the provision refers to the parties' capacity at the time of arbitration. [footnotes omitted]

The Swiss Supreme Court relied upon just this sort of analysis in holding that Elektrim had lost its capacity to arbitrate under Polish law once its insolvency proceeding had been opened.

The fact that the Convention can be understood to permit a defense to arbitration does not determine which result is the best policy.

Certain important requirements of insolvency procedures must be balanced against the benefits of arbitration. These requirements are closely related to the purposes of insolvency law. It is the essence of insolvency law that each creditor sacrifices many rights for the collective benefit of the creditor body, especially in a reorganization case.

22. Id. See also LOWENFELD, supra note 20, at 401.
24. See Elektrim, supra note 10. At least one author criticizes the idea that insolvency creates an incapacity under the terms of the Convention. He would look at the proper "characterization" of the issue instead. Mark Robertson, Cross-Border Insolvency And International Commercial Arbitration: Characterization And Choice Of Law Issues In Light Of Elektrim S.A. V Vivendi S.A. And Analysis Of The European Insolvency Regulation, 12 INT'L ARB. L.R. 125-135 (2009). I would disagree, as would Professor Weintraub, seeing that approach as a label for a result. See R. WEINTRAUB, COMMENTARY ON THE CONFlict OF LAWS (5th ed. 2006).
Insolvency claims procedures are often "summary" in nature. That is, they are designed in the interests of economy to resolve contentious claims more quickly and inexpensively than would the normal processes of litigation or arbitration. While that means the result may be "rough justice" as compared with more elaborate procedures, a less robust but less expensive procedure often makes sense when there is not enough value available to satisfy most claims in full and a relatively quick result is important to permit distributions to creditors at the earliest time. In addition, certain claims are unique to insolvency law. The Paulian (avoidance) actions are the most obvious examples. These sorts of claims are often intertwined with contract claims in disputes over commercial transactions.

The avoidance of expense and delay in the insolvency claims process has a special impact on the desirability of enforcing arbitration in multinational insolvency cases. International commercial arbitration is very expensive and often very slow. Whatever the virtues of domestic arbitrations in saving litigation costs, international arbitrations are notoriously expensive, perhaps even more expensive than court procedures, and they often drag on for years. Thus in the international context, the argument for preferring court procedures on grounds of reduced expense and delay is enhanced.

Although various measures in an insolvency case may enhance value for all creditors, expenditures that benefit only one creditor or group of creditors necessarily reduce the recoveries of others. In that context, enforcement of an arbitration agreement or award is a priority in favor of the counterparty to that contract over all other unsecured creditors who are consigned to the court process. An illustration with concrete figures makes this clear. If court resolution of the counterparty's claim would cost $50,000 of the assets available to the administrator, and arbitration costs $100,000, then the counterparty has been preferred to the extent of $50,000, and the other creditors have lost their share of that amount. Given that equality is the central principle of bankruptcy distribution, the granting of an implicit priority to one general creditor over another should require a powerful justification.

The virtues of predictability are especially important in international cases. As noted above, predictability is greatly improved as between the parties to multinational transactions by the presence of an arbitration agreement or award. 25, 26


26 Of course, a counterparty could be secured, but usually is not.
clause in a contract. However, arbitration does not provide transparent predictability to other creditors of the debtor counterparty. A decision to enforce arbitration will affect hundreds or even thousands of parties—the other creditors of the debtor—who entered into contracts with the debtor without knowing what choices the debtor has made concerning arbitration. By contrast, the claims process in insolvency court is easily predictable. In the case of an international contract, the counterparty to the arbitration contract has a fairly strong chance of predicting the "center of main interests" ("COMI") of the future debtor, which is the place where a main insolvency proceeding would be opened. The ease of predicting a company’s COMI leads to a greater likelihood that all creditors will be able to predict the claims-arbitration rule to be applied. Thus, the counterparty that enters into a contract with a corporation headquartered in Country B will be able to have its lawyers ascertain the rules concerning enforceability of arbitration clauses under the insolvency laws of Country B. In the example under discussion where the other contract party is a Polish company, the counterparty would know that its arbitration rights would not be enforced if the Polish concern entered an insolvency proceeding. That would also be the expectation of others who deal with the Country B company and have a concern about its financial circumstances.

However, even where these factors influence a court to deny effect to the arbitration clauses or arbitration awards, the best result may be different in some cases in which either arbitration or local litigation cases may have proceeded close to resolution by the time the insolvency proceeding is opened, as may have been true in Elektrim. Where that is true, the expense and delay of redoing a claims process almost completed may be greater than permitting the pending arbitration to be finished and an award entered.

These variables may provide some support for a discretionary rule like that emerging in some cases in the United States, because such a rule enables a court to choose one process or the other as suits the particular case. It also provides a mechanism whereby the party seeking arbitration and the tribunal itself might usefully influence the result by offering to finish the arbitration by a certain date at a fixed expense. Of course, such a rule also requires giving substantial discretion to the court, which some will find undesirable or inconsistent with existing legal regimes. On the other hand, the Polish rule greatly enhances predictability and in a highly transparent way: the insolvency claims procedure of the main proceeding would always be used in lieu of arbitration, a result in case of insolvency that the contract parties and the other creditors could include in the calculation of their pricing and terms.
CHOICE-OF-LAW

Territorialism and Universalism

A brief overview of theories of multinational insolvency will put the choice-of-law issues in context. Territorialism and universalism are the terms used to describe the two approaches to multinational insolvency matters. Territorialism is the traditional "grab rule," wherein each national court seizes what property it can and distributes its proceeds under local law. Universalism is based on the idea that an effective insolvency law, operating in rem as to hundreds or even thousands of claimants, must have a legal reach coextensive with the market.\(^{27}\) Therefore, in a globalizing world we would ideally have one proceeding for a multinational company that would realize upon its assets and distribute the resulting value globally, whether by way of liquidation or reorganization.\(^{28}\) Given the difficulties of achieving the ideal in a world of nation states, a notion of modified universalism has achieved considerable support.\(^{29}\) It is understood as a pragmatic doctrine that seeks to achieve practical results that approach so far as possible those that would obtain in a pure universalist system. The logic of modified universalism tends in general to favor choice-of-law rules that apply the law of the "main" insolvency proceeding in many circumstances. The EU Regulation adopts that approach, although with many important exceptions.\(^{30}\)

The Choice of Law Questions

In principle, there are no fewer than three choice-of-law questions that arise from the facts in the two Elektrim cases: the applicable insolvency law, the law applicable to halting the arbitration, and the law governing the ultimate enforceability of the arbitration agreement or award, in the insolvency court or elsewhere.

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\(^{28}\) See AM. L. INST., *PRINCIPLES OF COOPERATION AMONG THE NAFTA COUNTRIES* 8 (2003); Model Law, supra note 3.


\(^{30}\) See EU Regulation, supra note 3, at arts. 4, 15, 17-18, 27.
APPLICABLE INSOLVENCY LAW

The first question seems easy enough in the Elektrim case. On the facts, the Polish proceeding seemed clearly to be the “main” proceeding as that term would be used under the European Regulation or the Model Law on Cross-Border Insolvency (“Model Law”).31 In any event, there was no other pending insolvency proceeding, so there was no other insolvency law to be applied. Thus the first question is answered easily in both Elektrim cases: Poland provides the applicable insolvency law. That leaves the two questions related to the claims process.32

APPLICABLE CLAIMS—ARBITRATION RULE

In a fully universalist system of the management of multinational insolvencies, the arbitration clause would be abrogated by the single applicable insolvency law, and the effect would be as if a Polish insolvency moratorium (or stay) was applied to halt the arbitration and to require litigation of the claim in the insolvency court. Conversely, in a fully traditional, territorialist jurisdiction, the answers to the claims-arbitration questions would be equally easy. The Polish insolvency case would have no effect locally, and the arbitration agreement and any resulting award would be enforceable in the local court at the place of arbitration and perhaps elsewhere, but not in the insolvency court.

However, in the world of modified universalism as reflected in both the European Regulation and the Model Law,33 the local court34 has an important role to play in answering the two claims-arbitration questions.35 First, it must decide whether to halt the arbitration in light of the insolvency. Is that decision governed by local law or the law of the insolvency court? That is the first claims-arbitration issue. In the English Elektrim case, the court found that the European Regulation

31. It appears that the English version of the Model Law was not applicable to the case.
32. Similarly in Armada, it was clear that the Swiss insolvency law was the only one plausibly applicable.
33. See supra note 30 and accompanying text.
34. Depending on the state of the arbitration proceeding and the circumstances of the insolvency proceeding, it will often be proper to apply to the arbitral tribunal in the first instance to request a stay or dismissal of the arbitration. That was done in both the Elektrim cases. For ease of expression, I will refer instead to the local court at the place of arbitration, which is where the insolvency administrator must turn if the tribunal refuses the request.
35. There is also an important choice-of-forum issue here. Should the choice-of-law questions and the underlying merits of the claims-process issues be decided by the local court, or should the local court defer to the insolvency court? This paper does not address that problem, although the author would argue that the insolvency court is generally the preferred forum for that decision. This area is one of many in multinational insolvency law where choice of law and choice of forum are intertwined.
allocated that issue to the local law and therefore applied English law to determine if the arbitration should have been halted, even temporarily. 36 Second, the court must decide if the arbitration should be permitted to resolve the merits of the claim.

CASE MANAGEMENT

The English court in *Elektrim* assumed the arbitration had not been stayed, so the award made after the opening of the Polish insolvency was not in violation of any applicable stay order. The decision thus ignored the question of a temporary stay. 37 That question is a matter of case management—aiming for maximization of value and accuracy of result. If a lawsuit or arbitration continues after an insolvency proceeding is brought, there is a serious risk it will not be well defended (or prosecuted), especially if a trustee or administrator has just been appointed, which is still the procedure in most kinds of insolvency proceedings in most countries. Indeed, experience in insolvency matters shows that the prior conduct of a lawsuit or arbitration may have been neglected by a corporate leadership caught in the turmoil of financial crisis. Thus the debtor’s case may be weakened already when control of the debtor is assumed by an administrator unfamiliar with the matter and distracted by a host of other pressing concerns.

The consequence of an arbitration thus neglected is that deadlines may be missed, defaults may be entered, and some important arguments on the merits may not be made or may be made badly. 38 Lawyers may be unpaid and uninstructed, circumstances notoriously inconsistent with legal success. Preparation for a key hearing may be hasty and incomplete. If the result is that a claim is honored that would have been rejected in the normal contentious process or if the claim is awarded at an amount far higher than merited, then the other creditors of the debtor

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36. Interestingly, it appears that an arbitration would be stayed in England upon the filing of a winding up or an administration proceeding. Insolvency Act, 1986, c. 45, § 130(2); sch. B1 ¶ 43(6). The UK court did not look to its insolvency rule for this purpose, although one might have thought that law would be the obvious one to apply. A different rule applied under the Model Law as adopted in England. *See Armada.* On the other hand, the arbitration would apparently not be stayed if the creditor were secured. *See Armada* ¶ 49.

37. By contrast, the court in *Armada* was directed to the local insolvency law by the provisions of the Model Law, and it was therefore conceded that the arbitration involving the debtor was stayed upon recognition. Model Law, *supra* note 3, art. 20. Note that the EU Regulation applies the stay of the main proceeding (article 4) while the Model Law adopts the local stay. In articles 4 and 15 of the EU Regulation the English court found that local law applied to pending arbitrations, although they speak of “lawsuits.” That is a plausible reading, but the current author would have been glad to see an exploration of the policy arguments for a different interpretation.

have suffered unjustified injury. The Vivendi-Elektrim arbitration award may have been quite correct, but it was for certain quite large—almost €2 billion. An award so large might elbow out all the other creditors by its sheer size. If we suppose for argument's sake it were twice as large as it would have been if properly defended, then the other creditors would likely have been severely prejudiced. Of course, I have no view whether the Elektrim award was accurate, nor do I know if the case was well defended. The defense may have been excellent in fact. The point is merely that if the case were not well defended because of the factors mentioned above, the result would be seriously unjust to a large number of innocent creditors of the debtor.

The risk of flawed adjudication is sufficiently substantial by itself as to justify some outside control over pending proceedings to avoid these results. That control might be exercised by the local court of the place of arbitration, in direct response to notice of the opening of the insolvency proceeding, or in response to a request from the foreign insolvency court for assistance in the form of a temporary stay of the arbitration. In appropriate circumstances, the insolvency court should telephone, fax, or mail the local court, so that the local court can feel confident in the justice of the request. Given the mutual trust required by the legal structure of the EU, the local court would presumably grant such a request almost always. Such a procedure granting a temporary, provisional delay of the arbitration would deal with the first part of the stay question as the case-management problem it really is.

39. See id.

40. The Armada court recognized the importance of the factors of ill-defended claims and increased costs and delay. Armada ¶ 57. It ultimately gave the prize to arbitration of the claims largely because they were governed by English law, and the court wished not to "visit upon" the Swiss court the burden of applying English law. Id. ¶ 61. The point may be well taken but would perhaps have been better weighed by the Swiss court itself.

41. It was common ground in Armada under the Model Law and its application of the English stay that the arbitration with the debtor was stayed pending the ruling of the English court. Armada ¶ 21.

42. Again, I mean to include first resort to the arbitration tribunal when appropriate. As to court-to-court contacts, direct communication between courts and administrators has gone from being unknown to being increasingly accepted as a crucial part of the management of multinational insolvencies. See Principles, supra note 6; Model Law, supra note 8, arts. 25-26; Jay L. Westbrook, International Judicial Negotiation, 38 TEX. INT' L.J. 567 (2003).

ARBITRATION ON THE MERITS

Once the arbitration has been delayed and the insolvency administrator has had a reasonable opportunity to become familiar with the case and to consult with arbitration counsel, the remaining issue is whether the restraint of the arbitration proceeding should be lifted and the merits of the claim should be resolved there rather than in the insolvency court. The proper choice of applicable law determining that point is the final question presented above.

Obviously, there would be no point in permitting an arbitration to be commenced or a pending arbitration to proceed unless the results were final on the merits. Enforcement of the award could be sought in the insolvency court or in jurisdictions outside the country where the insolvency is pending.

If enforcement is sought in the insolvency court, the award-creditor would argue that its claim against a share of the insolvency assets was conclusively established by the award. However, if the jurisdiction of the insolvency proceeding would apply its own law and that law would have insisted upon claims resolution through the court process, then it seems quite possible that the insolvency court would not enforce the arbitration award. If the insolvency court has control, directly or through the cooperation of other courts, over substantially all of the debtor’s assets, the award will be worth very little. If the insolvency court was an EU court and if it accepted the emerging English interpretation of article 15 of the EU Insolvency Regulation, then it might recognize the applicability of the law of the place of arbitration to an arbitration pending at the time of opening the insolvency proceeding. In that case it would enforce the award. On the other hand, it seems less likely a non-EU court would accept the applicability of the local claims-arbitration rule when the arbitration likely violated the foreign court’s stay. So as to the assets controlled in a non-EU insolvency proceeding, the arbitration may well have been a waste of time and money.

