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AND ITS HISTORICAL BACKGROUND

Chi Chung

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**Editors' note: due to the international nature of our articles, our board was unable to locate English translations of some cited materials. Citations to those materials were retained in deference to our esteemed authors.*

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THE BILATERAL INVESTMENT TREATY BETWEEN CHINA AND TAIWAN AND
ITS HISTORICAL BACKGROUND*Chi Chung**

INTRODUCTION

The bilateral investment treaty between China¹ and Taiwan took effect on January 31, 2013. Although it is the 104th bilateral investment treaty for China² and the 17th bilateral investment treaty for Taiwan,³ it is a milestone for both the China-Taiwan relationship and Taiwan's relationships with the rest of the world. This Article discusses its contents and historical background.

Longtime observers of China and Taiwan would of course note that the word "treaty" seems politically incorrect and therefore impossible in the China-Taiwan context. Indeed, the word "treaty" is not used in the document. In addition, perhaps to the surprise of casual observers, the investment treaty between China and Taiwan was signed by the purportedly private-sector institutions authorized by the PRC and ROC governments. Among thousands of bilateral investment treaties in the world,⁴ the China-Taiwan investment treaty is one of the few that were signed by purportedly private sector institutions.⁵ This Article provides the historical background to help explain the contents and purposes of the investment treaty.

The rest of this article is organized as follows: Part I presents the contents of the investment treaty between China and Taiwan. Part II discusses the political history between China and Taiwan and the history of economic and

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¹ By "China," I refer to the People's Republic of China (the PRC), and, by "Taiwan" I refer to the Republic of China (the ROC) on Taiwan. The words "China" and "Taiwan" are used in this article as shorthand expressions.

² *Bilateral Investment Agreements*, UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT, http://unctad.org/Sections/dite_pccb/docs/bits_china.pdf (last visited May 18, 2014).

³ *Bilateral Investment Agreements*, UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT, http://unctad.org/Sections/dite_pccb/docs/bits_taiwan.pdf (last visited May 18, 2014).

⁴ According to a count by United Nations Conference on Trade and Development (UNCTAD) in 2003, there were 2,265 bilateral investment treaties in 2003. *Analysis of BITs*, UNITED NATIONS CONFERENCE ON TRADE AND DEV. http://www.unctadxi.org/templates/Page____1007.aspx (last visited May 18, 2014).

⁵ For example, the formal title of the India-Taiwan investment treaty was Agreement between the India Taipei Association in Taipei and the Taipei Economic and Cultural Center in New Delhi on the Promotion and Protection of Investments, which was signed on October 17, 2002. *Bilateral Investment and Protection Agreement, India-Taiwan, Oct. 17, 2002, available at* <http://finmin.nic.in/bipa/Taiwan.pdf>.

social interactions between the people of China and the people of Taiwan. Part III discusses the legal history of the investment relationship between China and Taiwan. In the Conclusion, I will discuss the extent to which the investment treaty lives up to its promise.

I. CROSS-STRAIT AGREEMENT ON INVESTMENT PROTECTION AND PROMOTION

On August 9, 2012, the heads of the Association for Relations Across Taiwan Strait⁶ (*haixia liangan guanxi xiehui*; hereafter the “ARATS”) in China, and the Straits Exchange Foundation⁷ (*caituan faren haixia jiaoliu jijinhui*; hereafter the “SEF”) in Taiwan signed the Cross-Strait Agreement on Investment Protection and Promotion (*haixia liangan touzi baohu he cujin xieyi*; hereafter the “Investment Agreement”).⁸ It took effect on January 31, 2013.⁹ In Taiwan, it was approved at the 3,310th Meeting of the Executive Yuan on August 16, 2012, and sent to the Legislative Yuan for reference (*beicha*) on the same day by the Letter (*han*) Tai-Fa-Tzu No. 1010141035. The Investment Agreement consists of 18 articles. Rather than referring to China or Taiwan by name, the Investment Agreement uses the phrases “both Contracting Parties” (*shuang fang*) and “one Contracting Party” (*yifang*).¹⁰

Article 1 defines five terms used in the Investment Agreement: investment, investor, returns, measures, and Cross-Strait Investment Dispute Resolution Institution. Investment (*touzi*) is defined as “the assets that are brought by the investors of one Contracting Party to the other Contracting Party and have the character of investment.”¹¹ Article 1 goes on to give seven

⁶ The PRC government has organized, through funding and staffing, the ARATS specifically for the purpose of dealing with the ROC. See generally ASS'N FOR RELATIONS ACROSS THE TAIWAN STRAITS, <http://www.arats.com.cn/> (last visited May 18, 2014).

⁷ The ROC government has organized, through funding and staffing, the SEF specifically for the purpose of dealing with the PRC. See generally STRAITS EXCH. FOUND., <http://www.sef.org.tw/> (last visited May 18, 2014).

⁸ See *Cross-Strait Investment Protection and Promotion Agreement*, ASS'N FOR RELATIONS ACROSS THE TAIWAN STRAITS, http://www.gwytb.gov.cn/lhjl/laxy/201208/t20120814_2913800.htm (last visited May 18, 2014); *Cross-Strait Investment Protection and Promotion Agreement*, STRAITS EXCH. FOUND., <http://www.mac.gov.tw/public/Attachment/210417181458.pdf> (last visited May 18, 2014). The translations of the contents of the Investment Agreement are my own.

⁹ *Mainland-Taiwan Investment Protection Pact Effective*, TAIWAN AFFAIRS OFFICE OF THE STATE COUNCIL PRC, http://www.gwytb.gov.cn/en/CrossstraitTrade/201302/t20130201_3736343.htm (last visited May 18, 2014).

¹⁰ The phrase “both Contracting Parties” (*shuang fang*) appears in Article 1, Section 5, for example. The phrase “one Contracting Party” (*yifang*) appears even more often in the Investment Agreement. ASS'N FOR RELATIONS ACROSS THE TAIWAN STRAITS, *supra* note 8.

¹¹ *Id.* The Romanization of the quoted text is as follows: “yifang touzi ren yizhao ling yifang de guiding zai gai ling yifang suo touzhi de juyou touzi texing de gezhong zichan.”

examples of the types of investment (*touzi*) covered by the Investment Agreement: (1) personal property, real property, and other property rights; (2) shares, capital subscriptions, and other forms of equity investment in enterprises; (3) rights to demand monetary payments or other rights to demand performance that has economic value; (4) intellectual property rights, names and trademarks of enterprises, and goodwill (*shangyu*); (5) quasi-contractual rights (*leisi qiye quanli*) such as construction, management, and manufacturing; (6) business concessions conferred by law (*jingying texu quan*) to farming and the extraction of natural resources; and (7) loans and debentures with or without security (*danbao*). In addition, Article 1 defines “the character of investment” (*touzi texing*) as the use of capital or other resources in expectation of income or profits and the accompanying risks. Article 1 further states that the assets that constitute investment may, in accordance with the relevant rules of the place where the investment is located, change its form, but their characterization of investment remains unaffected.

Investor (*touzi ren*) is defined as “the natural person of one Contracting Party or the enterprise of one Contracting Party that invests in the area of the other Contracting Party.”¹² In addition to this definition, Article 1 adds three stipulations: (1) the natural person of one Contracting Party refers to the natural person who possesses the “document that proves his status” (*shenfen zhengming wenjian*); (2) the enterprise of one Contracting Party refers to the entities (*shiti*) that are established in accordance with the rules (*guiding*) of one Contracting Party, including corporations, trusts, sole proprietorship, partnership or other organizations; and (3) any entities that are established in accordance with the rules of a third party (*di san fang*) but are owned or controlled by the natural person or enterprise of one Contracting Party are also considered enterprises of that Contracting Party.