On the other hand, if there are substantial assets located in the place of arbitration, the award could be enforced against those assets. In that case, the local court would be permitting action directly against assets under the legal control of the main proceeding in likely violation of the

44. That is, the results would be final subject only to the New York Convention defenses. New York Convention, supra note 2, art. V.
45. I confess to wondering if the English insolvency court would be entirely sanguine about accepting a Polish award under the reverse circumstances.
46. See supra notes 13 & 14 and accompanying text.
47. The award might also be enforceable under the New York Convention in other jurisdictions that elected not to cooperate with the main proceeding, if there were substantial assets in such a jurisdiction.
main proceeding's stay or moratorium. That result would be territorialism of the classic variety and therefore would likely be repugnant to those jurisdictions, like the United Kingdom and indeed all the EU member states, that have embraced the principle of modified universalism.

The central point is that a jurisdiction's choice-of-law decision about arbitration should be closely linked to its policy on recognition and cooperation in insolvency matters. If a country takes a largely territorialist view, with little deference to a foreign insolvency proceeding pending in the debtor's home country, then its policy of supporting arbitration should probably prevail unless a local insolvency proceeding is filed. On the other hand, if a jurisdiction is committed to some significant degree to modified universalism or at least close international cooperation in multinational insolvencies, then the logic of that commitment requires a global approach to claims resolution to the maximum extent possible. If a local court permits arbitration to go forward to an award and enforces that award against local assets, then it has moved away from an international system back to the traditional territorial regime in insolvency matters. If it refuses to enforce against local assets and sends the arbitration award claimant to the insolvency court, and that court refuses to accept the award as conclusive, the arbitration will have cost everyone concerned much time and money for nothing.

So it seems right to argue that a court with a commitment to modified universalism in insolvency matters should apply the law of the insolvency court with regard to the proper process for resolving claims or should defer that decision to the insolvency court itself. If a company based in New York enters insolvency there, the court at the place of arbitration should in most cases adopt the American rule of usually permitting arbitration to go forward (although after a temporary delay as noted above), while in the case of a Warsaw-based company, the local court should halt the arbitration and refer the claimant to the insolvency court. Better still, in my view, in both situations the local court should submit the whole question to the insolvency court to decide if arbitration should be permitted.48

This conclusion is reinforced by the fact that the debtor prior to insolvency may have entered into more than one arbitration contract calling for arbitration in different jurisdictions, as in the case of Elektrim.

If local law is applied to resolve the enforceability of the arbitration clause, *Elektrim* demonstrates there will often be disparate results unrelated to the merits of the claims. Only by applying the procedural law of the insolvency court can it be assured that the same process will be applied to similarly situated contract counterparties. Closely related is the fact that parties can choose the place of arbitration and therefore attempt to manipulate the procedural rules governing claims, especially if the debtor company seems financially shaky at the time the contract is written. It is much harder for a counterparty to influence the location of the main insolvency proceeding and therefore the enforceability of the arbitration clause. Finally, and not least important, modern reorganization procedures, which are crucial to preserving value for all creditors in large global insolvencies, require a central oversight and control of insolvency cases. The attempt to rescue a multinational often will not survive a multiplication of procedures across a number of national jurisdictions.

For all these reasons, it seems to me the best rules are that temporary stays of arbitration should routinely be granted upon the insolvency of one party and that the ultimate method of claims resolution should be determined under the law of the insolvency court. In some cases, the insolvency court should permit a pending arbitration to go forward if it has progressed well down the road to a decision on the merits, although preferably after a pause to permit the insolvency administrator to defend the claim properly.

Modified universalism has come to be viewed as the most desirable (or the least undesirable) of the possible approaches to multinational insolvencies. The logic of that approach—and the fact of globalization that underlies its rationale—leads almost always to the conclusion that the law of the main insolvency proceeding should be chosen to govern the various legal issues that may arise concerning the debtor and its assets.49 Thus it is not surprising that a close analysis leads to the same result here.

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Online Small Claim Dispute Resolution Developments—Progress on a Soft Law for Cross-Border Consumer Sales*

Colin Rule, Louis F. Del Duca, and Daniel Nagel**

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I. Prototype Online Low-Cost High-Volume Small Claim Business to Consumer and Business to Business Disputes

Maria Elena Cardoza, a student in Tegucigalpa, purchases a refurbished laptop online for $700 from PAPPLE, a small computer company in California. When the computer arrives by mail, Maria discovers that the screen does not work. Her calls and emails to PAPPLE’s customer service department receive no responses. She complains to her local consumer protection agency, but they have no jurisdiction in California (and are not fluent in English) so are of little help. She learns that filing a small claims case in California against PAPPLE will require her to be represented by a local lawyer, who will charge more than the $700 value of the item under dispute. What should she do?

Maria’s dilemma is unfortunately not uncommon in the area of low cost-high volume online transactions. Thousands of similar transaction issues arise every day within and across borders around the world. The proliferation of online purchases in the last decade has set this problem in even starker relief. In response, many scholars have proposed the development of a global system of online dispute resolution (hereinafter “ODR”) to govern cross-border consumer transactions. Based on simple procedural rules and the granting of relief on an equitable basis this approach allows for a fast, easy and comparably cheap way to settle disputes.

Furthermore, the introduction of international principles for cross-border consumer contracts has been suggested to provide a uniform basis for a subject-matter assessment of disputes. Thus, such a set of principles, called the Global Principles of International Consumer Contracts (hereinafter “GPICC”), would be to consumer transactions what the Uniform Principles of International Commercial Contracts
(hereinafter "UPICC") authored by the International Institute for the Unification of Private Law (hereinafter "UNIDROIT") is to commercial sales. A global soft law for international consumer transactions would benefit both consumers and businesses alike worldwide, facilitating resolution of disputes which inevitably arise.

This article discusses recent developments around this ODR proposal, details progress toward the development a soft law for cross-border consumer sales, and explains how the two developments may complement each other.

II. ONLINE DISPUTE RESOLUTION PROPOSAL FOR SMALL CLAIM DISPUTES

An aggrieved party to a low value, cross-border online consumer transaction is faced with a litany of good reasons to give up. What court has jurisdiction over both parties? How far will the parties have to travel to protect their interests? What substantive law will the forum apply? How familiar is the forum with applicable substantive law? How long will it take until relief is granted? Will the prevailing party be able to enforce a judgment in the losing party’s home jurisdiction? And the cost of hiring an attorney to answer these questions is probably more costly...

1. The International Institute for the Unification of Private Law (often referred to by its French acronym UNIDROIT) is an independent intergovernmental organization with its headquarters in Rome, Italy. It prepares conventions, model laws, guidelines, principles, and other types of instruments to modernize, harmonize, and coordinate transnational, private and commercial law transactions. For further information on the history, membership, structure, and work of UNIDROIT see www.unidroit.org.


3. Hard laws are binding legal norms adopted by government. Soft laws are legal norms which become binding only if parties to a transaction voluntarily agree to incorporate them and make them applicable to their transaction or if they are made binding by their adoption by legislative, judicial or administrative action. Examples of soft law include The Restatements of Law in the United States, the UNIDROIT Uniform Principles of International Commercial Contracts (UPICC) and the International Chamber of Commerce Incoterms.

4. See generally Louis F. Del Duca, Albert H. Kritzer and Daniel Nagel, Achieving Optimal Use of Harmonization Techniques in an Increasingly Interrelated Twenty-First Century World of Consumer Sales: Moving the EU Harmonization Process to a Global Plane, 27 PENN ST. INT’L L. REV. 641 (2008). For a discussion of the policy considerations involved in the choice between hard-law instruments (such as treaties or conventions) and soft-law instruments (such as model laws that can be voluntarily utilized, such as the ICC Incoterms), see Louis F. Del Duca, Developing Global Transnational Harmonization Procedures For the Twenty-First Century: The Accelerating Pace of Common and Civil Law Convergence, 42 TEX. INT’L L.J. 625 (2007).
than the purchase itself. An inexpensive, simple online procedure is needed to resolve these types of issues (such as Maria’s dispute in the example) quickly and efficiently, without the involvement of lawyers or courts.

The United States has advanced such an ODR proposal5 for cross-border contract disputes between businesses and consumers (hereinafter “B2C”) where the amount in dispute is $10,000 or less.6 This procedure has three basic stages. At stage one, the parties voluntarily agree to talk to one another electronically. By voluntarily opting into this ODR procedure, the parties can avoid the difficulties listed above (e.g., uncertainties regarding venue, choice of law, recognition of judgments, personal jurisdiction, and the inconvenience of traveling to a distant forum).7 Moreover, by opting into this procedure, the parties would agree that this ODR procedure is the legal framework by which their dispute will be resolved.

Once the parties have agreed to consent to ODR, the buyer completes an online form which includes a checklist of types of claims,8 which could include:

- Non-delivery of goods or non-provision of services,
- Late delivery of goods or late provision of services,
- Vendor sent wrong quantity,
- Delivered goods were damaged,
- Delivered goods or provided services were improper,
- Vendor made misrepresentations about goods,
- Vendor did not honor express warranty, or
- Vendor improperly charged or debited buyer’s account.9

This type of checklist, though simple, is the legal basis for this type of ODR process for resolving a given dispute. It determines the legal framework in which a given dispute will be resolved. Thus, the checklist eliminates the need to decide whether the law of the seller’s place of business or the law of the consumer’s residence (a controversial issue indeed) will apply to the dispute. By incorporating the basis for asserting the claim into the electronic system, the creation of a best-practices approach, focused on equity, that effectively solves for the parties the

6. See id. at 255.
7. See id. at 228.
8. See id. at 261.
9. See id.
problem of what substantive law should apply eliminates the need for any hard-law solution of the dispute. For low cost-high volume transactions, consumers and businesses alike will probably prefer to use these basic ODR procedures as a matter of efficiency and fairness.

For the twenty or so percent\textsuperscript{10} of parties who fail to resolve their dispute at stage one, the model law requires that an ODR provider selected from a list of competent providers be automatically brought into the picture. The ODR provider examines electronic records of the transaction between the parties and tries to help the parties resolve their dispute. If the parties cannot agree to abide by the proposal of the ODR provider, then, as a last resort, the parties proceed to arbitration.

Exciting progress has been made subsequent to the previously mentioned United States Department of State proposal made in cooperation with business and consumer experts for development of an ODR framework for low cost-high volume online consumer transactions.\textsuperscript{11} More recently, at its July meeting, The United Nations Commission on International Trade Law\textsuperscript{12} (hereinafter "UNCITRAL") approved the formation of a working group to consider a possible instrument on the topic of ODR relating to cross-border electronic commercial transactions, including business-to-business and business-to-consumer transactions. This is real progress. The resolution of disputes within the legal framework set up by ODR systems could lead to equitable, best-practices, and lex-mercatoria-type approaches and facilitate development of a soft law\textsuperscript{13} set of norms for general use in resolving disputes in business-to-business and business-to-consumer transactions.

III. ONLINE DISPUTE RESOLUTION DEVELOPMENTS

A. The Evolution of Online Dispute Resolution

The field of ODR emerged in the late 1990s as a response to the growing volume of eCommerce worldwide. New online marketplaces


\textsuperscript{12} UNCITRAL was established by the General Assembly in 1966. UNCITRAL is regarded as the vehicle by which the United Nations could play a more active role in reducing or removing these obstacles. For further information please see www.uncitral.org.

\textsuperscript{13} See supra note 3.
were generating transaction issues that were undermining user trust, and traditional judicial redress channels were unable to respond effectively. Prof. Ethan Katsh and Prof. Janet Rifkin of the University of Massachusetts-Amherst wrote the first book on the subject in 1999, titled *Online Dispute Resolution* (which gave the field its name). International organizations and public institutions immediately understood the utility of applying commercial dispute resolution to these new low-value online issues, but they were wary of the potential for abuse. That led in 1999 to the publication of “Guidelines for Consumer Protection in the Context of Electronic Commerce” by the OECD. The United States, not wanting to be left behind, convened a conference the following year jointly sponsored by the Federal Trade Commission and the Department of Commerce entitled “Alternative Dispute Resolution for Consumer Transactions and the Borderless Online Marketplace,” which brought together large companies engaged in eCommerce, ODR startups, payment providers, and consumer advocacy organizations.

There was much discussion at that meeting around whether eCommerce merchants and marketplaces should be required to provide ODR services to their users, but the eventual outcome of the meeting was to go with a voluntary, self-regulation approach.

The primary disagreements coming out of the FTC/DOC meeting were between the advocates for business and advocates for consumers. There was a longstanding mistrust between these two groups based on their supposedly opposed interests, and because understanding of how ODR would work was sketchy at best, both sides were inclined to resist it. Once details emerged over the next few years, however, the two sides came to understand how ODR can both protect consumers and bolster trust in transactions, which improves the bottom line for businesses. A key breakthrough was the international agreement between the Global Business Dialogue on eCommerce (now called the Global Business Dialogue on eSociety) and Consumers International in 2003, which both

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called for greater use of ODR and issued consensus standards that should govern ODR providers and systems.\(^\text{17}\)

Another group that was initially resistant to ODR was the legal community, because they feared these new online mechanisms would take away cases. Again, once the operation of ODR mechanisms was clarified, the legal community came to understand that these processes would focus on low-value cases that were underserved or even ignored by existing judicial channels. In 2002 the American Bar Association released a set of standards for eCommerce ADR, which were drafted by a special task force that had convened meetings to discuss the document around the world.\(^\text{18}\)

These agreements helped to build momentum behind ODR, but there was still little governmental action to build a comprehensive global system. Non-governmental organizations came together to fill the breach, and in 2004 a new group called the Global Trustmark Alliance was launched by prominent organizations around the world, including the Better Business Bureau, Eurochambres, TrustUK, the Asia Trustmark Alliance, and the Korea Institute for Electronic Commerce.\(^\text{19}\) This organization aimed to create a non-governmental trust-building network using web seals and ODR, and while all the key partners were on board, the system was not able to build critical mass.

At the end of the decade the consensus was clear that ODR was the best way to address low value cross-border disputes, but experiments aimed at broad-based adoption remained sporadic. In 2007 the OECD issued recommendations calling for states to establish mechanisms for the arbitration of consumer disputes, and in 2009 the European Committee for Standardization released best practices for ODR gleaned from a large sample of ODR providers, academics, and public entities.\(^\text{20}\) The US government proposal to the OAS, and the subsequent launch of the UNCITRAL Working Group on ODR, represent the first real opportunity to build a global ODR system with the buy-in and support of public agencies in addition to non-governmental entities.


B. **Advantages of Online Dispute Resolution**

ODR is an extremely useful way to resolve disputes that inevitably arise out of some portion of online transactions, as demonstrated by the success of the erstwhile variety of ongoing ODR systems. Unlike other alternative dispute resolution (hereinafter “ADR”) methods, ODR is fast, efficient, flexible and inexpensive. It is especially useful for parties to low cost-high volume transactions who wish to avoid the expense of hiring an attorney and pursuing litigation to solve disputes over low-cost items. In addition, ODR provides a sound basis for governing cross-border disputes as it is easily accessible at any time and from anywhere in the world. Finally, ODR can be a simple, streamlined process, even for people who do not regularly use the Internet. The purpose of ODR is to provide an easy, efficient, and safe dispute resolution method to consumers doing business with online and/or offline sellers.

C. **Increases in Online Commercial Transactions**

The number of commercial transactions that consumers complete online continues to increase. For example, consumers in the United States spent $131.8 billion on online commercial transactions in 2009. This amount is expected to increase, with a projection of consumers spending $182.6 billion on online commercial transactions by 2012.

Consumers throughout the world increasingly use online commercial transactions to make their purchases. For example, online retail sales increased thirty-one percent in France, Germany, Italy, the Netherlands, and the United Kingdom in 2007. Worldwide, consumers annually spend about $470 billion online. This number is expected to

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23. Id.


25. Id.
exceed $1 trillion by 2012. Because the number of online commercial transactions is expected to increase, the importance of ODR will also simultaneously increase.

D. Business to Business, Business to Consumer, and Consumer to Consumer Transactions

Business to business (hereinafter “B2B”), consumer to consumer (hereinafter “C2C”), and B2C ODR can provide efficient, cost-effective ways to resolve disputes arising from online business transactions. The types of ODR systems vary widely based on the needs of the disputants. For example, ODR services may be automated or human facilitates, involve synchronous or asynchronous communication channels, or be non-binding or binding. Because many consumers today are unaware of what ODR services are available to them, ODR service providers work hard to make their processes easy to find, procedurally transparent, and user friendly.

The International Chamber of Commerce (hereinafter “ICC”) has developed ICC Best Practices for ODR in Online B2C and C2C Transactions, a source of guidance for ODR service providers. These Best Practices are intended to increase consumer confidence in doing business online. The ICC has formulated the best-practice guidelines in consultation with the ICC Court of Arbitration. They focus on specific issues raised by conducting ADR online, and they follow the recommendations that are emerging from the industry and concerned organizations. In addition, the guidelines encourage companies engaged in online transactions with consumers to use ODR wherever practicable. Because ODR has been shown to effectively resolve online disputes and improve consumer confidence, the ICC encourages companies to clearly communicate the ODR option to consumers.

26. Id.
28. Id.
29. Id.
30. Id.
31. Id.
32. Resolving Disputes Online, supra note 27, at 7.
33. Id.
34. Id.
35. Id.
36. See id.
The ICC’s Best Practices guidelines focus on educating businesses as to how ODR systems can resolve customer complaints that cannot be resolved by companies’ own internal customer-redress systems.\textsuperscript{37} The ICC’s best practice B2C guidelines emphasize that companies engaged in online transactions should provide consumers with readily and easily accessible ODR systems.\textsuperscript{38} These systems are not intended to replace customer service departments, however. To reduce the number of disputes requiring ODR, companies should establish front-end consumer-redress systems as a first line of defense.\textsuperscript{39} 

In addition to the B2C guidelines, the ICC gives information to ODR service providers about how to deliver effective and efficient service to businesses and consumers.\textsuperscript{40} For example, the ICC recommends that B2C and C2C ODR service providers ensure that their websites contain simple, comprehensive and accessible explanations for first-time users who may be unfamiliar with how the ODR process operates and what information is required from participants.\textsuperscript{41} To enhance the quality of B2C and C2C ODR services, ODR service providers should take full advantage of new technologies to provide innovative and user-driven services.\textsuperscript{42} B2C and C2C ODR systems should be easily accessible from any country, and formal requirements for case submission should be kept to the necessary minimum.\textsuperscript{43} ODR systems should resolve disputes quickly, and costs of ODR services should be minimized so that all consumers can avail themselves of such services.\textsuperscript{44} In addition, dispute-resolution personnel should be impartial.\textsuperscript{45} Impartiality can be guaranteed by adequate auditing and procedural-review arrangements.\textsuperscript{46} ODR professionals should have sufficient skills and training to complete their function, but they are not required to be licensed legal practitioners.\textsuperscript{47} 

The ICC provides recommendations to ODR service providers on the accessibility, convenience and privacy of ODR.\textsuperscript{48} For accessibility, the ICC guidelines provide that the B2C and C2C ODR system should be available to users twenty-four hours a day, seven days a week, fifty-two
weeks a year, with the exception of maintenance downtimes.\textsuperscript{49} In addition, users should have access to the process and to their own case information twenty-four hours a day, with the exception of maintenance downtimes.\textsuperscript{50} For convenience purposes, the ICC recommends that ODR service providers include their contact information, such as e-mail addresses and telephone numbers, on their web sites.\textsuperscript{51} ODR service providers should also establish a network of trained technical-support staff.\textsuperscript{52} For privacy, the ICC recommends that ODR service providers maintain a high level of security and authentication with appropriate procedures for access to case files and other data.\textsuperscript{53} In addition, ODR service providers should keep confidential the communications between each party and the mediator or arbitrator.\textsuperscript{54} Finally, ODR service providers should conduct risk assessments and formulate, implement and regularly review an organization-wide information security policy.\textsuperscript{55}

The ICC emphasizes that consumers should know what to expect from the ODR process.\textsuperscript{56} To ensure that consumers receive adequate information, the ICC recommends that B2C and C2C service providers clearly and conspicuously make available to users all pertinent information about the ODR process prior to their agreement to participate.\textsuperscript{57} For example, ODR service providers should explain whether the process is exclusively online or both offline and online.\textsuperscript{58} A definitions section of what is a neutral mediator, arbitrator, and third party should be included.\textsuperscript{59} In addition, ODR service providers should give simple information to users about the differences between mediation and arbitration.\textsuperscript{60} Finally, ODR service providers should indicate time limitations, fees and costs, whether the service provides binding or non-binding outcomes, and whether decisions are published online.\textsuperscript{61}

\textsuperscript{49} Id.
\textsuperscript{50} Id.
\textsuperscript{51} Id.
\textsuperscript{52} Resolving Disputes Online, supra note 27, at 7.
\textsuperscript{53} Id. at 7.
\textsuperscript{54} Id.
\textsuperscript{55} Id. at 13.
\textsuperscript{56} Id. at 8.
\textsuperscript{57} Resolving Disputes Online, supra note 27, at 13.
\textsuperscript{58} Id.
\textsuperscript{59} Id.
\textsuperscript{60} Id.
\textsuperscript{61} Id.
IV. SOFT LAW OR HARD LAW? DEVELOPMENT OF UNIDROIT'S SOFT LAW UNIFORM PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS


The United Nations Convention on Contracts for the International Sale of Goods (hereinafter "CISG") was adopted in April 1980 at the conclusion of a diplomatic conference in Vienna. The origins of that historic accomplishment can be traced to 1929, when the International Institute for the Unification of Private Law set out to articulate black-letter law to govern international sales contracts.63

In 1968, UNCITRAL started the project anew.64 However, although UNCITRAL's efforts would ultimately be successful, the path to success was not always easy going. According to Professor Michael Bonell, sharp differences in the legal traditions and socioeconomic structures amongst the sixty-two countries that attended the diplomatic conference at which the original text of the CISG was approved for ratification by individual countries threatened to derail the entire ratification process.65 Because of the delicate atmosphere in which the CISG was adopted, "some issues had to be excluded from the scope of the CISG at the outset,"66 lest the ratification process stagnate or fail completely. In particular, consumer contracts were expressly excluded from the scope of the CISG.67 The classification of the CISG as 100% hard law is subject to the adjustment that Article 6 permits the parties to a contract otherwise subject to the CISG to opt out of the CISG in its

64. See id.
65. Michael Joachim Bonell, The CISG, European Contract Law and the Development of a World Contract Law, 56 AM. J. COMP. L. 1, 1-3 (2008). For example, about half the countries represented at the conference were civil-law countries, whereas the other half were common-law. In addition, some of the countries represented had capitalist economies, while others had communist economies. See also Michael Joachim Bonell, The UNIDROIT Principles of International Commercial Contracts and CISG—Alternatives or Complementary Instruments? 1 UNIF. L. REV. 26, 28 (1996).
67. See id. (citing CISG art. II).
entirety, or a specific article or articles of the CISG.68 This opt-out provision in substance gives the CISG an additional soft-law character.

Despite having a deliberately restricted scope, which inter alia excluded coverage of consumer contracts, the CISG has been a highly successful international agreement.69 By 1994, thirty-four countries had adopted it.70 Today, seventy-four countries are parties to the CISG.71 It governs seventy-five percent of world trade,72 and about 2,500 cases litigated before courts or arbitration or mediation panels have been resolved under it.

B. Development of Soft Law Uniform Principles of International Commercial Contracts

Inspired by the CISG's success yet also by the shortcomings of its deliberately restricted scope, UNIDROIT developed and promulgated the UPICC over several years in the early 1990s.73

[I]t was precisely because the negotiations leading up to the CISG had so amply demonstrated that this Convention was the maximum that could be achieved on the legislative level, that UNIDROIT decided to abandon the idea of a binding instrument and instead proceeded merely to "restate" (or whenever appropriate "pre-state") international contract law and practice.74

68. CISG Article 6 provides: "The parties may exclude the application of this Convention or, subject to article 12, derogate from or vary the effect of any of its provisions." United Nations Convention on Contracts for the International Sale of Goods art. 6, Apr. 11, 1980, 1489 U.N.T.S. 3.


74. Id.
Not surprisingly, the UPICC is broader than the CISG.\textsuperscript{75} Whereas the latter applies only to sales transactions, the UPICC applies, potentially, to all kinds of international commercial transactions.\textsuperscript{76} Yet the UPICC, like the CISG, expressly does not apply to consumer transactions.\textsuperscript{77}

The UPICC's drafters did not endeavor to utilize as a comparative reference base the laws of every country.\textsuperscript{78} Instead, they devoted special attention to the CISG, the United States' Uniform Commercial Code and the Restatement (Second) of Contracts, other UNCITRAL instruments, and non-legislative instruments, such as INCOTERMS, amongst other sources.\textsuperscript{79}

C. Influence of Uniform Principles of International Commercial Contracts on Hard Law

The UPICC is nonbinding; however, it has made "a significant contribution to the development of a veritable world contract law."\textsuperscript{80} It has influenced the adoption of binding law in several countries. Estonia and Lithuania,\textsuperscript{81} for example, modeled their civil codes after the UPICC.\textsuperscript{82} In 1999, China enacted a contract law that was inspired by the


\textsuperscript{79} See id.


\textsuperscript{81} The parts of Lithuania's draft Civil Code that deals with contracts closely tracks UPICC. See Valentinas Mikelenas, Unification and Harmonisation of Law at the Turn of the Millennium: The Lithuanian Experience, 5 UNIF. L. REV. 243, 251-52 (2000) (citing Michael Joachim Bonell, The UNIDROIT Principles in Practice: The Experience of the First Two Years, 2 UNIF. L. REV. 37 (1997)).

CISG and the UPICC.\textsuperscript{83} And courts in Australia, New Zealand and England have looked to the UPICC in rendering decisions.\textsuperscript{84}

The UPICC has also been influential in arbitration.\textsuperscript{85} Some 150\textsuperscript{86} arbitral awards refer to the UPICC.\textsuperscript{87}

\textsuperscript{83} Id. at 19 (citing Huang Danhan, \textit{The UNIDROIT Principles and their Influence in the Modernisation of Contract Law in the People's Republic of China}, \textit{Unif. L. Rev.} 107 (2003); Xi Jing, \textit{The Impact of the UNIDROIT Principles on Chinese Legislation, in THE UNIDROIT PRINCIPLES 2004. THEIR IMPACT ON CONTRACT PRACTICE, JURISPRUDENCE AND CODIFICATION} 119 (Eleanor Cashin Ritaine and Eva Lein eds., 2007)).


\textsuperscript{85} According to research by Eleonora Finazzi Agrò and LLM student Giulia Principe, the International Chamber of Commerce (ICC) has applied the UPICC to eight cases between 1996 and 2008 in which the parties did not include a choice-of-law clause in their contract. In four other cases that the ICC decided, the parties expressly chose the UPICC to govern their contract, or arbitrators suggested the ICC apply the UPICC to the case. Other tribunals that have applied the UPICC to disputes before them include the Arbitral Tribunal of the Chamber of Commerce of Lausanne, the Milan International Chamber of Commerce, the Chamber of Commerce of the Russian Federation, and the Arbitral Centre of Mexico. The ICC also has applied the UPICC to interpret and integrate applicable national and international law. Moreover, the UPICC has been applied to or cited in cases by courts such as the Tribunal Supreme of Spain (May 16, 2007 n. 506/2007), the Federal Court of Australia (Alcatel Australia LTF v. Scarcella & Ors (1997)), the Supreme Court of Western Australia (Central xchange Ltd v. Anaconda Nickel Ltd (2002)), the Court of Appeal of New Zealand (Hideo Woshimoto v. Canterbury Golf International Ltd (2000)), the Court of Appeal of England (Chartbrook Ltd v. Persimmon Homes Ltd (2008)), and the European Court of Justice (Fonderie Officine Meccaniche Tacconi, C-334/00 (2002)). Eleonora Finazzi Agrò has pointed out that both national and international tribunals have cited the UPICC for various purposes, such as to interpret and supplement the CISG, to offer a synopsis of generally accepted principles of contract law and to restate international commercial contract law.