Returns (*shouyi*) are defined as the monetary amounts yielded by investments, including profits, dividends, interests, capital gains, royalties, and other similar returns that do not violate the law. Measures (*cuoshi*) are defined as any rule, policy, or other administrative act (*xingzheng xingwei*) that affects the investor or investment. The Cross-Strait Investment Dispute Resolution Institution (*liang an touzi zhengduan jie jue jigou*) is defined as the arbitration institutions, mediation centers and other mediation institutions that each Contracting Party confirms and communicates to the other in writing after the Investment Agreement takes effect.

Article 2 deals with the scope of the Agreement and exemptions; it consists of eight sections. Section 1 states that the Investment Agreement applies to measures taken or maintained by one Contracting Party toward the

¹² *Id.* The Romanization of the quoted text is as follows: zai ling yifang congshi touzi de yifang ziran ren huo yifang qiye.

investors who are from the other Contracting Party. Section 2 states that the Agreement applies to the investments made by one Contracting Party's investors in the other Contracting Party, regardless of whether these investments are made before or after the Agreement takes effect, but that the Agreement does not apply to the investment disputes (*touzi zhengduan*) that are referred to by Article 13, Paragraph 1 of the Agreement and resolved before the Agreement takes effect. Section 3 states that the Agreement applies to the measures taken or maintained by all levels of either Contracting Party's administrative departments or by any institutions that are authorized by such departments to exert administrative powers. Section 4 permits a Contracting Party to take, maintain or execute any measure it considers necessary to keep its significant security interests (*zhongda de anquan liyi*).

Article 2, Section 5 sets out the circumstances in which one Contracting Party may, on the basis of the principles of non-arbitrariness (*fei renyi*) and against unreasonable discrimination (*fei bu heli qishi*), not constituting latent (*yinxing*) restrictions on trade or investments, take or maintain measures that restrict investments: (1) measures that are necessary in order to comply with the rules¹³ that do not contradict the Investment Agreement; (2) measures that are necessary to protect the lives or health of the humanity, animals or plants; and (3) measures that are necessary to protect natural resources from depletion.

Article 2, Section 6 permits a Contracting Party to take or maintain, on the basis of prudence, measures that are related to financial services, including but not limited to (1) measures that protect investors, depositors, holders of insurance policies, or the people to whom the providers of financial services owe fiduciary duties; and (2) measures taken to ensure the operation and stability of the financial system. Section 7 excludes the Investment Agreement from application to government procurement (*gonggong caigou*) and subsidies provided by a Contracting Party (*you yifang tigong de butie huo buzhu*).

Article 2, Section 8 states that the Investment Agreement does not apply to the tax measures (*zushui cuoshi*) of either Contracting Party except in two circumstances: (1) If the investors who are from a Contracting Party file a statement in writing with the tax authority of the other Contracting Party alleging that the tax measures of the other Contracting Party "involve Article 7 of the Investment Agreement" (*sheji ben xieyi di qi tiao de guiding*), the tax authorities of both Contracting Parties should make a joint decision within six months regarding whether the tax measure in question constitutes nationalization (*zhengshou*). If the tax measure in question constitutes

¹³ *Id.* The word "rules" seems abrupt and unspecific. In my opinion, the word "rules" refers to the legal rules of the PRC and the ROC. The PRC and the ROC avoided the phrase "legal rules" probably for fear of touching on their unresolved sovereignty dispute. More will be discussed in the section on the political history between China and Taiwan.

nationalization, then the Investment Agreement applies to the tax measure in question. (2) If the tax authorities of both Contracting Parties cannot make a joint conclusion within six months as to whether the tax measure constitutes nationalization, the investors of the Contracting Party may seek to resolve the issue in accordance with Article 13 and the Annex of the Investment Agreement.

Article 3 consists of six sections. Section 1 obligates either Contracting Party to give the investors who are from the other Contracting Party and their investments both fair treatment and full protection and safety. According to Section 1, fair treatment (*gongzheng yu gongping daiyu*) consists of a Contracting Party complying with the principle of due process, treating the investors who are from the other Contracting Party fairly in any hearings or trials, and taking no obviously discriminatory or arbitrary measures. Full protection and safety (*chongfen baozhang yu anquan*) means that a Contracting Party must take reasonable and necessary measures to protect the safety of the investors who are from the other Contracting Party and that of their investments. Section 1 states additionally that a Contracting Party's violation of other clauses of the Investment Agreement does not itself constitute a violation of Section 1.

Article 3, Section 2 obligates both Contracting Parties to protect the personal freedom (*renshen ziyou*) and safety of investors and "relevant personnel" (*xiangguan ren yuan*), to fulfill the obligations of notification (*tongzhi yiwu*) related to personal freedom in accordance with the time limits set out in the respective rules, and to improve the existing mechanisms of notification (*tongbao jizhi*). Section 3 states that a Contracting Party should treat the operation, management, maintenance, enjoyment, use, sale, or other disposition of the investment made by an investor who is from the other Contracting Party no less favorably than an investment made by its own investors. Section 4 states that one Contracting Party should treat the establishment, expansion, operation, management, maintenance, enjoyment, use, sale, or other disposition no less favorably than an investment made by any third party investor. Section 5 states that Section 3 and Section 4 do not apply to the existing "measures that are inconsistent with Section 3 or Section 4" (*bufu cuoshi*) and therefore do not require that those measures be changed, but Section 5 does obligate either Contracting Party to gradually eliminate such measures. In addition, Section 5 states that any modification or change in the measures that are inconsistent with Section 3 or Section 4 cannot further restrict the investors who are from the other Contracting Party and their investments. Section 6 states that the investors who are from the other Contracting Party cannot use Section 4 as the basis for a dispute resolution procedure other than that provided for by the Investment Agreement.

Article 4, entitled Transparency, consists of two sections. Section 1 obligates either Contracting Party to, in accordance with its rules (*guiding*), timely promulgate or otherwise make public the investment-related rules, measures, procedures, etc., that are either generally applicable or applicable only to the other Contracting Party. Section 2 obligates either Contracting

Party to, in accordance with its rules and at the request of the other Contracting Party, offer information about changes in the rules, measures, and procedures that are promulgated and affect the investors who are from the other Contracting Party.

Article 5 also consists of two sections. Section 1 states that both Contracting Parties agree to, based on “the principle of seeking mutual benefits” (*hu li hu hui de yuanze*), accept and protect direct investments from the other side. Section 2 states that both Contracting Parties agree to gradually loosen or eliminate the restrictions on mutual investment, to create a fair environment for investment, and to promote mutual investment.

Article 6 contains two sections as well. Section 1 states that both Contracting Parties agree to gradually simplify the application documents and review procedures for investment. Section 2 states that both Contracting Parties agree to “provide convenience” (*tigong bianli*) for investors from the other side, and it provides two examples of such convenience: First, one Contracting Party makes it convenient for the investors who are from the other Contracting Party to receive information about investment, the relevant licenses for operation, the travel of personnel, and management and operations. Second, one Contracting Party makes it convenient for the other Contracting Party and its potential investors to hold seminars, conferences, and other activities that may facilitate investment.

Article 7, entitled Nationalization (*zhengshou*), includes four sections. Section 1 prohibits one Contracting Party from nationalizing the investment and returns of the investors who are from the other Contracting Party except when nationalization is: (1) in pursuit of public purposes; (2) in accordance with the rules of the Contracting Party where the investment is located and due process; (3) not discriminatory nor arbitrary, and (4) compensation is given in accordance with Section 4. In addition, Section 1 points out that nationalization that includes both direct and indirect nationalization. Section 2 defines indirect nationalization as the “measures that amount to direct nationalization in effect.”¹⁴ Section 2 states that the question of whether a measure or a series of measures constitutes indirect nationalization should be determined on a case-by-case basis, examining the facts and taking into account four factors: (1) the measure’s economic impact on investment, yet a negative impact on the economic value of the investment cannot itself constitute indirect nationalization; (2) the extent to which the measure discriminates against the investors who are from the other Contracting Party and their investments in either its scope or its application; (3) the extent to which the measure interferes with the obvious, reasonable expectation of the investors who are from the other Contracting Party toward their investments;

¹⁴ *Id.* The Romanization of the quoted text is as follows: *xiaoguo dengtong yu zhijie zhengshou de cuoshi*.

and (4) whether the measure taken is bona fide and in pursuit of public interest, and whether the relationship between the measure taken and the purpose pursued meets the requirement of the principle of proportionality. Section 3 states that the nondiscriminatory regulatory measures taken by either Contracting Party in order to protect public health and legitimate public welfare such as safety and environment do not constitute indirect nationalization. Section 4 states that the compensation referred to in Section 1 should be equal to the fair market value of the nationalized investment or returns either at the time of nationalization or at the time when the nationalization is made known to the public, whichever comes first. Section 4 also requires that interest be calculated at a reasonable business interest rate for the period between the day of nationalization and the day on which the compensation is paid. The payment of compensation should not be delayed and should be real, convertible into other currency, and freely transferred to other persons.

Article 8, entitled Compensation for Losses concerns a Contracting Party's investors' loss of investment or returns in the area of the other Contracting Party due to armed conflict, emergency, or similar incidents in the area of that other Contracting Party. In such cases, the other Contracting Party's government must give compensation to the investors that is the same as, or better than, the best compensation given to its own investors or investors of any third party (*di san fang*).

Article 9 is entitled Subrogation. Section 1 states that the institutions designated by a Contracting Party, after making payments to investors of that Contracting Party on the basis of the security, guarantee, or insurance contracts that concern the non-commercial risks of investment, such as currency exchange and nationalization—may assert the rights and claims of such investors and undertake their obligations that correspond to the investors' original rights, claims, and obligations. Section 2 states that one Contracting Party should notify the other Contracting Party of its designation of the institutions for the purpose of Section 1 and of any subsequent changes.

Article 10, entitled Transfer, consists of four sections. Section 1 obligates one Contracting Party to permit investors from the other Contracting Party to transfer the investors' investments and returns. The section gives seven examples of such investments and returns: (1) the capital that is used to establish, maintain, and expand investment; (2) profits, dividends, interests, capital gains, royalties, and other expenses that are earned because of intellectual property rights; (3) payments that are related to the investment contracts, including payments that derive from loan contracts; (4) the income that is realized as a result of selling or liquidating all or part of the investment; (5) a natural-person investor's income and compensation related to the investment; (6) the payments that investors receive in accordance with Article 7 and Article 8 of the Agreement; and (7) the compensation received in accordance with Article 3 of the Annex of the Investment Agreement.

Subject to the exceptions set out in the Agreement, Article 10, Section 2 requires both Contracting Parties to guarantee that the transfer of Section 1

may be made in a currency that is freely convertible at the exchange rate on the market on the day of transfer, without delay. Section 3 permits a Contracting Party, on the basis of fairness and non-discrimination, to apply the relevant rules *bona fide* to disallow or delay transfer, despite Section 1 and Section 2, in the following circumstances: (1) bankruptcy, insolvency, or the protection of creditors' interests; (2) the issuance, sale, trading, and disposition of securities, futures contracts, option contracts, and other derivatives; (3) the measures that are necessary for the investigation of crimes or for the fact-finding prior to an administrative decision (*xingzheng chufen*); (4) requiring the filing of forms required when transferring cash or other currency instruments; and (5) ensuring the enforcement of judicial judgments or administrative decisions. Section 4 permits a Contracting Party to temporarily impose restrictions, in accordance with "rules or customs" (*guiding huo guanli*), on transfer when its balance of payments is or is about to be "seriously in deficit" (*yanzhong shiheng*), and requires the implementation of such restrictions be fair, non-discriminatory, and bona fide.

Article 11, entitled Denial of Benefits (*jujue shouyu liyi*), states that a Contracting Party has the power to deny "treaty benefits"¹⁵ to an enterprise (*qiye*) of the other Contracting Party if that enterprise is owned or controlled by a "natural person" (*ziran ren*) or enterprise that is from a third party and does not "engage in substantial business operations"¹⁶ in that other Contracting Party. Article 12 states that the disputes arising between Contracting Parties due to the interpretation, implementation, and application of the Investment Agreement should be resolved in accordance with Article 10 of the Economic Cooperation Framework Agreement (ECFA; *haixia liangan jingji hezuo jigou xieyi*).¹⁷

Article 13 consists of five sections and deals with the resolution of disputes between investors and the Contracting Party where the investment is located. Section 1 defines investment disputes (*touzi zhengduan*) as disputes that arise because the investor of one Contracting Party claims that he suffered losses as a result of violations of obligations as provided for in the Agreement committed by "relevant departments or institutions" of the other Contracting Party. Section 1 sets out five methods of investment dispute resolution: (1) friendly negotiation (*youhao xieshang*) between the parties to the dispute; (2) resolution by either mediation at the place where the investment is located or mediation at a higher institutional level (*shangji*); (3) resolution by the Mechanism of Helping Resolve Investment Disputes as provided for in Article

¹⁵ *Id.* The Romanization of the quoted text is as follows: *zai ben xieyi xiang xia de liyi*.

¹⁶ *Id.* The Romanization of the quoted text is as follows: *congshi shizhi xing shangye jingying*.

¹⁷ *Id.*; The ECFA is a free trade agreement (FTA) between China and Taiwan signed on June 29, 2010 by Chiang Pin-kung and Chen Yunlin, the heads of the SEF and the ARATS, in Chongqing, China.

15 of the Investment Agreement; (4) an investor may submit the disputes between him and the Contracting Party where the investment is located with regard to compensation for investment that arise under the Investment Agreement to mediation by the Cross-Strait Investment Dispute Resolution Institution (*liang an touzi zhengduan jie jue jigou*), and the Cross-Strait Investment Dispute Resolution Institution should report the status of these disputes with regard to compensation for investment to the Working Group on Investment that is established by Article 15 of the Investment Agreement; and (5) resolution in accordance with the administrative redress (*xingzheng jiuji*) or judicial procedure of the Contracting Party where the investment is located.