\textsuperscript{87} See UNILEX UNIDROIT PRINCIPLES, \textit{Selected Cases By Arbitral Tribunal}, http://www.unilex.info/dynasite.cfm?dssid=2377&dsmid=13620&x=1 (last visited May 29, 2010). For example, a case decided by the China International Economic and Trade Arbitration Commission in 2005 illustrates the extent to which the UPICC has affected arbitral awards. The case involved a Chinese buyer and French seller who entered into two contracts for the sale of freezer facilities. The agreed-upon price exceeded $600,000. Delivery of some of the equipment was delayed, and this led to a dispute over the contract price. Following unsuccessful negotiations, the seller filed an arbitration application. The parties failed to agree on what substantive or procedural law would apply to the contract. The arbitration panel noted that the UPICC was not an international convention, and that the parties had not included a choice-of-law clause in their contracts that chose the UPICC as applicable law. The arbitration panel nevertheless ruled that it would apply the UPICC. So ruling, the Arbitration Commission noted that both France and China are member states of the UPICC and concluded that the UPICC should be used to determine the proper interest rate to apply to the late payments that the buyer owed the seller. Accordingly, it calculated the interest rate pursuant to UPICC Article 7.4.9, even
Since 1994, more than 220 cases or arbitral proceedings have been resolved according to the UPICC. 88 Twelve cases have been handed down by courts in Australia, including one case by the High Court of Australia; 89 seven cases have been handed down by Chinese courts; 90 three cases have been decided by French courts; 91 seven cases have been decided by Italian courts; 92 six cases have been decided by courts in the Netherlands; 93 thirteen cases have been handed down by Spanish courts; 94 seven cases have been decided by United Kingdom courts; 95 and two cases have been decided by United States courts. 96

In 2004, UNIDROIT's Governing Council adopted a new edition of the UPICC. 97 Few substantive amendments were made to the 1994 edition's provisions because courts had applied them so easily and successfully. 98 However, the 2004 edition significantly expanded the scope of the 1994 edition. Five new chapters covering authority of agents, third-party rights, setoff, assignment of rights and contracts, and limitation periods were added. 99

V. DEVELOPING SOFT LAW GENERAL PRINCIPLES OF INTERNATIONAL CONSUMER CONTRACTS

The GPICC would be a response to the growing need for voluntary soft-law global principles of international consumer contracts. It would create a voluntary set of global principles of international consumer contracts that could develop into best practices, lex mercatoria and a

88. See UNILEX UNIDROIT PRINCIPLES, Select Cases by Date, http://www.unilex.info/dynasite.cfm?dssid=2377&dsmid=13618&x=1 (last visited June 1, 2010).
89. See id.
90. See id.
91. See id.
92. See id.
93. See UNILEX UNIDROIT PRINCIPLES, Select Cases by Date, http://www.unilex.info/dynasite.cfm?dssid=2377&dsmid=13618&x=1 (last visited June 1, 2010).
94. See id.
95. See id.
96. See id.
98. See id. at vii.
99. See id. at viii.
global law that regulates sales to consumers in a uniform manner, thus moving European consumer protection initiatives to a global plane. 100 The GPICC could serve as a model with reference to which national and international legislators could enact hard law to govern consumer contracts, would apply to a consumer contract if chosen by the parties as the applicable law, and could be applied in dispute resolution. 101 For just as the UPICC has been a valuable aid to the global harmonization of commercial contract law, so too a comparable aid would be valuable to the global harmonization of consumer contract law. 102 Academics, members of the judiciary, and business- and consumer-group representatives will serve as interest groups of the GPICC initiative.

A major strength of the GPICC would be that opting in to its provisions would be voluntary and would depend on the intent of the parties. 103 In other words, parties would be free to contract over whether the GPICC would govern their agreements. 104 The GPICC would be initially developed as soft law because a global uniform hard law of consumer sales is not presently realistic. 105 It is impossible to regulate everything with hard law, as the Internet amply demonstrates. 106 As best

100. Cf., inter alia, the “Blue Button”-approach as an optional instrument to choose the application of European Consumer Law (see Schulte-Nölke, Options for a less complex and more coherent European consumer and e-commerce contract law, Notes for the Vienna ODR Conference 2010).


101. See id.


103. See id. at 646-47; at 56, 57.


106. See Louis F. Del Duca, Albert H. Kritzer and Daniel Nagel, Achieving Optimal Use of Harmonization Techniques in an Increasingly Interrelated Twenty-First Century
practices develop in applying the soft law, they could be translated into hard-law instruments (international treaty or model law) and eventually an international treaty or global law.107 Finally, the GPICC could be added as an option to the ODR system in order to enable the assessment of more complicated disputes where a mere use of a check-list is considered insufficient by the parties, thus extending both the scope of applicability and application.

VI. CONCLUSION

To be effective, an ODR system must be fair and cost-effective for vendors and customers. It must transparently, fairly, economically and quickly resolve disputes that inevitably accompany commercial transactions. Both vendors and consumers could benefit from a properly constructed ODR system. Identifying areas of consensus is the beginning step of implementing a global ODR system that effectively resolves e-commerce-based disputes.

The widespread success of UNIDROIT’s UPICC shows that soft-law solutions to commercial issues can be effective. But the UPICC’s success is not unlimited. The UPICC does not apply to international consumer contracts. Neither does the CISG. Establishing a soft-law instrument that can govern international consumer transactions would benefit businesses and consumers around the globe. Presently, the initial phase of establishing the GPICC entails the establishment of a soft-law regime because of difficulties inherent in creating hard law to cover all geographical regions (despite jurisdictional boundaries) and legal systems. An effective soft-law solution now could usher in a hard-law solution in the future, if necessary.

An adequately comprehensive GPICC must reckon with the realities of the recent proliferation of e-commerce both in respect to the subject-matter of modern consumer sales and in respect to a fair, efficient and accessible basis for resolving disputes. Though the GPICC could be applied by any national court or other competent authority, there is also the possibility of combining the advantages of the GPICC with existing ODR mechanisms. This could lead to a significant increase in the use of ODR mechanisms in complicated cases, as the assessment would be based on uniform legal principles. Governments, commercial entities, industries and consumer advocates from around the world would directly benefit from such a global ODR system.

107. See id. at 649 n.26; at 59 n.26.
Creation of a Global Consumer Law Forum will facilitate the operation of working groups from around the world in cooperating in developing the GPICC. An Oversight Committee can then be formed to propose GPICC revisions as they become needed. Though much progress remains to be made, much has been accomplished in two short years. We hope to continue this progress going forward.


109. See id.
Rethinking the Usefulness of Mandatory Rights of Withdrawal in Consumer Contract Law: The Right to Change Your Mind?

Jan M. Smits*

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Abstract

Both in Europe and the United States, withdrawal rights are increasingly part of mandatory legislation to protect consumers. Withdrawal rights allow the consumer to terminate the contract within a set 'cooling-off period.' This paper offers a threefold analysis of these rights. First, it makes a comparison between statutory withdrawal rights in Europe and in the United States. Second, it presents the results of a modest survey of the voluntary use of withdrawal rights in general conditions of retailers. Third, it evaluates the usefulness of mandatory

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withdrawal rights. The paper shows what can be the effect of introducing such mandatory rights on the behaviour of both retailers and consumers. The main reason why a retailer voluntarily grants withdrawal rights to a consumer is that it creates trust and thus enhances the willingness of the buyer to purchase products. This trust-building process can be undermined if the legislator imposes statutory withdrawal rights, leading to crowding-out effects. Finally, the consequences of this finding for the optimal design of withdrawal rights are discussed.

I. INTRODUCTION

In contract law, frequent use is made of so-called rights of withdrawal. These rights allow a party to a contract (usually a consumer) to terminate the contract within a certain period of time after its conclusion (the 'cooling-off period'). In the last decade, these withdrawal rights have mushroomed. Not only do many European directives contain such rights, but the withdrawal rights also figure more and more prominently in contract law of national origin. Outside of Europe, this proliferation of cooling-off periods can also be witnessed in the United States and in other parts of the world.

Interestingly enough, the effectiveness of withdrawal rights is seldom tested. Although at first glance it seems that these rights are an effective way to protect a consumer against making rash decisions, the question is whether this is really the case. This paper, therefore, considers the usefulness of withdrawal rights against the purpose these rights intend to fulfil. This contribution first looks at the existing withdrawal rights in Europe and in the United States and at the functions they are supposed to serve (section 2). However, in my broad definition of withdrawal rights, I cannot limit myself to an analysis of statutory rights only. Consumer transactions are, to a very large extent, governed by general conditions, and it is interesting to see whether standard form contracts grant additional withdrawal rights to consumers (section 3). For the purpose of this paper, it is even essential to know about how retailers deal in practice with customers that are not satisfied with a product or service. This can provide us with insight into the effect of introducing statutory withdrawal rights on the behaviour of consumers (section 4). This in turn leads to an analysis of whether withdrawal rights should be mandatory or optional and at which level of regulation (national or European/federal) they should be granted (section 5).
II. WITHDRAWAL RIGHTS IN EUROPE AND IN THE UNITED STATES

A typical characteristic of withdrawal rights is that they allow the cancellation of contracts without giving any reason. Consumers need not explain why it is that they want to cancel the contract: they only need to return the good or send the seller a notice of cancellation within the cooling-off period. It is clear that this is an important deviation from traditional contract law, in which the binding force of contracts can be set aside only in exceptional circumstances: in cases where the consent of a party was based on a wrong assumption ('malformed') or in cases of non-performance or defective performance by the other party. In this respect, withdrawal rights are principally different from other contractual rights. This section provides a brief overview of existing withdrawal rights in Europe and in the United States.

Most European directives in the field of consumer protection oblige the professional seller or provider of a service to provide the consumer with (often detailed) information on the good or service and on the rights of the consumer. Such information duties are often complemented by a right of withdrawal. Such a combination of information duties and withdrawal rights can be found in directive 97/7 on distance selling (Art. 6: 7 working days), directive 2002/65 on distance marketing of consumer financial services (Art. 6: 14 calendar days), directive 2002/83 on life assurance (Art. 35: up to 30 days), directive 2008/48 on consumer credit (Art. 14: 14 calendar days) and in directive 2008/122 on timeshare (Art. 6: 14 calendar days). Directive 85/577 on doorstep selling also gives a right of withdrawal to the consumer (Art. 5: 7 days), but does not oblige the seller to give any other information than the existence of this right. The much discussed proposal for a European directive on consumer rights seeks to harmonise various directives by proposing a uniform set of general information requirements (Art. 5) and one uniform withdrawal period of 14 calendar days (Art. 12), with an extension to three months in case the necessary information is not provided (a sanction already used in several of the existing directives). This period of 14 days is in line with Art. II.-5:103 of the Draft Common

1. See, e.g., Peter Rott, Information obligations and withdrawal rights, in EUROPEAN UNION PRIVATE LAW 187 (Christian Twigg-Flesner ed., Cambridge 2010); see also Marco Loos, Rights of withdrawal, in MODERNISING AND HARMONISING CONSUMER CONTRACT LAW (Geraint Howells & Reiner Schulze eds., 2009).


3. Several national jurisdictions already provided for withdrawal rights in case of doorstep selling in the 1970s.

Frame of Reference of European Private Law,\(^5\) that devotes a whole chapter to the right of withdrawal.

It should be noted that most European directives only provide minimum norms: member states are allowed to give the consumer more protection in their national law. Thus, when it comes to the withdrawal period of seven working days in case of distance selling, individual European member states have implemented this rule in a different way.\(^6\) Countries like Austria, Belgium, France and the Netherlands follow the directive, but Italy allows 10 days for withdrawal, while Germany, Sweden, Denmark, Finland and Portugal have an even longer period of 14 days.

Apart from the rules of European origin, several European countries have introduced withdrawal rights in areas not covered by European law. One example is provided by Dutch law, which allows the purchaser of a house or an apartment to terminate the contract within three days after the contract was signed and handed over to the buyer.\(^7\) The explicit aim of this cooling-off period is to allow the buyer to consult an expert and to remedy a rash decision to enter into the contract. An example from German law is the withdrawal right in case of distance education: the student has until 14 days after receiving the first teaching materials to cancel the contract.\(^8\) Here, the (questionable) aim is to enable the student to obtain a clearer picture of the quality of the course. In French law, two different devices exist. On the one hand, French law recognises a so-called délai de réflexion, prohibiting the consumer from accepting an offer within a certain time period. Such a period of deliberation exists for credit contracts for immovable entities (10 days), distance education (7 days) and the purchase of immovable property to be used as the private dwelling of the buyer (7 days). On the other hand, French law also allows the withdrawal period stricto sensu in the form of the so-called droit de repentir. Apart from the topics covered by European legislation (on which France, as various other European countries, often had rules before they were adopted by the European legislator), French law allows consumers to withdraw from (for example) settlements


\(^8\) Fernunterrichtsschutzgesetz [FernUSG] [Distance learning Protection Act], Aug. 24, 1976 Widerrufsrecht, § 4 (This right was preceded by the Auslandsinvestmentgesetz of 1969, creating a withdrawal right in contracts for certain foreign investments.).
entered into by victims of traffic accidents and from contracts with marriage agencies. 9

In the United States, cooling-off periods are also well known, even though their number at the federal level is fairly limited. The two most important examples of federal rules are the three-day cooling-off rule of the Federal Trade Commission and the similar rule of the Truth in Lending Act.

The FTC rule 10 dates back to 1972 and allows the buyer to cancel a purchase of $25 or more within three business days if the sale takes place at the buyer’s home or at a location that is not the seller’s permanent place of business (such as a hotel, convention centre or restaurant). The salesperson must inform the consumer about the cancellation right at the time of sale and give him two copies of a cancellation form. 11 This federal rule can best be compared with the European withdrawal right in case of door-to-door contracts. It does not apply to distance contracts: contracts concluded by mail or telephone (or online) are explicitly excluded. The rule is also not applicable to transactions such as sales of real estate and new cars, and sales of arts or crafts at fairs. After the cancellation, the seller has ten days to refund the money. 12

Under the well known Truth in Lending Act of 1968, 13 the consumer also has three business days to rescind the contract in a consumer credit transaction involving a security interest in the consumer’s principal dwelling (unless the loan is not intended primarily for personal family purposes or the loan is a purchase-money loan (i.e. for the purchase of a home)). As in European consumer law, this period is extended in case the lender does not adequately inform the consumer of the right to rescind. 14

In addition to these two federal rules, many individual American states have their own “cancellation laws.” A brief survey of the law of New York 15 reveals that consumers have withdrawal rights under state law if they (to name a few examples) buy automobiles; conclude a contract with a professional seller over the telephone; lease or buy

11. Id.
12. Id.
14. Id.
subdivided land; or contract with a credit-service business, a health club, an emergency-response service or a dating service. In many other states, similar rights exist. California for example\textsuperscript{16} not only allows cancellation of the contract in most of the cases in which New York allows it, but also extends the application of withdrawal rights to cases dealing with mobile telephone contracts, funeral contracts, electric service contracts, dental service contracts, many types of insurance contracts, service contracts for used cars, home appliances and new motor vehicles services, and contracts of credit repair and mortgage foreclosure consultants and with dance studios. Furthermore, contracts for services in the areas of discount buying, employment counselling, immigration and job listings are governed by cooling-off periods ranging from three to sixty days.