Article 13, Section 2 states that the Annex to the Investment Agreement applies when an investor seeks to resolve disputes regarding compensation for investment through the Cross-Strait Investment Dispute Resolution Institution. Section 3 states that both Contracting Parties should, after the Investment Agreement takes effect, exchange and make public the list of institutions that qualify for the status of Cross-Strait Investment Dispute Resolution Institution. Section 3 also states that such a list of institutions may be changed after negotiation between both Contracting Parties. Section 4 states that, if an investor has chosen to resolve investment disputes through administrative redress or judicial procedure, then the investor cannot submit the same dispute to mediation by the Cross-Strait Investment Dispute Resolution Institution unless it is consistent with the “relevant rules” (*xiangguan guiding*) of the Contracting Party where the investment is located. Section 5 states that mediation by the Cross-Strait Investment Dispute Resolution Institution is not an option for investors whose investment disputes have been subject to judicial procedure prior to the effect date of the Investment Agreement, unless both parties to the investment dispute agree and it is consistent with the relevant rules of the Contracting Party where the investment is located.

Article 14 deals with investment disputes that arise under private contracts (*touzi shangwu jiu fen*). It consists of five sections. Section 1 states that both Contracting Parties confirm that the investor of one Contracting Party and the natural person, legal person, or other organization of the other Contracting Party may agree when signing the business contracts (*shangwu qi yue*), in accordance with the relevant rules (*xiangguan guiding*) and the principle of party autonomy (*dangshiren zizhu yuanze*), on the methods of the resolution of disputes that arise under such contracts. Section 2 and Section 3 permit the investor of one Contracting Party and the natural person, legal person, or other organization of the other Contracting Party to insert an arbitration clause into their business contracts, or agree to submit their disputes to arbitration even when no arbitration clause was inserted in the business contracts. Section 4 states that the parties of disputes that arise under private contracts may choose an arbitration institution of either Contracting Party and the place where the arbitration is held. Section 4 also states that, after disputes arise, such parties may also, if the private contracts do not include an arbitration clause, choose to submit the disputes to an arbitration institution of either Contracting Party and choose the place where the arbitration is held.

Section 5 states that both Contracting Parties confirm that the parties to private contracts may, in accordance with relevant rules, apply for the recognition and enforcement of arbitral awards.

Article 15, entitled Communication Mechanism (*lianxi jizhi*), consists of two sections. Section 1 states that both Contracting Parties agree to authorize the Working Group on Investment (*touzi gongzuo xiaozu*) of the Cross-Strait Economic Cooperation Committee (*liang an jingji hezuo weiyuan hui*) to deal with matters that relate to the Investment agreement. Section 1 also authorizes communication between the “contact persons” (*lianluo ren*) designated by the “departments that are responsible for the matters in each Contracting Party” (*shuangfang yewu zhuguan bumen*). Section 2 authorizes the Working Group on Investment to establish “work mechanisms” (*gongzuo jizhi*) and provides two examples of such work mechanisms. First, the Mechanism of Helping Resolve Investment Disputes (*touzi zhengduan xiechu jizhi*) helps resolve the disputes between investors and the Contracting Party within which the investments are located. Section 2 also states that the Contracting Party within which the investments are located should, through the Mechanism of Helping Resolve Investment Disputes, inform the other Contracting Party of the latest status of investment disputes. The second is the Mechanism of Investment Counseling (*touzi zixun jizhi*), which exchanges information regarding investment, promotes future investment, simplifies and speeds up the procedure for investment, and offers counseling regarding dispute resolution and other matters related to the Investment Agreement.

Article 16 requires that the communications (*yewu lianxi*) between Contracting Parties be in the particular “document format” (*wenjian geshi*) agreed to by both Contracting Parties. Article 17 states that any future modification of the Investment Agreement should be consented to through the negotiation of both Contracting Parties and be confirmed in writing. Article 18, entitled Entry into Force, states that the Agreement shall enter into force on the day after the exchange of letters between the Contracting Parties informing each other of the completion of relevant procedures (*xiangguan chengxu*).

At the end of the document are the signatures of the heads of the ARATS and the SEF. Between Article 18 and the signatures of the heads of the ARATS and the SEF is the following paragraph regarding the signing date, Annex, and terminology:

The Agreement was signed on August 9. Both Contracting Parties signed four copies of the Agreement, and each Contracting Party retains two copies. The Annex constitutes part of the Agreement. Although the four copies of the

Agreement may refer to the same thing by different phrases, these phrases contain the same meanings. The four copies have the same effects.¹⁸

II. HISTORICAL BACKGROUND

A. *Political History*

As discussed in Part I, the investment treaty between China and Taiwan is called Cross-Strait Agreement on Investment Protection and Promotion. The agreement avoids mentioning such words as “treaty,” “law,” “China,” and “Taiwan.” Therefore, in order to understand the investment treaty between China and Taiwan, an understanding of the political history between China and Taiwan is necessary.

The ROC (*zhonghua minguo*) was founded in 1911.¹⁹ Between 1911 and 1928, there were a number of civil wars and regime changes in China. Chiang Kai-shek and his political party, Kuomintang (hereafter referred to as the KMT) ruled China from 1928 to 1949, when they lost the Chinese Civil War to the Chinese Communist Party (hereafter referred to as the CCP). In 1949, the CCP, led by Mao Zedong, proclaimed the establishment of the PRC (*zhonghua renmin gonghe guo*) as Chiang Kai-shek and his forces retreated to Taiwan, Penghu, Kinmen, Matsu, and other neighboring islands.²⁰

The government formed and led by Chiang in 1949 in Taiwan, Penghu, Kinmen, Matsu, and the neighboring islands continues to exist today as the ROC. The continued use of the name *ROC*, coupled with the consequences of international relations during the Cold War, may have affected the diplomacy and participation of the PRC and the ROC in international organizations. For example, the PRC did not successfully take the ROC’s seat in the United

¹⁸ *Id.* The Romanization of the quoted text is as follows: ben xieyi yu bayue jhuri qianshu, yishi sifen, shuangfang ge zhi liangfen, ben xieyi de fujian goucheng ben xieyi de yi bufen sifen wenben zhong duiying biaoshu de butong yongyu suo han yiyi xiangtong, sifen wen ben juyou tongdeng xiaoli.

¹⁹ For earlier periods of Chinese history, *see, e.g.*, JOHN KING FAIRBANK & MERLE GOLDMAN, CHINA: A NEW HISTORY (2nd enl. ed., 2006, 1992).

²⁰ The islands to which Chiang and the KMT retreated do not share the same historical background. Whereas Kinmen and Matsu, which are outlying islands off the seashore of China, had always been part of China, Taiwan and Penghu were not part of China during Chiang’s rise to power and the Second World War. The Qing Dynasty of China had ceded Taiwan and Penghu to Japan in the Treaty of Shimonoseki in 1895. Treaty of Peace, China-Japan, Apr. 17, 1895, 181 Consol. TS 217. When Japan surrendered at the end of the Second World War, ROC troops accepted Japan’s surrender of Taiwan and Penghu on behalf of the Allied command on October 25, 1945. Some have argued that because Japan surrendered Taiwan and Penghu to the Allied command and that ROC troops were merely agents of the Allies, the ROC did not assume sovereignty over Taiwan and Penghu. *See* Treaty of Peace with Japan, Allied Powers-Japan, Sept. 8, 1951, 3 U.S.C. 3169, 136 U.N.T.S. 46 (“Japan renounces all right, title and claim to Formosa and the Pescadores.”).

Nations and its Security Council until 1971,²¹ and until 1978, the ROC was the only Chinese government recognized by the United States.²² In diplomatic disputes, both the PRC, ruled by the CCP, and the ROC, ruled by the KMT, maintained a so-called one-China policy, according to which there is only one Chinese state. What the PRC and the ROC competed for was the authority to internationally represent the combined territory of the PRC and ROC.

Military confrontations between the PRC and ROC continued until 1958. Between 1949 and 1987, all forms of transportation, communication, and mail between the PRC and the ROC were prohibited. Although the PRC had signaled its willingness to lift the ban on travel between the PRC and the ROC in 1978, the ROC did not allow family visits to the PRC until 1987.²³ In the early 1990s, there was optimism that the PRC and ROC would gradually negotiate their unification. During that period, the PRC and the ROC signed several agreements (*xieyi*) in Singapore through the ARATS and the SEF. Although the ARATS and the SEF are not government entities, they receive government funding and are directed by the PRC and ROC governments to act as the interface between the two entities. Through these bilateral agreements, the Chinese and Taiwanese governments make commitments and engage each other on a regular basis. For example, the agreement on notary (*gongzheng*)²⁴ makes it possible for certificates issued by the Chinese government to be accepted as authentic in Taiwan and for certificates issued by the Taiwanese government to be accepted as authentic in China.²⁵ The process works as follows: when a person in Taiwan wants to use in a certificate issued by the Taiwanese government in China, he or she must first go to the SEF. The SEF then photocopies the certificates to be authenticated and issues a formal letter to the applicant. The SEF sends another letter directly to the ARATS, while the applicant travels to China with both the formal letter issued by the SEF and the government certificate and submits them to the appropriate PRC government office. Finally, the PRC government office verifies with the

²¹ See, e.g., Samuel S. Kim, *China, The United Nations, And World Order* (Princeton Univ. Press 1979).

²² For more details on the U.S.-China relationship, see, e.g., ROBERT S. ROSS, *NEGOTIATING COOPERATION: THE UNITED STATES AND CHINA 1969-1989* (Stanford U. Press 1995); ROBERT L. SUETTINGER, *BEYOND TIANAMEN: THE POLITICS OF U.S.-CHINA RELATIONS 1989-2000* (Brookings Instit. Press 2003).

²³ More details will be provided later in the Section on "History of Economic and Social Interactions."

²⁴ *Notarial Certificate Verification Protocol [liang an gongzheng shu shiyong chazheng xieyi]*, Mainland Affairs Council, available at <http://www.mac.gov.tw/public/Data/042314393871.pdf> (last visited July 20, 2013). The Romanization of its title is as follows: *liang an gongzheng shu shiyong chazheng xieyi*.

²⁵ See, Chi Chung, *International Law and the Extraordinary Interaction Between the People's Republic of China and the Republic of China on Taiwan*, 19 *IND. INT'L & COMP. L. REV.* 233 (2009).

ARATS whether the SEF indeed confirmed the authenticity of the certificate. Although there are no embassies in the China-Taiwan relationship to verify the authenticity of documents, ARATS and SEF act as the functional equivalents.

However, the bilateral relationship between the PRC and the ROC became increasingly fraught with tension as the ROC sought greater participation in international organizations and cooperation with other countries.²⁶ The PRC opposed this effort in order to avoid implying that the PRC accepted the ROC as an entity separate from China.²⁷ One key event is the 1995-96 missile crisis.²⁸ In June 1995 Lee Teng-hui, President of the Republic of China on Taiwan, visited his alma mater, Cornell University in Ithaca, New York, and delivered a speech.²⁹ In protest, the Chinese army in July 1995 fired missiles 80 miles northeast of Taiwan in a 10-nautical-mile circular area.³⁰ In November 1995, the Chinese army announced plans to conduct exercises in March 1996, the same month Taiwan was holding its presidential election.³¹ In March 1996, the United States announced deployment of two aircraft carrier battle groups a few hundred miles off the coast of Taiwan.³²

Although the tension decreased shortly thereafter, it escalated once more after President Lee stated in an interview on German radio on July 9, 1999, that the PRC-ROC relationship should be regarded as a special state-to-state relationship (*teshu de guo yu guo guanxi*).³³ The announcement prompted China to threaten the use of force and prompted a U.S. Department of State spokesman to state, “[w]e do not support Taiwan independence; we do not support Taiwanese membership in organizations where statehood is required; we do not support a two-China policy or a one-China/one-Taiwan policy.”³⁴

²⁶ Allen S. Whiting, *China's Use of Force, 1950-96, and Taiwan*, 26 INT'L SECURITY 103, 120-23 (2001). See also Robert S. Ross, *Navigating the Taiwan Strait: Deterrence, Escalation Dominance, and U.S.-China Relations*, 27 INT'L SECURITY 48, 54 (2002).

²⁷ *Id.*

²⁸ *Id.*

²⁹ Whiting, *supra* note 26 at 120-21.

³⁰ *Id.* at 121.

³¹ *Id.* at 122.

³² *Id.*

³³ See generally OFFICE OF THE PRESIDENT (ROC) TAIWAN, <http://www.president.gov.tw/Default.aspx?tabid=131&itemid=6542&rmid=514>; Sean D. Murphy, *Contemporary Practice of the United States Relating to International Law*, 93 AM. J. INT'L L. 879, 896 (1999). See also President Lee, President of China, Presidential Speech on National Day [*guoqing zongtong jianghua*], (October 10, 1999), available at <http://english.president.gov.tw/Default.aspx?tabid=491&itemid=17525&rmid=2355&sd=1999/10/01&ed=1999/10/31> (last visited May 19, 2014); *Taiwan's Unnerving President Does It Again*, ECONOMIST (July 15, 1999), available at <http://www.economist.com/node/223078/print> (last visited May 18, 2014).

³⁴ Murphy, *supra* note 33, at 896.

Chen Shui-bian succeeded Lee and served as President of the ROC from May 20, 2000, to May 19, 2008.³⁵ Before Chen won the presidential election in 2000, his Democratic Progressive Party (hereafter referred to as the DPP) had not adopted the one-China policy, as had both the CCP and the KMT. Instead the DPP developed its own policies toward the matter.³⁶ Article 1 of its Party Platform (*danggang*) as revised in October 1991 by the National Assembly of Party Members (*quanguo dangyuan daibiao dahui*) stated that one of the DPP's primary goals was "to establish the Republic of Taiwan with independent sovereignty."³⁷ In 1999, however, the National Assembly of Party Members of the DPP passed the Resolution on Taiwan's Future (*Taiwan qiantu jueyi wen*), the preface (*qianyan*) of which asserted that the goal of establishing the Republic of Taiwan had already been achieved.³⁸ In addition, the Resolution asserted (*zhuzhang*) that "Taiwan is an independent sovereign state; any change of the status quo—independence—must be determined by a referendum of all inhabitants in Taiwan"³⁹; and that "Taiwan does not belong to the People's Republic of China; 'one-China Principle' and 'one-country-two-systems' are China's unilateral assertions and do not fit Taiwan."⁴⁰

The PRC was disturbed by the DPP's characterization of Taiwanese independence as the status quo, and therefore, the DPP's electoral victory in 2000 greatly concerned the PRC.⁴¹ In his inaugural speech on May 20, 2000, ROC President Chen Shui-bian promised:

[a]s long as the CCP regime [of the PRC] has no intention of using military force against Taiwan, we will not declare independence; will not change the official name of the state; will not seek to amend the

³⁵ BBC NEWS, Profile: Chen Shui-bian, (Feb. 11, 2014), <http://news.bbc.co.uk/2/hi/2172980.stm>.