The above makes abundantly clear how widespread statutory withdrawal rights actually are. This makes it important to ask what the justification is for the use of such rights.\textsuperscript{17} Scrutiny of the motives behind the legislation in both Europe and the United States reveals that usually two different motives exist to allow the consumer some time for reconsideration. Both motives are based on the idea that the consumer needs to be protected.\textsuperscript{18} The first type of protection is against a lack of psychological strength and the second is against a lack of informational strength.\textsuperscript{19} A lack of psychological strength is present if the other party makes use of aggressive sales techniques (such as in doorstep sales), taking the consumer by surprise or intruding the privacy of her home: even if a consumer would have all the information he or she needs, the consumer could still be psychologically forced to enter into the contract.\textsuperscript{20} A lack of informational strength on the other hand is a more frequent phenomenon. In certain types of contracts, it is impossible for the consumer to have an accurate picture of the product that is being sold or of the reliability of the other party (such as in distance contracts). In the view of many legislators, a withdrawal right can then be used to remedy such an information asymmetry: it allows the consumer to

\textsuperscript{17} See, e.g., Pamaria Rekaiti & Roger Van den Bergh, Cooling-Off Periods in Consumer Law, 23 J. CONSUMER POL’Y 373 (2000); see also Horst Eidenmüller, Die Rechtfertigung von Widerrufsrechten, Archiv für die civilistische Praxis 210 (2010), pp. 67 ff.  
\textsuperscript{18} See KATALIN JUDIT CSERES, COMPETITION LAW AND CONSUMER PROTECTION 151-92 (Alphen aan den Rijn, 2006) (discussing the various goals of consumer protection).  
\textsuperscript{19} Cf. JAC. HJIMA, WETTELUKE BEDEKTIJD 20 (Deventer, 2004); and Günter Reiner, Der verbraucherschützende Widerruf im Recht der Willenserklärungen, 203 ARCHIV FÜR DIE CIVILISTISCHE PRAXIS 1, 9 ff. (2003).  
\textsuperscript{20} Id.
acquire the information it needs by (e.g., in case of distance contracts) inspecting the product after delivery. Both motives fit in with the traditional goal of protecting the consumer against a party that is economically superior and better informed. This raises the question of the extent to which withdrawal rights are indeed effective in fulfilling this function. Before this question is discussed, however, we will first look at contract practice on the right to return goods.

III. NON-STATUTORY RIGHTS OF WITHDRAWAL: CONTRACT PRACTICE ON THE RIGHT TO RETURN GOODS

Apart from the statutory rights discussed in the previous section, there is a widespread practice that customers can return goods. Many retail shops throughout the world have adopted the policy that customers can do so at will and receive back the contract price or at least a credit note with which they can buy a different product in the same shop. This return policy is often laid down in the general conditions of the retailer. These contractual rights are even so common that the general public in some countries seems to think that there is a "general right to return goods." However, surprisingly little empirical material exists to test how widespread these return policies really are. Therefore, part of this paper is a very modest survey of these return policies as can be discerned from the general conditions employed by shops. Although the data are not representative for the entire retail practice, they do give a fair impression of existing return policies.

My survey is based on the general conditions of thirty-two shops that consumers visit regularly: supermarkets, department stores, pharmacies and sellers of clothing, furniture, electric appliances, toys and books. The survey is primarily based on the general conditions that these companies use in the Netherlands, but these conditions are compared with those of shops in some other countries (notably Belgium, Germany, the United Kingdom and the United States). I am aware of the fact that in order to be representative for the whole of Europe and the United States, this survey needs to be extended, but my only purpose here is to have a fair impression of international retail practices. I distinguish between general conditions for online sales and for "normal" sales.

21. Several American websites on consumer rights therefore contain a warning that no such general right exists.

22. This does not mean that withdrawal rights do not also exist for other types of contract. One important example from Dutch law can be found in the model general conditions of the Dutch association of insurers, providing for a cooling-off period of seven days in insurance contracts.

23. The materials on which the findings are based are available from the author.
For online sales, most Dutch companies make use of the model general conditions that were drafted through the cooperative efforts of the professional organisation of retailers in the Netherlands and the most important Dutch consumer association.\textsuperscript{24} These conditions are highly influenced by European directive 97/7 on distance contracts. Although the directive prescribes a minimum cooling-off period of seven working days, the model conditions allow consumers to withdraw from the contract within fourteen days. The majority of Dutch shops have adopted this model, although about half of the shops I looked at have extended this period even further to thirty days. This practice does not seem to differ from other European countries, but it seems less lenient than the policy of at least some retail shops in the United States: there, it is no exception that the return period is 180 days (despite the fact that, in most States, no statutory withdrawal rights exist for online contracts).

The survey also confirms the perception that withdrawal rights exist on a large scale in case of regular sales in shops. Only one shop in the sample of thirty-two did \textit{not} allow the consumer to return the goods and either receive reimbursement of the contract price or a credit note.\textsuperscript{25} But differences do exist as to the length of the cooling-off period: most shops allow fourteen days, followed by a significant number of shops that allow their customers to return goods within thirty days or (in the case of an internationally active seller of furniture) even ninety days. Four shops use a period of eight days, and one big Dutch supermarket even allows a right to return goods without specifying any time limit. Again, this practice does not seem to differ too much from practices in Belgium and Germany, whereas in the United States the period appears to be longer for contracts with large retailers (in which case periods of ninety or even 180 days are not exceptional).

The abundant granting of withdrawal rights to consumers in general conditions, even if there is no statutory need to do so (either because there is no statutory right at all or because such a right is for a shorter time period), raises the interesting question of how the introduction of mandatory law in this field influences the voluntary behaviour of business in allowing consumers to return goods. This is part of the more general question of just how effective mandatory withdrawal rights

\textsuperscript{24} These general conditions of the ‘Nederlandse Thuiswinkel Organisatie’ were drafted in cooperation with the ‘Consumentenbond’ under the auspices of the ‘Coordinatiegroep Zelfreguleringsoverleg’ of the ‘Sociaal-Economische Raad’ and introduced in 2009.

\textsuperscript{25} In this case, the shop gave as a reason why no such right exists—that it concerns an “outlet” (note that other outlet stores were part of the survey, but still allowed products to be returned).
actually are. The next section will consider the usefulness of withdrawal rights against the purposes these rights intend to fulfil.

IV. THE EFFECTIVENESS OF STATUTORY WITHDRAWAL RIGHTS: ON CROWDING OUT EFFECTS

It was seen above that withdrawal rights have the function of remedying a lack of psychological or informational strength on the part of the consumer. It is not difficult to see that this function will not always be satisfied in all of the applications mentioned in section II. It is intuitive that the length and further design of the cooling-off period decide whether the granting of the withdrawal right will be successful.\(^{26}\) Thus, it is well established that a mandatory information duty on the part of the professional party combined with a withdrawal period may simply be too much: this cannot only drive suppliers of goods out of the market; the extra effect of a withdrawal right next to extensive duties to give information does not add much to help the consumer make up her mind because of the risk of an information overload. In case of financial services (like insurance products or credit agreements), a cooling-off period will not help because the possible consequences of such products will often only become clear after a long time. In other cases (such as the three days’ cooling-off period for the purchase of a house in Dutch law), it is often difficult to see how, within such a brief period, any extra information could be gathered that was not already available before the purchase. And even regarding distance contracts, concerns have been expressed about how effective withdrawal rights actually are. It may be true that they allow the consumer to inspect the product and decide whether he really wants to purchase it. But this motive does in itself not justify making the right mandatory. Gerhard Wagner rightly says that there is no potential flaw in the rational self-determination of the consumer and that therefore a waiver of the right to withdraw should be possible: “a consumer may rationally decide to waive the right of withdrawal in exchange for a better price.”\(^{27}\) This leaves door-to-door contracts as the main field in which withdrawal periods are legitimate because such periods can remedy a lack of self-determination of the consumer. However, here too we should acknowledge that the effectiveness of these rights depends on the presumptions that consumers are rational beings, are driven by self-interest and are willing to act upon

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\(^{26}\) Cf. e.g. Hans-W. Micklitz, Norbet Reich & Peter Rott, Understanding EU Consumer Law 198 (2009); cf also Rekaiti & Van den Bergh, supra note 17, at 380.

it to trigger their rights. All of these are presumptions that have been criticised in various behavioural studies. In effect, this type of protection is not primarily used by those who need it the most (because they are not in a position to exercise their rights), but mostly by consumers who do not need the protection anyway.

Although it is questionable whether legislators are always aware of these problems, a more fundamental question is whether the granting of (mandatory) withdrawal rights is a good thing at all. We saw in section 3 that many retailers grant withdrawal rights voluntarily, even in cases where no legal obligation exists to do so. These contractual rights cannot be motivated by the reasons underlying the existence of statutory rights: if consumers buy a product in a shop, they are not considered to be taken by surprise or to lack information about the product. It is therefore likely that there is another reason why retailers grant these rights: they do so to create trust with their customers. Next to giving warranties and engaging in advertising or labelling schemes, allowing a customer to return the product can help to create trust in a particular seller and to increase the number of transactions. Consumers are more willing to buy products that they can return.

The contractual practice of granting withdrawal rights in the absence of a legal duty to do so therefore casts doubt on the motivation of retailers to allow consumers to withdraw from contracts. Accordingly the usefulness of mandatory legislation in this area must be questioned. Apparently, the imposition of mandatory withdrawal rights is based on the assumption that behaviour of parties is driven by self-interest and that the granting of a withdrawal right is not in line with such self-interest. But the correctness of this view is doubtful: if creating trust and attracting customers are indeed the motivating factors for a party to grant a withdrawal right, then this trust-building process would be undermined if legislators were to impose statutory withdrawal rights. It will be shown in the following section of this paper that this "crowding out" effect is indeed likely to occur.

The starting point is the importance of social norms, which control behaviour in spite of legislation. It is widely accepted that these social norms...
norms are influenced by considerations of reciprocity (or even of fairness in general). Behavioural studies clearly show that behaviour of people and of organisations is therefore not necessarily motivated by self-interest. This altruistic behaviour can be influenced in a negative way by regulation: the intrinsic, "other-regarding" motivation of people is then replaced by extrinsic motivation, leading to opportunistic behaviour. This is a well known phenomenon of which many examples exist. Titmuss showed in a famous study that the voluntary system of blood donation in the United Kingdom led to a larger supply of high quality blood than the remunerated system in the United States: paying for blood did not lead to an efficient increase in the number of donors.

Another example concerned an experiment conducted in day-care centres in Israel: the introduction of a fine for parents that were late in picking up their children led to a doubling of the number of latecomers. This "motivational crowding out" can be easily explained: in the absence of a "formal" reward or sanction, a person can show its intrinsic motivation to help others or to "do the right thing." As soon as a monetary reward or a fine is introduced, others will perceive the beneficial behaviour as not being motivated by altruism, leading to a decrease in the willingness to act in this way. In the day-care experiment, parents simply perceived the fine as the price to be paid for coming late and therefore as much less of a disincentive for coming late than the feeling of acting in the wrong way.

These two examples show that the introduction of an explicit policy or incentive can undermine moral and altruistic behaviour. In other words, pre-existing values to act in a socially beneficial way can be compromised. Creating mandatory withdrawal rights can have the same effect. A survey by Borges and Irlenbusch investigated whether

34. Uri Gneezy & Aldo Rustichini, A Fine is a Price, 29 J. LEGAL STUD. 1 (2000).
35. See BRUNO S. FREY, NOT JUST FOR THE MONEY: AN ECONOMIC THEORY OF PERSONAL MOTIVATION (Edward Elgar 1997).
36. See Kenneth J. Arrow, Gifts and Exchanges, 1 PHIL. & PUB AFFAIRS 343 (1972), and Samuel Bowles & Sandra Polania Reyes, Economic Incentives and Social Preferences: A Preference-based Lucas Critique of Public Policy, 2734 CESifo Working Paper 3, 3 (2009), available at http://ideas.repec.org/p/ces/cswps/2734.html, which points out that there may even be a neurological basis for the counterproductive effects of explicit incentives.
the provision of rights to protect one party reduces considerations of fairness in the other party. They explain that between 1998 (one year after the directive on distance selling was published) and 2004, the return quota in Germany increased from 24% to 35%. They convincingly relate this increase in the use of withdrawal rights to the crowding out of reciprocity.\footnote{38. Id. at 94.}

one should expect that there is a considerable difference in withdrawal behaviour depending on whether they are voluntarily granted by sellers or whether they are imposed by law. If the seller voluntarily offers a withdrawal right to the buyers this might be perceived by them as a generous act and they might feel inclined to reciprocate by not exploiting the seller too much. On the other hand a withdrawal right imposed by law would provide the buyers with an entitlement to exert this right. Additionally, it would deprive the seller of showing “friendly” intentions and thereby buyers might not see the need to be considerate of the seller.

Their survey substantiates that this is indeed the case: “return behaviour” is influenced by how buyers perceive a seller’s behaviour (as voluntary or as a consequence of applying mandatory rules). This effect is likely to become more important if it is true what some say about the consumer of the future, who would be even less self-interested: she will still want what is best for herself, but not at the cost of others.\footnote{39. See e.g. ALAN FAIRNINGTON, THE AGE OF SELFISH ALTRUISM: WHY NEW VALUES ARE KILLING CONSUMERISM (Wiley 2010).}

Further evidence for this phenomenon can be found in the general conditions of retailers discussed in section III. Even in areas where mandatory withdrawal rights exist, retailers usually allow their customers to withdraw from the contract for a longer period than necessary. The most plausible reason why they do so is to attract customers, and the only way to do this is to go further than the statutory rule prescribes.

The remaining question is what this all means for the design of withdrawal rights. The above does not mean that mandatory withdrawal right should be abolished all together, but it should make us think about the ideal “governance system” of these rights. Such a system should not only try to tackle the problems identified in the beginning of section 4. It should also take into account the importance of reciprocal behaviour and of creating trust between seller and consumer. The ideal governance system of withdrawal rights should also offer a solution for the crowding out of reciprocity by mandatory rules, while trying to avoid conflicts between intrinsic and extrinsic motivations of parties. It should also specify when withdrawal rights should be mandatory or optional and at
which level of regulation (at the level of countries/states or at the European/federal level) they should be granted. Although it seems nigh impossible to design a system that would meet all these requirements, the next section does attempt to provide the contours of such a system.

V. TOWARDS AN OPTIMAL DESIGN FOR WITHDRAWAL RIGHTS: ON CHOICE ARCHITECTURE

It was seen above that withdrawal rights are particularly well founded where a party cannot exercise its autonomy as a result of pressure put on that party. The clear example of this is doorstep selling, where the traditional instruments of mistake, undue influence and the general unconscionability or good faith doctrine are not optimal. It is then better to standardise the likelihood that the consumer felt pressured by allowing her to withdraw from the contract. This is different in the case of distance contracts, where there is no need to give a mandatory rule allowing the consumer to rethink its decision to enter into the contract. Here, the traditional instruments of private law can do the trick much better. An extra argument in favour of this view is that a mandatory withdrawal right may lead to a crowding out effect: individual retailers will no longer be able to show their willingness towards consumers to give them an extra right, thus seducing them to purchase their products.