³⁶ THE PARTY PLATFORM, http://www.dpp.org.tw/upload/history/20100604120114_link.pdf (last visited July 26, 2013).

³⁷ *Id.* The Romanization of the quoted text is as follows: *jianli zhuquan dili zizhu de Taiwan gonghe guo*.

³⁸ Press Release, DPP Party Convention, DPP Resolution on Taiwan's Future (May 8, 1999) (<http://www.taiwandc.org/nws-9920.htm>) ("The congressional election in 1992, direct presidential election in 1996, and constitutional amendment in 1997 made Taiwan a *de facto* democratic and independent state.") The Romanization of the quoted text is as follows: *yi jiu jiu er nian de guohui quanmian gaixuan yi jiu jiu liu nian de zongtong zhijie minxuan yiji xiuxian feisheng deng zhengzhi gaizao gongcheng yi shi Taiwan shishi shang chengwei minzhu dili guojia*.

³⁹ *Id.* The Romanization of the quoted text is as follows: *Taiwan shi yi zhuquan dili guojia renhe youguan dili xianzhuang de gengdong bixu jingyou Taiwan quanti zhumin yi gongmin toupiao de fangshi jueding*.

⁴⁰ *Id.* The Romanization of the quoted text is as follows: *Taiwan bingbu shuyu zhonghua renmin gonghe guo zhongguo pianmian zhuzhang de yige zhongguo yuanze yu yiguo liangzhi genben bu shiyong yu Taiwan*.

⁴¹ BBC NEWS, *supra* note 35.

Constitution to describe the cross-strait relationship as a state-to-state one; will not seek to hold a unification/independence referendum to change the status quo; and will not abolish the National Unification Council or the Guidelines for National Unification.⁴²

During his two terms as ROC President from 2000 to 2008, Chen kept the first three of his five promises: (a) not to declare independence, (b) not to change the official name of the state, and (c) not to amend the Constitution to describe the PRC-ROC relationship as a state-to-state relationship. However, Chen sought to hold a highly controversial referendum in March 2004. Although he argued that it was not a referendum on independence that changed the status quo, the United States and the PRC disagreed.⁴³ In addition, with regard to the National Unification Council and the Guidelines for National Unification, Chen argued on January 29, 2006, that “[t]he time to seriously consider their abolition (*feichu*) has come.”⁴⁴ After stirring intense controversy, Chen backed off. On February 27, 2006, he declared that the National Unification Council had “ceased (*zhongzhi*) to function” and the Guidelines for National Unification had “ceased to apply.”⁴⁵ To some, “ceasing to apply” had a different meaning than “abolishing,” whereas to others, Chen was simply playing word games.⁴⁶ Between 2000 and 2008, the period when Chen served as the ROC President, having been re-elected for a second term in 2004, Chen stopped short of declaring independence or changing the official name of the ROC.

⁴² Chen Shui-bian, President, Taiwan, Taiwan Stands Up: Presidential Inauguration Address (May 20, 2000) (transcript available at [http://china.usc.edu/\(S\(vp0nss55wvfm1kbu11v2nn45\)A\(cFcf0oy-zAEkAAAAANThhZWE5OWItMzg0MS00N2E0LTg1ZTgtYTY0NWM3ZmYyNDAXsqE6IN5ymm iSuRACVYt93gM_-41\)\)/ShowArticle.aspx?articleID=1302&AspxAutoDetectCookieSupport=1](http://china.usc.edu/(S(vp0nss55wvfm1kbu11v2nn45)A(cFcf0oy-zAEkAAAAANThhZWE5OWItMzg0MS00N2E0LTg1ZTgtYTY0NWM3ZmYyNDAXsqE6IN5ymm iSuRACVYt93gM_-41))/ShowArticle.aspx?articleID=1302&AspxAutoDetectCookieSupport=1)). The Romanization of the quoted text is as follows: *zhiyao zhonggong wuyi duitai dongwu benren baozheng zai renqi zhinei buhui xuanbu duli buhui genggai guohao buhui tuidong liangguolun ruxian buhui tuidong gaibian xianzhuang de tongdu gongtou ye meiyou feichu guotong gangling yu guotonghui de wenti*. For an examination of the 2000 election, see TAIWAN'S PRESIDENTIAL POLITICS; DEMOCRATIZATION AND CROSS-STRAIT RELATIONS IN THE TWENTY-FIRST CENTURY TAIWAN'S 32–33 (Muthiah Alagappa ed., M.E. Sharpe Inc.) (2001).

⁴³ See generally Jih-wen Lin, *Taiwan's Referendum Act and the Stability of the Status Quo*, ACADEMIA SINICA, 3–4, <http://www.ipsas.sinica.edu.tw/image/speech/24/1.pdf> (last visited May 18, 2014).

⁴⁴ The Romanization of the quoted text is as follows: *muqian shi renzhen sikao feichu guotonghui ji guotong gangling de shidang shiji*. See e.g., Alan D. Romberg, The Taiwan Tangle, in 18 CHINA LEADERSHIP MONITOR, 1, 7 (2006), available at the Web site of Hoover Institution, Stanford University, http://media.hoover.org/sites/default/files/documents/clm18_ar.pdf (last visited May 18, 2014).

⁴⁵ *Chen Says The NUC Will Cease*, TAIPEI TIMES, Feb. 28, 2006, available at <http://www.taipetimes.com/News/front/print/2006/02/28/2003294988>.

⁴⁶ *Id.*

On May 20, 2008, Ma Ying-jeou of the KMT succeeded Chen Shui-bian as President of the ROC and was reelected in 2012 for a second four-year term.⁴⁷ The Ma administration maintained a different perspective on the one-China principle from that held by the Chen administration.⁴⁸ Whereas the PRC government maintained that Taiwan is part of China and that the PRC represents China, the Ma administration maintained that Taiwan is part of China and that the ROC has legitimate authority to rule Taiwan, Penghu, Kinmen, and Matsu.⁴⁹ For example, Ma stated in an interview on July 25, 2013, that the cross-strait relationship is a special relationship but not a state-to-state one.⁵⁰

The ARATS-SEF mechanism continues to be important. First, the notary system described earlier continues to function. From May 1, 2008, to October 31, 2011, a period of 42 months, the ARATS-SEF mechanism dealt with 452,079 cases of document authentication.⁵¹ Second, through the ARATS-SEF mechanism, the Ma administration held nine rounds of high-level talks (*gaoceng huitan*)⁵² with the PRC government and signed dozens of agreements that encompass a wide range of issues, including judicial assistance, trade, and so on.⁵³

B. History of Economic and Social Interactions

The political history between China and Taiwan is vital but still incomplete for an understanding of the investment treaty between China and Taiwan. It is important to explore the history of economic and social interactions, the foundation of which is travel between the PRC and the ROC. Military confrontations between the PRC and ROC continued until the

⁴⁷ Andrew Jacobs, *President of Taiwan Is Re-elected, a Result That Is Likely to Please China*, N.Y. TIMES, Jan. 14, 2012, available at http://www.nytimes.com/2012/01/15/world/asia/taiwan-presidential-election.html?_r=0.

⁴⁸ *Id.*

⁴⁹ See THE PARTY PLATFORM, *supra* note 36, at 3 (supporting the proposition that in general, Chen's administration and the DPP, the ruling party between 2000 and 2008, oppose the idea that the ROC represents the Chinese state; instead they want a Taiwanese state separate from the Chinese state represented by the PRC).