These findings still leave open the question of what geographical scope should be implemented for withdrawal rights for doorstep selling. Both in the European and United States contexts, the choice is between regulation at the European federal or Member State level for Europe and at the federal or state level for the United States. Although we lack hard and firm criteria to decide which level is best,\(^\text{41}\) it seems the right approach of both the United States FTC rule and the European Directive on doorstep selling is to choose the European/United States federal level. This choice is motivated by the great importance of protecting consumers on the federal or European market in case of the invasion of privacy that comes with doorstep selling. In line with Ayres and Braithwaite’s model of “dynamic regulatory institutions,”\(^\text{42}\) it makes sense to safeguard intrinsic motivation at a lower level by creating only informal sanctions (and thus enhance dialogue and trust) while allowing formal sanctions for major violations.

\(^{40}\) Wagner, supra note 27, at 58.


But this is not all. In addition to the optimal legal design of withdrawal rights, it is useful to think about how to give parties incentives to make the right choice in the first place (instead of remedying the wrong decision afterwards). This is what so-called choice architecture deals with: the way in which choices are presented influences the way in which decisions are made. Can we think of tools that nudge people to make a better choice when they purchase a product in their own home?\textsuperscript{43} It was argued above that in doorstep selling the main problem lies in the consumer's being pressured to enter into the contract, just to get rid of the salesperson invading her privacy. One possible solution to this problem would be to design the contracting process in such a way that door-to-door sellers are obliged to sell their products in two stages. In the first stage, they would be allowed to visit potential customers and show the products they want to sell. A contract entered into in this stage of the contracting process would not be valid. Only in a second stage (after the seller left the house) could a valid contract be concluded, by making a telephone call, sending in a form or ordering the product on a website. This would of course require that the customer know about these protective rules, but this is a matter of informing her. In distance contracts, we can think of similar mechanisms to overcome the problem of consumers lacking information about the product.\textsuperscript{44} Legislators thus performing the role of choice architects can help in finding the optimal design for withdrawal rights.

\textsuperscript{43} RICHARD H. THALER \& CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH AND HAPPINESS (Yale 2008).

\textsuperscript{44} See also Eidenmüller, supra note 17, at 97.
Court Jurisdiction and Recognition in Multi-National Political Structures: Canada and the European Union

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I. INTRODUCTION—REPLACING WIDELY DIFFERENT JURISDICTION RULES WITH A UNIFORM SET OF STANDARDS

The rules for determining the jurisdiction of Canadian courts have been modernized and codified recently in several provinces. At the same time, the approach to court jurisdiction that has prevailed among European Union Countries since 1968 has been updated and extended to more states.

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In this article the author examines these systems in the context of actions involving commercial contracts (other than insurance or employment contracts or contracts involving rights in immovable property) and assesses the extent to which they represent fundamentally different views as to how to address the problems of recognition and enforcement of judgments of courts located in different jurisdictions. The article focuses on the Uniform Court Jurisdiction and Proceedings Transfer Act promulgated by the Uniform Law Conference of Canada, 2003 and the Lugano Convention, 2007.

In May 2009, the revised Lugano Convention on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters, 2007 (hereinafter, the “Convention”) was ratified by the European Community on behalf of its member States. Norway, Denmark and Switzerland ratified the Convention later in the year. This Convention embodies most of the provisions of the Lugano Convention of 1988, which in turn, extended the effect of the Brussels Convention of 1968 to European Free Trade Association states. A slightly modified version of the Brussels Convention was adopted as internal EU law in Brussels I (Council Regulation (EC) No 44/2001) passed on December 22, 2000 (entry into force March 1, 2002). While Brussels I Regulation and the Convention are separate documents, the structure of the Convention is based on the principles of Brussels I.

The Canadian Uniform Court Jurisdiction and Proceedings Transfer Act (hereinafter, the “Uniform Act”) was developed by the Uniform Law Conference of Canada, an intergovernmental body established to facilitate the uniformity of provincial and territorial legislation. To

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1. The companion Uniform Enforcement of Canadian Judgments and Decrees Act provides a uniform system for registration and enforcement on Canadian judgments. In this respect, it parallels Section 2 of the Lugano Convention.

2. There are three Protocols to the Convention that address a range of matters including interface between the Convention and Brussels I, transition, reservations, and the effect of other conventions to which a state bound by the Convention is a party.


4. In the following paragraphs, a reference to “province” includes a territory.
date, it has been enacted in only three Canadian provinces and one territory; however, there is convincing evidence that its provisions represent a consensus with respect to most aspects of inter-jurisdictional recognition and enforcement of money judgments. Furthermore, the approach of the Act reflects the "new" constitutionally prescribed non-statutory conflict of laws rules of most other jurisdictions in Canada relating to court jurisdiction and recognition of judgments. It is the

5. Judgment recognition and enforcement is, for the most part, a matter within the exclusive jurisdiction of Canadian provinces.


7. Law Reform Agencies in two additional provinces have recommended to their legislatures adoption of the Uniform Act with some modifications. See Enforcement of Judgments, Final Report, the Alberta Law Institute, No. 94 (2008) and Private International Law, Manitoba Law Reform Commission, Report 119 (2009). The Ontario Court of Appeal has recently concluded that the Model Act, for the most part, represents the present state of the common law in that province. See Van Breda v. Village Resorts Ltd., 98 O.R.3d 721, 741-44 (2010).

8. See generally Canadian Uniform Court Jurisdiction and Proceedings Transfer Act. While the Uniform Act was designed to be implemented in both common law jurisdictions and Quebec (which has a civil law system), significant changes in policy and drafting would be required for its implementation in that province. Book 10 of the Quebec Civil Code contains detailed provisions dealing with jurisdiction. Article 3168 provides that, in respect of personal actions of a patrimonial nature, a court has jurisdiction only where the defendant has his or her domicile or residence in Quebec; the defendant is a legal person not domiciled in Quebec but has an establishment in Quebec and the dispute relates to its activities in Quebec; the parties have by agreement submitted to it all existing or future disputes between themselves arising out of a specified legal relationship; or the defendant submits to its jurisdiction. While some aspects of the test contained in Article 3168 parallel aspects of sections 3 and 10 of the Uniform Act, it is quite conceivable that a factor indicating a "real and substantial connection" to another province falls outside the list of factors set out in Article 3168. The refusal of a Quebec court to recognize a judgment of the court of another Canadian jurisdiction in this context may result in violation of the constitution principle set out in the Supreme Court decisions in Morguard Trust v. De Savoye, 3 S.C.R. 1077 (1990) and Hunt v. T&N plc, 4 S.C.R. 289 (1993), which are treated as establishing a constitutionally based rule for determining jurisdiction for the purposes of inter-provincial recognition of judgments. See generally, Geneviève Saumier, The Recognition of Foreign Judgments in Quebec, 81 CAN. BAR. REV. 677, 704 (2002).

9. The Uniform Act deals only with proceedings; it does not deal with common law rules relating to territorial limits of remedies.

10. The Uniform Law Conference of Canada identified four main purposes for the Act:

(1) to replace the widely different jurisdictional rules currently used in Canadian courts with a uniform set of standards for determining jurisdiction;
(2) to bring Canadian jurisdictional rules into line with the principles laid down by the Supreme Court of Canada in Morguard Investments Ltd. v. De Savoye, 3 S.C.R. 1077 (1990), and Amchem Products Inc. v. British Columbia (Workers' Compensation Board), 1 S.C.R. 897 (1993);
(3) by providing uniform jurisdictional standards, to provide an essential complement to the rule of nation-wide enforceability of judgments in the uniform Enforcement of Canadian Judgments Act; and
most recent\textsuperscript{11} Canadian statutory formulation of the recognition and enforcement principles. As such, it is an appropriate vehicle for comparing Canadian law with the Convention.\textsuperscript{12}

II. POLICIES IMPLEMENTED—FACILITATING COMMERCE BY ACHIEVING A HIGH LEVEL OF PREDICTABILITY IN ENFORCING

(4) to provide, for the first time, a mechanism by which the superior courts of Canada can transfer litigation to a more appropriate forum in or outside Canada, if the receiving court accepts such a transfer.

"To achieve the first three purposes, this Act would, for the first time in common law Canada, give the substantive rules of jurisdiction an express statutory form instead of leaving them implicit in each province’s rules for service of process." However, the current (non-statutory) rule, which (subject to arguments of forum non conveniens) permits a court to take jurisdiction on the basis of the defendant’s presence alone, without any other connection between the forum and the litigation, will therefore no longer apply. This change in the existing rule is proposed not only on the ground of fairness, but also because the existing rule is of doubtful constitutional validity, since a defendant’s mere presence in a province is probably not enough to support the constitutional authority of a province to assert judicial jurisdiction over the defendant. . . . Territorial competence will depend . . . on whether there is, substantively, a real and substantial connection between the enacting jurisdiction and the facts on which the proceeding in question is based. This provision would bring the law on jurisdiction into line with the concept of ‘properly restrained jurisdiction’ that the Supreme Court of Canada, in Morguard Investments Ltd. v. De Savoye, 3 S.C.R. 1077 (1990), held was a precondition for the recognition and enforcement of a default judgment throughout Canada. . . . The present Act, if adopted, will ensure that all judgments will satisfy the Supreme Court’s criterion of ‘properly restrained’ jurisdiction, which the court laid down as the indispensable requirement for a judgment to be entitled to recognition at common law throughout Canada.


11. Reciprocal Enforcement of Judgments Acts were enacted in most provinces during the first part of the last century. E.g., S.S., 1996, c. R-3.1. These Acts provide for recognition and enforcement of judgments of reciprocating provinces, some states of the United States and a few countries. This legislation is subject to the more recent constitutional principles set out in Morguard Trust v. De Savoye and Hunt v. T&N plc, supra note 8.

12. A comparison between the approach of the Lugano Convention and that of recent Canadian statutory measures would be incomplete without reference to the Uniform Enforcement of Foreign Judgments Act, which provides a structure for the recognition and enforcement of non-Canadian judgments. However, since the Lugano Convention leaves recognition of judgments from non-Convention states to the domestic conflict-of-laws rules of each state party to the Convention, such a comparison is not possible without examining the recognition rules of all such states. The author of this article has made no attempt to do this. However, see generally Charles Platto and William Horton, Enforcement of Foreign Judgment Worldwide (Graham & Trotman and International Bar Assn. 2nd ed. 1993).
JUDGMENTS AMONGST SUB-UNITS

Both systems have been designed to function in the context of political structures, the European Union (plus Norway and Switzerland), on the one hand, and Canada, on the other, which have subunits—states or provinces—with constitutional power with respect to recognition and enforcement of money judgments. The public policy that both the Convention and the Uniform Act were designed to implement is the facilitation of commercial relationships between persons in different states or provinces by providing a high level of predictability that a judgment obtained in one such state or province will be recognized and enforced in another state or province. It has been observed that the Lugano Convention, reflecting the commercial policies of the European Union, ensures that there is “free movement of judgments to secure adequate legal protection of individuals and enterprises” by providing a structure through which countries can “trust each others’ legal systems and judiciaries.” The commentary to the Uniform Act includes in the list of purposes of the Act the replacement of “widely different jurisdictional rules currently used in Canadian courts with a uniform set of standards for determining jurisdiction” and, “by providing uniform jurisdictional standards, to provide an essential complement to the rule of nation-wide enforceability of judgments in the uniform Enforcement of Canadian Judgments Act.”

III. SPECIFIC OBJECTIVES—IMPLEMENTING UNIFORM STANDARDS FOR JURISDICTIONS AND RECOGNITION OF JUDGMENTS

Rules of law that address jurisdiction can be seen as having two objectives. One of these (hereinafter, “objective one”) is to prescribe clear, consistent tests under which it can be determined which court(s) has jurisdiction to address a dispute or grant a declaratory judgment. The principal purpose of this objective is to tell plaintiffs where they must bring their actions for judgments that will be recognized by other political units bound by the system, and to tell defendants where they can be expected to defend actions against them.

Features characteristic of systems designed to implement this objective include specific, limited tests for jurisdiction and power given to courts of one political unit to refuse to enforce a judgment of a court of another political unit that took jurisdiction on an impermissible basis. In its purest form, objective one precludes forum shopping and the

13. Id. at 153.
14. Id.
15. Introductory Comments, supra note 10, at comments 0.1(1) and (3).
possibility of conflicting decisions dealing with the same dispute between the same parties. Furthermore, it precludes the possibility that a court will decline jurisdiction on the basis that a court of another political unit is a more appropriate forum to address a proceeding.

The second objective (hereinafter, “objective two”) has a different focus. It is to provide rules for identifying those fora, the judgments of which will be recognized by other political units bound by the system. The objective is not to provide a high level of predictability as to the jurisdiction in which an action will be heard. Its primary focus is on recognition and enforcement. It is designed to implement a “full faith and credit system” similar to the one that is constitutionally prescribed in the United States.\footnote{16} A judgment of a court that took jurisdiction on the basis of one of a number of specific criteria must be recognized and enforced in all other political units that have adopted the same criteria. The jurisdiction of a court that issues a judgment in one political unit cannot be questioned when that judgment is being enforced in another.\footnote{17} Under this approach, the plaintiff may choose any one of the available fora in which to bring its action with the assurance that, under normal circumstances, a judgment obtained will be recognized and enforced in all other political units that participate in the system. Endemic to this approach is the potential for forum shopping by the plaintiffs and a possible logistical advantage for a plaintiff who decides to bring an action in a forum that entails significant cost and inconvenience for a defendant. However, abuse of this feature of the system can be controlled through collateral mechanisms such as power given to a court to refuse to hear a case (a forum non conveniens ruling) or to transfer it to a court of another political unit that is a more appropriate forum.

In the following paragraphs of this article, the author describes the extent to which the Convention and the Uniform Act fulfill the objectives described above. The focus is on the non-specific rules of the Convention and Uniform Act dealing with court jurisdiction in cases involving proceedings arising out of contractual relationships.\footnote{18}

17. For example, the Uniform Enforcement of Canadian Judgments and Decrees Act, s. 6(3) provides that when a judgment of another Canadian court is tendered for registration as the judgment of the enforcing court, the court “shall not make an order staying or limiting the enforcement of a registered Canadian judgment solely on the grounds that (i) the judge or tribunal that made the judgment lacked jurisdiction over the subject-matter of the proceedings that led to the judgment or over the party against whom the enforcement is sought under the principles of private international law or (ii) the domestic law of the province or territory where the judgment was made.”
It has been recognized by the author that there exists a substantial body of jurisprudence dealing with provisions of the Convention (or its predecessors, the Brussels Convention and former Lugano Convention) that bears on the interpretation and application of these provisions. By the same token, there are decisions of Canadian courts dealing with provisions of the Uniform Act and the common-law concept of “real and substantial connection.” However, extensive analysis of this jurisprudence has not been included in this article.

IV. OVERVIEW

It is clear that the approach of the Convention is to implement both objectives one and two described above, while that of the Uniform Act is to implement primarily objective two. The Uniform Act addresses objective one to the extent necessary to facilitate objective two. The Convention has been designed to provide much greater certainty and, consequently, uniformity, through the prescription of two factors on which jurisdiction and recognition are based: domicile of the defendant and place of contractual performance. Article 2 § 1 provides that an action against persons domiciled in a state bound by the Convention shall be brought in the courts of that state. Article 5 § 1 permits an action relating to a contract in the state where the contract was performed or was to be performed.

The Uniform Act is less restrictive in this respect and, consequently, offers a lower level of predictability. Section 3 provides for the

actions that do not fall within the commercial classification such as actions in tort (art. 5 § 3); actions for restitution for criminal acts (art. 5 § 4); actions against settlers, trustees or beneficiaries under trusts (art. 5 § 6); actions relating to consumer contracts (art. 5 § 4) and employment contracts (art. 5 § 5). The Convention provides special rules for actions relating to insurance (art. 5 § 3); actions involving claims to rights in rem to immovable property, including tenancies of immovable property (art. 22 § 1); actions relating to the constitutional aspect of legal person (art. 22 § 2); actions involving the validity of an entry in a public registry (art. 22 § 3) and proceedings concerning intellectual-property rights (art. 22 § 4).

The Uniform Act contains special rules applicable to actions involving arrest of vessels (§ 5), proprietary or possessory rights in property (§ 9(a)), a trust (§ 9(d)), restitutionary obligations (§ 9(f)), tort (§ 9(h)), determination of personal status (§ 9(j)) and recover taxes (§ 9(l)).

19. The companion Uniform Enforcement of Canadian Judgments Act provides a uniform system for registration and enforcement on Canadian judgments. Under this legislation, a judgment of a court of another Canadian province or territory must be registered and enforced in another Canadian province or territory.

20. Both systems recognize the jurisdiction of a court: (i) designated in a forum-selection agreement between the parties; (ii) to which the defendant has submitted; and (iii) in counterclaim proceedings against a plaintiff in another action brought before the court. See Lugano Convention art. 6 § 3, art. 23, art. 24; Uniform Act §§ 4(a)-(c).

21. Lugano Convention, supra note 23, art. 2 § 1.

22. Id. at art. 5 § 1.
"territorial competence" of a court (jurisdiction to hear an action and render judgment, also referred to as jurisdiction *simpliciter*23) if the defendant is ordinarily resident in the province or territory of the court at the time of commencement of the proceedings that led to the judgment or if there is "a real and substantial connection" between the province or territory of the court and the facts on which the proceedings against the person were based.24 Section 10 of the Act sets out a non-exhaustive list of factors that, if established, give rise to a presumption that a real and substantial connection exists between the case and the forum. This provision is examined later in this article.

V. **IN PERSONAM JURISDICTION**

Both the Convention and the Uniform Act provide for court jurisdiction based on personal factors associated with the defendant. As noted above, Article 2 of the Convention provides that, subject to specified exceptions, actions against a person must be brought in the jurisdiction in which the person is domiciled. However, the Convention contains no definition of "domicile" in cases involving defendants who are natural persons. The matter is left to the internal law of the forum state (Article 59). The result is the potential for forum shopping where there is a difference in approach taken under the law of states as to what constitutes domicile. Article 6(1) provides a special rule applicable in situations where there are two or more defendants with separate domiciles. In such a case, the action may be brought in any one of the domiciles so long as the claims are "so closely connected that it is expedient to hear and determine them together." Since this determination is made by the forum court, the certainty of the domicile rule is diminished.

Where the defendant is a "company or other legal person or association of natural or legal persons," alternatives are provided. Article 60 provides that when this type of defendant is involved, the person is deemed to be domiciled in a state where the defendant has its "statutory seat," central administration or principal place of business. If one of these is a state bound by the Convention, the Convention

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23. See Uniform Act § 3. This term denotes jurisdiction other than "subject-matter competence," which relates to restrictions on the court's authority such as the nature of the dispute and the amount in issue.

24. This formulation was introduced by the Supreme Court of Canada in *Morguard Trust v. De Savoye*, supra, note 8.

25. In the context of the United Kingdom, this means the defendant's place of registered office, if one, and otherwise in the place of incorporation or formation (Art. 60(3)).
applies. Where two or more of these are states bound by the Convention, presumably the choice of the forum is left to the plaintiff.

The Uniform Act provides that a court has jurisdiction if, at the time of commencement of the proceedings, the defendant was "ordinarily resident" in the forum province (Section 3(d)). The Act does not define the term "ordinarily resident" as it applies to natural persons. The Uniform Law Conference concluded that this should not result in uncertainty because the term has been defined in numerous cases involving other statutes and any "express statutory definition would probably fail to match the existing concept and would therefore provide difficulty rather than certainty."26 Where two defendants are involved and only one is ordinarily resident in the forum province, there is no presumption that the court has jurisdiction with respect to the second defendant unless the proceeding has a real and substantial connection to the forum province.

As is the case with the Convention, the Act provides rules determining when a corporation is ordinarily resident in a province. Section 7 lists alternative factors, more numerous and less restrictive than those of the Convention.27 Under the Convention, an organization is deemed to be located in a state if it has its principal place of business in that state. Under the Uniform Act, all that is required is that the organization have a place of business (whether principal or otherwise) in the province, have or be required to have a registered office (which need not be it "statutory seat") in the province, or have an office or agency in the province at which service of process may be effected.

VI. NON-PERSONAL FACTORS

The uncertainty associated with the lack of a definition of personal domicile, referred to above, and the alternatives available in the case of a corporate defendant is increased in the context of commercial contracts falling within the scope of this paper by Article 5 of the Convention. Under Article 5(1)(a), a plaintiff can disregard the defendant domicile rule of Article 2 where the matter relates to a contract.28 The action may be brought by a plaintiff in the "place of performance of the obligation in question."29 Article 5(1)(b) provides that, in the context of a sale of goods, this is the place where the goods were delivered or should have been delivered, and in the context of a contract for the provision of

27. Where a partnership is involved, the connecting factors are registered office, place of business or central management in the province (section 8).
28. See Lugano Convention, supra note 23, art. 5(1)(a).
29. Id.
services, this is the place where the services were provided or should have been provided.\textsuperscript{30} However, other than proceedings involving contracts for the sale of goods or services, the Convention provides no guidance as to the meaning of “place of performance of the obligation in question.”\textsuperscript{31} Since a single contract may provide for several obligations, it appears possible that actions involving such a contract may be brought in any one of different fora. This uncertainty has been the source of considerable litigation before the European Court of Justice, which has not provided a definitive approach.\textsuperscript{32}

The approach contained in Article 5(1) of the Convention is implemented on a somewhat expanded scale by section 3 of the Uniform Act. In the case of litigation involving a commercial contract, a court has jurisdiction if there is a real and substantial connection between that province and the facts on which the proceedings against the defendant were based (Section 3(e)).\textsuperscript{33} Section 10 of the Act sets out a non-exclusive list of factors that, if extant, give rise to a rebuttable presumption that such a connection exists.\textsuperscript{34} The features of this provision most relevant to a non-specific commercial contract are set out in sections 10(e) and 10(h).\textsuperscript{35} A court is presumed to have jurisdiction where the action involves breach of contractual obligations that, to a substantial extent, were to be performed in the province where the court is located (Section 10(e)(i)).\textsuperscript{36} In addition, a court has presumed jurisdiction where the action concerns contractual obligations where the contract resulted from a solicitation of business in the province of the forum by or on behalf of the seller (section 10(e)(iii)(B)) or where the action “concerns a business carried on in” the forum province (Section 10(h)).\textsuperscript{37} It is not a requirement in the context of the latter factor that the action involve performance of the contract in that province. Another factor that connects the proceedings to a province is the designation of

\textsuperscript{30} See id. art. 5(1)(b).
\textsuperscript{32} See generally, R. Kelly & Grace O'Connor, Article 5(1) of The Brussels Regulation: Internal Conflict in the Conflict Of Laws, 4 CAMBRIDGE STUDENT L. REV. 11 (2008-09).
\textsuperscript{33} See Uniform Law Conference of Canada, Uniform Statutes, Uniform Court Jurisdiction and Proceedings Transfer Act, supra note 10, § 3(e).
\textsuperscript{34} See id. § 10.
\textsuperscript{35} See id. §§ 10(e), 10(h).
\textsuperscript{36} See id. § 10(e)(i).
\textsuperscript{37} See id. § 10(e)(iii)(B), 10(h).
COURT JURISDICTION AND RECOGNITION

the law applicable to the contract made "in express terms" by the parties to the contract (Section 10(e)(ii)). A factor often associated with commercial contracts that induces the presumption that there is a real and substantial connection between a proceeding and a province is the location in that province of movable or immovable property where a party to the proceedings is seeking a ruling as to proprietary or possessory rights or a security interest in the property (Section 10(a)).

VII. COMPARISON OF THE CANADIAN UNIFORM ACT AND THE LUGANO CONVENTION

It is reasonable for comparison purposes to treat "domicile" referred to in Article 2 of the Convention and "ordinary residence" referred to in section 3(d) of the Uniform Act as rough equivalents. Furthermore, there are parallels between the two systems with respect to the second major test of jurisdiction prescribed by the Convention. Section 5(1)(b) of the Convention refines the "place of performance of the obligation" factor in the context of contracts for the sale of goods or the provision of services as the state where the delivery occurred or should have occurred. While there is no similar statutory refinement of the meaning of place of performance in section 10(e)(i) of the Uniform Act, in many cases, this will be the place of delivery of goods or services under a sales or service contract.

The equivalent of the Article 5(1)(a) of the Convention test contained in section 10(e) of the Uniform Act refers to the jurisdiction in which the contractual obligations to "a substantial extent" were to be performed. The provision directs the court applying the section to focus on the feature of the contract that involves substantial performance where there is more than one performance obligation. While it provides somewhat more guidance than does section 5(1)(a), it still entails an assessment as to which performance obligation required of each party to the contract is the most substantial. Where it is clear that one party has

38. See Uniform Law Conference of Canada, Uniform Statutes, Uniform Court Jurisdiction and Proceedings Transfer Act, supra note 10, § 10(e)(ii).
39. See id. § 10(a) (alluding to a rough equivalence applicable only to immovable property is contained in the Convention); see Lugano Convention, supra note 23, art. 6(4) (providing an alternative to the place of domicile of the defendant where contract proceedings against the defendant can be combined with proceedings against the same defendant involving rights in rem in immovable property, where in such a case, the action may be brought in the court of the state where the property is situated); see also, Lugano Convention, supra note 23, art. 22 (explaining a court of the state in which immovable property is situated has exclusive jurisdiction with respect to actions involving rights to the property).
40. See Lugano Convention, supra note 23, art. 5(1)(b).
the dominant obligations (e.g., the seller who must deliver goods) the "substantial" test must be applied where the performance is to occur in two or more provinces.

However, the important difference between the approaches of the Convention and the Model Act is not found in the detailed provisions setting out specific jurisdictional factors. What is of much greater significance is the extent to which each system recognizes the jurisdiction of courts on the basis of factors other than domicile (ordinary residence) or place of performance of contractual obligations. The Convention is very limited in this respect. However, as noted above, section 3(e) of the Uniform Act permits a court to take jurisdiction when it concludes that there is "a real and substantial connection" between the facts of the case and the province of the forum. The list of factors in section 10 that require the conclusion that such a connection exists is not exclusive. A court may decide that there are other factors that induce this connection. Furthermore, section 12 of the Uniform Act recognizes the power of a provincial legislature to grant or deny through other, more focused, legislative provisions exclusive or concurrent jurisdiction to courts on the basis of factors not recognized in the Act as giving jurisdiction to these courts.\(^{41}\)

The lack of prescription of the forum in which an action is to be commenced embodied in the Uniform Act is further emphasized by section 6, which empowers a court that does not otherwise have jurisdiction to hear a case and issue a judgment where there is no court outside the province in which the plaintiff can commence the proceedings, or the plaintiff cannot reasonably be expected to commence proceedings. When a court concludes that a court of another province that does have jurisdiction is one in which the plaintiff cannot reasonably be expected to bring his or her action, it is employing the principle of *forum non conveniens* in reverse. This provision, which originated in Article 3136 of the Quebec Civil Code, was apparently included *ex abundanti cautela*. It is superfluous\(^{42}\) and, perhaps, constitutionally suspect.\(^{43}\) It is inconceivable that this jurisdiction would ever be invoked.

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41. See Uniform Law Conference of Canada, Uniform Statutes, *Uniform Court Jurisdiction and Proceedings Transfer Act*, supra note 10, § 12 (explaining the constitutionality of such legislation can be questioned should it grant exclusive jurisdiction on a basis that does not meet the "close and substantial" connection test established by the Supreme Court).

42. See Saskatchewan, supra note 6 (explaining that enacted the Uniform Act did not include this provision).

43. See Morguard Trust v. De Savoye, supra note 8 (discussing the provision could well be called into question under the principle on a constitutional basis if the matter involved falls within the jurisdiction of another forum, and the province of that forum has not enacted this feature of the Uniform Act); see Janet Walker, *Muscutt Misplaced: The*
on the ground that there is no Canadian court readily available to the plaintiff.

VIII. LIS PENDENS AND FORUM NON CONVENIENS

Two different scenarios may involve actions commenced in courts of two jurisdictions relating to the same matter between the same parties. The first is where both courts have jurisdiction under the rules of the system. The second is where there is temporary uncertainty as to whether the court first seized with the action has jurisdiction, but it is clear that the second court does.

The Convention recognizes that in rare situations duplicate proceedings may be started in courts of different states that have jurisdiction in the same matter between the same parties. However, rather than giving to the courts the power to determine which of the two is the most appropriate under the circumstances, Articles 27-29 provide a first-in-time rule. The court first seized is given priority, and the other court must stay the proceedings before it. Under Article 27, where related actions are involved, a court may decline jurisdiction in favour of another court first seized with jurisdiction.

The first-in-time approach also applies to cases falling within the second scenario. A court in which an action is brought must stay proceedings until it has been determined whether another court before which an action involving the same parties and the same issues was earlier brought has jurisdiction. If that jurisdiction is established, the second court must stay proceedings before it.

Essentially the same approach applies where the court of another state has taken jurisdiction on a basis other than that permitted by the Convention. Under Article 26(1), it is up to the court first seized with the matter to voluntarily decline to hear the case unless the defendant has entered an appearance. However, as a result of Article 27(1), the court that clearly has jurisdiction must not proceed with an action brought

Future of Forum of Necessity Jurisdiction in Canada, 48 CAN. BUS. L.J. 135 (2009) (examining the doctrinal basis for what is described as “forum of last resort”).