⁵⁰ Debra Mao & Adela Lin, *Ma Says Taiwan People Override Missiles in Meeting Xi*, BLOOMBERG NEWS (July 26, 2013, 4:32 AM), <http://www.bloomberg.com/news/2013-07-26/masays-taiwan-people-override-missiles-in-deciding-on-xi-meet.html> (last visited May 18, 2014).

⁵¹ *Jump: The Achievements of the SEF*, STRAITS EXCH. FOUND. [*yuejin: haijihui de chengji dan*], <http://www.sef.org.tw> (last visited May 18, 2013).

⁵² Press Release, Mainland Affairs Council, MAC: Ninth Round of Cross-Strait High-Level Talks Successfully Concluded (June 22, 2013), <http://www.mac.gov.tw/ct.asp?xItem=105423&ctNode=6337&mp=3>.

⁵³ See generally Press Release, Mainland Affairs Council, Strait Agreements (June 22, 2013), <http://www.mac.gov.tw/ct.asp?xItem=67145&CtNode=5710&mp=1>.

Quemoy crisis in 1958.⁵⁴ As a result of the armed conflict, both the PRC and ROC governments prohibited all forms of transportation, communication, and mail between the people of the PRC and ROC.⁵⁵ Through border control and document checks required of outsiders, the PRC and ROC governments to a large extent enforced their prohibitions on travel across the Taiwan Strait.⁵⁶

The situation did not change until the PRC replaced its previous goal of liberating (*jiefang*) Taiwan with the goal of “bringing Taiwan to the embrace of the motherland,”⁵⁷ during its Third Plenary Meeting of the “Eleventh Central Committee of the Chinese Communist Party on December 22, 1978.”⁵⁸ On April 4, 1979, the ROC government announced that it refused to negotiate with the PRC and kept that position until November 2, 1987, when it lifted its ban on travel to allow its people to visit relatives living in the PRC. From then on, the people of the PRC and the people of the ROC were able to apply for permission to travel across the Taiwan Strait. Although the PRC and ROC governments still impose some requirements on travellers, the restrictions are more difficult to enforce than a flat ban on travel of all kinds. Between 1987 and May 2013, Taiwan residents made 73.67 million trips to the PRC⁵⁹ and Mainland residents⁶⁰ made 10.38 million trips to the ROC.⁶¹ In 2012 alone, Taiwan residents made 5.34 million trips to the PRC, while Mainland residents made 2.63 million trips to the ROC.⁶² Taiwan’s population is 23 million.⁶³

Some statistics demonstrate the intensity of the economic interactions between China and Taiwan.⁶⁴ ROC citizens and companies are among the

⁵⁴ OFFICE OF THE HISTORIAN, UNITED STATES DEPT. OF STATE, THE TAIWAN STRAITS CRISES: 1954–55 AND 1958, available at <https://history.state.gov/milestones/1953-1960/taiwan-strait-crises>.

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Communique of the Third Plenary Session of the 11th Central Committee of the Communist Party of China* [zhongguo gongchandang di shi yi jie zhongyang weiyuanhui di san ci quanti huiyi], Beijing Review.com (Nov. 29, 2008), http://www.bjreview.com.cn/special/30yearsofreform/2008-11/29/content_167170.htm. The Romanization of the quoted text is as follows: *taiwan huidao zuguo huaibao shixian tongyi daye*.

⁵⁸ *Id.* The Romanization of the title is as follows: *zhongguo gongchandang di shi yi jie zhongyang weiyuanhui di san ci quanti huiyi*.

⁵⁹ Mainland Affairs Council, 102 Years May Strait Exchanges Statistical Comparison Summary, <http://www.mac.gov.tw/public/Data/362715272171.pdf> (last visited May 18, 2014).

⁶⁰ By “Mainland residents,” I refer to the inhabitants of the PRC.

⁶¹ See MAINLAND AFFAIRS COUNCIL, *supra* note 59.

⁶² CPC CENT. COMM., CALENDAR OF CROSS-STRAIT PERSONNEL EXCHANGES AND EXCHANGES STATISTICS, http://www.gwytb.gov.cn/lajlwl/rywltj/201101/t20110120_1715616.htm (last visited May 18, 2014).

⁶³ CIA World Fact Book, *Taiwan* (2013).

⁶⁴ See generally ROC MAINLAND AFFAIRS COUNCIL, CROSS-STRAIT ECON. STATISTICS MONTHLY [*liang an jingji tongji yuebao*] 243, STATISTICS SUMMARY [*tongji tiyao*], <http://www.mac.gov.tw/public/Attachment/372314442865.pdf> (last visited May 18, 2014).

largest sources of foreign direct investment in the PRC.⁶⁵ From 1979 to March 2013, businesspeople from Taiwan invested in 88,443 projects in the PRC with the total amount of US\$57.8 billion.⁶⁶ Some analysts believe the real numbers are even larger because some investments made in the PRC by businesspeople from Taiwan are structured through legal entities established in other places, including the British Virgin Islands and Cayman Islands. From 1979 to March 2013, businesspeople from the British Virgin Islands invested a total of US\$131.11 billion in 22,388 projects in the PRC.⁶⁷ From 1979 to March 2013, businesspeople from the Cayman Islands invested US\$26.47 billion in 2,872 projects in the PRC.⁶⁸

Taiwan prohibited the investors from the PRC from investing in Taiwan until June 30, 2009.⁶⁹ On July 3, 2009, the Ministry of Economic Affairs (“MOEA”) of the Executive Yuan promulgated the Regulations on Approving Investments in Taiwan by People of the Mainland Area (*dalu diqu renmin lai tai touzi xuke banfa*) and stipulated that the regulations became effective on June 30, 2009.⁷⁰ The regulations allowed people of the PRC to establish subsidiaries, sole proprietorships, or partnerships in Taiwan and buy equity interests in corporations or enterprises that have already been established in Taiwan.⁷¹ In 2012, the people of the Mainland Area made, with ROC government approval, 138 investments in Taiwan with the total amount of US\$328 million.⁷²

Bilateral trade between China and Taiwan is also important. In 2012, 26.8 percent of Taiwan’s exports were destined for China, and 15.1 percent of Taiwan’s imports came from China.⁷³ In 2012, 1.8 percent of China’s exports were destined for Taiwan, and 7.2 percent of China’s imports came from Taiwan.⁷⁴ The total value of Taiwan’s exports to China in 2012 was US\$80.71 billion, and the total value of Taiwan’s imports from China in 2012 was US\$40.9 billion.⁷⁵

Not only are the economies but also the societies of the two entities are considerably connected. According to the Mainland Affairs Council,

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ Act Governing the Relations between the Peoples of Taiwan Area and Mainland Area, arts. 72 & 73 available at <http://www.mac.gov.tw/ct.asp?xItem=62893&ctNode=5666&mp=1>.

⁷⁰ Regulations on Approving Investments in Taiwan by People of the Mainland Area, Executive Yuan, available at <http://www.mac.gov.tw/ct.asp?xItem=93628&ctNode=5666&mp=1> (last visited May 18, 2014).

⁷¹ *Id.*

⁷² ROC MAINLAND AFFAIRS COUNCIL, *supra* note 64.