44. See Lugano Convention, supra note 23 (discussing how inflexible implementation of objective one noted above leaves little room for the application of the principle of forum non conveniens that could otherwise be used to address cases falling within the first scenario); see Owusu v. Jackson, C-281/02 (discussing that the European Court of Justice has held that the principle is not consistent with the Convention); see also Gilles Cumiberti, Current Developments, Private International Law, Forum Non-conveniens and the Brussels Convention, 54 INT’L & COMP. L.Q. 980 (2005) (discussing criticism of this conclusion).

45. See Lugano Convention, supra note 23, art. 30 (addressing the all-important question as to when proceedings have started in a jurisdiction).
before it until the issue of the first court’s jurisdiction is determined by the first court (Article 27(1)).

The system implemented by the Convention under which an action in one jurisdiction necessarily results in a stay of an action relating to the same matter between the same parties in another jurisdiction provides significant potential for abuse. A person who expects to be sued for breach of contract in a court of a state that clearly has jurisdiction can delay commencement of the action by bringing a baseless action against the potential plaintiff in another state alleging breach of the same contract by the potential plaintiff. The effect of this is to invoke the stay provided in Article 27(1) with respect to an action based on the contract thereafter brought by the plaintiff against the person in a state that clearly has jurisdiction under the Convention. This delays (possibly for many years, depending upon efficiency of the court system of the state in which the obstructing person brought his or her action) a just determination of the matter by the appropriate court. In addition, it places the plaintiff in the position of either having to argue before the court in which the person’s action was started that the court does not have jurisdiction under the Convention, or avoiding participation in the proceedings and seeking from the courts of the state or states in which the judgment is to be enforced a ruling that the judgment should not be recognized.

Given the much less precise and less restrictive grounds in the Uniform Act on which courts can take jurisdiction, theoretically, the risk is much greater that duplicate proceedings will be started in two provincial fora. Notwithstanding this, the Act contains no mechanism equivalent to that of the Convention under which it can be determined which proceeding may proceed and which must be temporarily or permanently stayed. Nor is there any basis on which to determine which of two judgments from courts in separate provinces is to prevail where the courts in both provinces took jurisdiction on the basis of one of the factors set out in section 3 of the Uniform Act. It is not possible for a court in one province to conclude that a court in another province took

46. See id. art. 35 (discussing it is open to the courts of a state to refuse to recognize a judgment of a court of another state when the latter court took jurisdiction on a basis not recognized by the Convention).

47. See Gasser v MISRAT, Case C-116/02 (discussing that the European Court of Justice ruled that delay in getting a court ruling is not grounds for refusing to apply Article 27).

48. See Trasporti Castelletti v Hugo Trumpy, Case C-159/97, [1999] ECR 1-1597 (ECJ) (discussing that this approach was used to delay hearing of a case for eight years); see aslo T. Hartley, The European Union and The Systematic Dismantling of the Common Law Of Conflict Of Laws, 54 INT’L & COMP. L.Q. 813, 815 (2005).

49. See Lugano Convention, supra note 23, art. 35.
jurisdiction on an impermissible ground (i.e., the defendant was not ordinarily resident in that province and there was no real and substantial connection to the province).\textsuperscript{50} Furthermore, it is not possible for a court to rule that the court of another province was a \textit{forum non conveniens}. Consequently, the common law “strong cause” principle no longer applies,\textsuperscript{51} and anti-suit injunctions cannot be used.\textsuperscript{52}

The Uniform Act does, however, provide two mechanisms through which duplicate actions in different provinces can be avoided. The first is statutory codification of the \textit{forum non conveniens} principle. This is addressed below. The second is a feature that dovetails with the principle of \textit{forum non conveniens}. Under sections 13-14 of the Act, a court has the power to transfer all or part of proceedings to another court. When a court that has both subject-matter jurisdiction and jurisdiction \textit{simpliciter} concludes that it is not a \textit{forum non conveniens}, it may request that another court of another province or a court of a state that has subject-matter competence and that is a more appropriate forum accept all or part of the proceedings. Where the referring court does not have subject-matter jurisdiction or jurisdiction \textit{simpliciter}, the transfer may be made to a court of another province or state that has both subject-matter jurisdiction and jurisdiction \textit{simpliciter}. Whether the court to which the request for transfer is made has subject-matter jurisdiction or jurisdiction \textit{simpliciter} is determined under the law of that jurisdiction.

\textsuperscript{50} See Uniform Law Conference of Canada, Uniform Statutes, Uniform Enforcement of Canadian Judgments Act, §§ 4, 6, available at http://www.ulcc.ca/en/us/index.cfm?sec=1&sub=1e1 (explaining the requirement of one province to recognize and enforce a “Canadian judgment” except in specified circumstances not relevant to the matters examined in this paper. A court is expressly precluded from staying or limiting the enforcement of a registered Canadian judgment on the grounds that the judge or court that made the judgment lacked jurisdiction over the judgment debtor under the principles of private international law (Section 6(2)). The assumption of this Act is that the judgment has been made by a court that has jurisdiction based on the rules set out in the Uniform Court Jurisdiction and Proceedings Transfer Act. There is no similar limitation on recognition under the Convention).

\textsuperscript{51} See Z.I. Pompey Industrie v. Ecu-Line N.V. [2003] 1 S.C.R.450 (discussing the principle that a court has the power to conclude that, even though the foreign court had jurisdiction on a basis recognized under the law of the domestic court (especially a choice-for-forum clause in an agreement between the parties), there is a strong cause for having the matter heard by the court and may proceed with the case).

\textsuperscript{52} See Amchem Productions Inc. v. British Columbia Workers’ Compensation Board [1993] 1 S.C.R. 897 (discussing an anti-suit injunction issued by a court that has jurisdiction to hear an action, against a plaintiff who has brought an action involving the same matter in the court of another jurisdiction in circumstance where the issuing court concludes it would be “oppressive or vexation” for the action to proceed).
A court is empowered to accept all or part of the proceeding transferred from a court located in another jurisdiction.\textsuperscript{53}

\section*{IX. JURISDICTION SIMPLICITER AND \textsc{FORUM NON CONVENIENS}}

Notwithstanding the identification in the Uniform Act of specific factors the existence of which, for the most part, dictate which court(s) has jurisdiction, litigants in jurisdictions that have enacted it do not have a high level of predictability with respect to jurisdiction \textit{simpliciter}. Uncertainty is endemic to the open-ended “real and substantial connection” test. There remains considerable disagreement among Canadian courts as to what factors the test contemplates.\textsuperscript{54} Furthermore, the value of the enumeration in section 10 of factors that give rise to the presumption of real and substantial connection is diminished, in any particular situation, by the possibility of one of the litigants establishing that there is a real and substantial connection to at least two provinces based on other factors.\textsuperscript{55} For example, in the context of litigation involving a commercial contract, notwithstanding that the forum where the substantial part of the contract obligations is to be performed has jurisdiction under sections 3 and 10(e)(i), it is still open to one of the litigants to demonstrate that the action has a closer and more substantial connection to another province and that the action should be heard in a court of that province.

The principal mechanism contained in the Uniform Act to address this situation is the principle of \textsc{forum non conveniens}.\textsuperscript{56} Once a court

\textsuperscript{53} See Uniform Law Conference of Canada, Uniform Statutes, \textit{Uniform Court Jurisdiction and Proceedings Transfer Act, supra}, note 10, §§ 15-23 (providing detailed rules dealing with the logistics of the transfer of proceeding from one court to another).


\textsuperscript{55} See Uniform Law Conference of Canada, Uniform Statutes, \textit{Uniform Court Jurisdiction and Proceedings Transfer Act, supra} note 10, § 10 (quoting § 10 of the Uniform Act provides in relevant part: “Without limiting the right of a plaintiff to prove other circumstances that constitute a real and substantial connection between (this province) and the fact on which a proceeding is based, a real and substantial connection between (this province) and those facts is presumed to exist. . . ”).

\textsuperscript{56} Currently, there appears to be some confusion in the case law as to whether the factors enumerated in section 11 that are to be taken into account when applying the \textsc{forum non conveniens} test play a role in the determination as to whether or not a court has jurisdiction \textit{simpliciter}. See Bouch v. Penny, [2009] 310 D.L.R. 433 (Can.); compare Stanway v. Wyeth Pharmaceuticals Inc., [2009] 314 D.L.R. 618. (Can.).
concludes on the basis of the factors set out in sections 3 and 10 that it has jurisdiction *simpliciter*, it must then determine whether or not it is the appropriate forum for the litigation. While the Uniform Act does not expressly so state, this is practically a mandatory step in the process when the defendant demonstrates that the action has a real and substantial connection to another province as well. Among the factors set out in Section 11(2) that a court must take into consideration when determining whether or not to accept or decline jurisdiction are the desirability of avoiding multiplicity of proceedings or conflicting decisions, the enforcement of an eventual judgment and "the fair and efficient working of the Canadian legal system as a whole." What is significant in this context is that it is up to one of the two courts involved to decide that it is a *forum non conveniens*, leaving the action to be determined by the other court.

Furthermore, a court may conclude that the action has its most real and substantial connection to the province of that court but nevertheless refuse to hear the case or may transfer it on the ground that, under the circumstances, it is not the most appropriate forum for the action. As noted above, section 11 of the Uniform Act provides that, after considering the interests of the parties and the "ends of justice" the court that has jurisdiction *simpliciter* may decline to exercise that jurisdiction on the ground that a court of another province (or state) is a more appropriate forum because, *inter alia*, it is more convenient and cost-effective for parties and witnesses.

X. IN SUMMARY

While the Convention, with its narrowly crafted tests for court jurisdiction, provides a significant level of predictability for both plaintiffs and defendants as to where an action must be commenced and defended, it does not completely eliminate the potential for forum shopping. By comparison, the imprecision of the "real and substantial connection" test of the Uniform Act when coupled with the lack of exclusiveness of the specifically enumerated factors in section 10 results in greater opportunity for forum shopping and a lower level of predictability for defendants as to where an action may have to be defended, and for plaintiffs as to whether a court will hear a case.

The differing approaches embodied in the Convention and Uniform Act can be explained, in part at least, by the contexts within which these systems function. The Convention applies to thirty sovereign states, many of which have very disparate legal and judicial systems. As a result, the approach contained in it is, perhaps, justifiably much more prescriptive than that contained in the Uniform Act, which was designed
to apply to thirteen jurisdictions in one country, all of which have similar judicial systems that function in the context of a single constitutional structure. While the Uniform Act has been designed to provide jurisdictional parameters for Canadian courts, its principal focus is on ensuring that judgments of the courts of one province are recognized and enforced in other provinces. The retention of the principle of *forum non conveniens* and the power to transfer and receive transfers of proceedings coupled with the inability of a court in a province to question the jurisdictional basis of a decision of a court in another province demonstrates a high degree of faith that Canadian courts will ensure that inefficiencies in and abuse of the system will be avoided. It remains to be seen whether this faith is warranted.

However, context does not explain entirely the difference in approach between the two systems. Essentially, the same approach to jurisdiction *simpliciter* contained in the Uniform Act is also contained in the Canadian Uniform Enforcement of Foreign Judgments Act applicable to non-Canadian judgments. The only significant difference between recognition and enforcement of domestic and foreign judgments is that in the latter case, the Canadian court has authority to refuse to recognize a foreign judgment on the basis of specified grounds or the conclusion that it was inappropriate for the foreign court to take jurisdiction.

If the two approaches are assessed on the basis of public policy, the outcome may not heavily favour one approach over the other. No doubt, the approach of the Convention provides a much higher level of

58. *See* Lugano Convention, *supra* note 23, arts. 33-35 (discussing grounds are very similar to those set out in Articles 33-35 of the Convention).
59. *See* Uniform Law Conference of Canada, Uniform Statutes, *Uniform Enforcement of Foreign Judgments Act*, §§ 4, 6, 10, available at http://www.ulcc.ca/en/us/index.cfm?sec=1&sub=1e5 (discussing judgments obtained by fraud or rendered in a proceeding that was conducted contrary to the principles of procedural fairness and natural justice or manifestly contrary to public policy in the province, or a judgment based on facts in a proceeding pending in the province or a judgment of a court of the province. Section 10 gives to the court before which the application for recognition is brought the power to refuse recognition, even where the foreign court had jurisdiction under the recognition rules set out in the Act (other than where there was a real and substantial connection between the state of the foreign court and the facts on which the proceeding was based), when "it was clearly inappropriate for the (foreign) court to take jurisdiction").

A novel feature of the Enforcement of Foreign Judgments Act, not directly related to recognition, is the requirement in section 6 that the recognizing court limit the amount of non-compensatory damages awarded by the foreign court to an amount similar to an amount that could be awarded by the recognizing court. The court may reduce a foreign damage award that is "excessive in the circumstances" to an amount not less than that which the enforcing court could have awarded in the circumstances.
predictability for both plaintiffs and defendants. However, there is “another side to the coin” when it comes to assessing the relative benefits of the two systems. The potential for obstructive actions on the part of defendants is much greater under the first-in-time system of the Convention. The Uniform Act contains no first-in-time rule. However, it contains two features that minimize at least some of the problems that the first-in-time rule addresses: the power to transfer all or part of an action to another court, and the power of a court to rule that it is a forum non conveniens. 60

In any event, the dominant, although not universal,61 Canadian view is that rigid certainty as to where an action must be commenced and defended is not necessarily a feature that is to be implemented at all costs. It is not the only public policy that should be embodied in law dealing with court jurisdiction and judgment recognition. A feature of the Uniform Act necessarily associated with the more flexible approach to jurisdiction it embodies is the opportunity for a court to facilitate justice and fairness as a minor aspect of the close and substantial test and through the exercise of the forum non conveniens principle. It may be clear that a provincial court has jurisdiction under one or more of the statutory tests, but it may not be so clear that justice and fairness to the defendant will result if the action were to be heard by that court. The facts of the case may dictate that these goals can be realized only if the action were heard by a court of another jurisdiction that has a real and substantial connection to the action.

60. See Uniform Law Conference of Canada, Uniform Statutes, Uniform Court Jurisdiction and Proceedings Transfer Act, supra note 10 (referencing that these measures do not provide a solution where a court proceeds to hear a case even though a court of another jurisdiction concludes that that first-mentioned court does not have jurisdiction simpliciter or is a forum non conveniens).

61. See Jean-Gabriel Castel, The Uncertainty Factor in Canadian Private International Law, 52 McGill L.J. 555 (2007) (citing a senior Canadian legal expert on Canadian conflict of law who favours the “certainty” approach and is very critical of recent Canadian judicial and legislative developments in the area of jurisdiction).