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Id.*

Executive Yuan, the ROC, from 1987 to May 2013, there were 358,966 marriages between Taiwan residents and Mainland residents, and the number of such marriages that ended in divorce is 89,762.⁷⁶ According to Dai Xiaofeng, head of the Cultural Exchange Bureau, Taiwan Affairs Office, State Council, PRC, at the end of September 2007 when the data was available, slightly fewer than 400,000 Taiwan residents were living in the Mainland for work or study and about 18,000 Taiwan residents were permanently residing in the Mainland.⁷⁷ As the China-Taiwan relations seem to have improved from 2007 to the present, the current numbers of Taiwan residents residing in the Mainland should be higher.

III. LEGAL HISTORY

A. *On the Side of China*

1. Overview

This section, through an examination of three court cases, discusses the legal history of the China-Taiwan investment relationship on the side of China. Overall, the PRC government has welcomed direct investment from the ROC.⁷⁸ However, the general attitude of welcoming direct investment from the investors of the ROC does not prevent investment disputes from arising. The first case concerned a nationalization dispute between a PRC local government and investors from the ROC. The second case concerned the

⁷⁶ See Mainland Affairs Council, *supra* note 59.

⁷⁷ Statement of Dai Xiaofeng, head of the Cultural Exchange Bureau, Taiwan Affairs Office, State Council, PRC (Nov. 1, 2007) available at <http://www.china.org.cn/english/China/230558.htm>. The reliability of this statistic is bolstered by the fact that it came from a PRC official at the Taiwan Affairs Office, the State Council. However, there may be a slight chance of exaggeration, as Dai Xiaofeng was in charge of both regulating the travel of Mainland residents to Taiwan and promoting cultural exchanges between the Mainland and Taiwan. His goal of promoting cultural exchanges might have affected the accuracy of the statistics that he provided.

⁷⁸ See, e.g., T.J. Cheng, China-Taiwan Economic Linkage: Between Insulation and Superconductivity, in DANGEROUS STRAIT: THE U.S.-TAIWAN-CHINA CRISIS 93–130 (Nancy Bernkopf Tucker ed., 2005); YOU-TIEN HSING, MAKING CAPITALISM IN CHINA: THE TAIWAN CONNECTION (Oxford U. Press 1998); EMERGING PATTERNS OF EAST ASIAN INVESTMENT IN CHINA: FROM KOREA, TAIWAN, AND HONG KONG (Sumner J. La Croix et al. eds., M.E. Sharpe, Inc., New York, 1995). In addition, Article 1 of the Law Protecting Investments by Taiwan Compatriots states that the legislative purpose of the Law Protecting Investments by Taiwan Compatriots is to “protect and encourage investments made by Taiwan Compatriots” (baohu he guli Taiwan tongbao touzi) and to promote the economic development of both sides of the Taiwan Strait. Baohu he guli Taiwan tongbao touzi, [Law Protecting Investments by Taiwan Compatriots] (promulgated by The President of the People’s Republic of China, Mar. 5, 1994, effective March 5, 1994) available at http://www.gwytb.gov.cn/gjstfg/jjfl/touzi/201101/t20110123_1724093.htm (last visited May 18, 2014).

handling of investment disputes by the executive and judicial branches of the PRC government. In the third case, a PRC court found a contract between an investor from the ROC and a person of the PRC invalid because they had conspired to evade restrictions imposed by the PRC government on the type of investments an ROC investor may make in the PRC.

Before delving into the court cases, a word about the Chinese Constitution and statutes is warranted. According to the Taiwan Affairs Council of the State Council of China, the legal foundation of the China-Taiwan relationship consists of the following rules. The Constitution (*xianfa*) of the People's Republic of China mentions Taiwan only in its Preamble (*xuyan*), stating that "Taiwan is part of the solemn territory of the People's Republic of China,"⁷⁹ and that "finishing the unification of the homeland is the solemn duty of all Chinese people, including Taiwan compatriots."⁸⁰ On the issue of investment protection, the *Law Protecting Investments by Taiwan Compatriots*⁸¹ was enacted by the Standing Committee of the National People's Congress on March 5, 1994 and has been valid since then. The State Council of the PRC promulgated the *Implementing Regulations for the Law Protecting Investments by Taiwan Compatriots*⁸² on December 5, 1999.

2. Nationalization

The case between Beijing Real Estate Development Corporation (hereafter referred to as Beijing) and Haikou City People's Government concerns the nationalization of a tract of land.⁸³ After investors from the ROC had incorporated Beijing in the Hainan Province, the PRC, Hainan Shang-yi Real Estate Corporation (hereafter referred to as Shang-yi) transferred 5024.67 square meters of land to Beijing on December 12, 1995, and Qionghua City Government thereafter issued a "Certificate of the Right to Use Public Land" on December 18, 1995.⁸⁴

⁷⁹ XIANFA preamble (1982) (China). The Romanization of the quoted text is as follows: *Taiwan shi zhonghua renmin gonghe guo de shensheng lingtu de yibufen*, available at <http://english.peopledaily.com.cn/constitution/constitution.html>.

⁸⁰ *Id.* The Romanization of the quoted text is as follows: *wancheng tongyi zuguo de daye shi baogua Taiwan tongbao zainei de quan zhongguo renmin de shensheng zhize*.

⁸¹ *Law Protecting Investments by Taiwan Compatriots*, *supra* note 78. The Romanization of its title is as follows: *zhonghua renmin gonghe guo Taiwan tongbao touzi baohu fa*.

⁸² *zhonghua renmin gonghe guo Taiwan tongbao touzi baohu fa shishi xize*, [Implementing Regulations for the Law Protecting Investments by Taiwan Compatriots] (promulgated by The State Council, Dec. 05, 1999, effective Dec. 05, 1999) available at http://www.gwytb.gov.cn/gjstfg/jjfl/touzi/201101/t20110123_1724092.htm (last visited May 18, 2014).

⁸³ *Beijing Real Estate Dev. Corp., v. Haikou City People's Gov't, High People's Ct. of Hainan Province*, Admin. Judgment No. 9 (2006).

⁸⁴ *Id.*

On May 31, 1999, Qiongsan City Government sent a *Notice to Develop and Use Public Land Within a Specified Period of Time*⁸⁵ (hereafter referred to as the Notice) to Shang-yi and ordered Shang-yi to notify Beiqing of the Notice. The Notice required development to begin before August 31, 1999 and be completed within two years, or the right to use the public land in question would be forfeited.⁸⁶ As Beiqing was preparing to begin construction, the Public Security Bureau, Transportation Bureau, and Road Bureau announced a road-revamping project that prevented Beiqing from beginning construction.⁸⁷ On November 27 and December 13, Qiongsan City Government issued two notices confiscating 5024.67 square meters of land that Beiqing had the right to use in order to widen the course of the Meishe River.⁸⁸ On January 28, 2000, the Public Land Bureau of Qiongsan City retracted the Notice from Beiqing in order to proceed with its project of widening the Meishe River.⁸⁹ On May 23, 2000, the Qiongsan City Government made a determination (*jueding*) that the land should be confiscated without compensating Beiqing because Beiqing had failed to develop that land for over two years, as prescribed by the agreement between Beiqing and the Land Management Bureau on September 27, 1994.⁹⁰ The determination also stated that, if Beiqing had grievances, it could apply to “a higher-level government office”⁹¹ for administrative reconsideration (*shenqing fuyi*) within sixty days or sue the Qiongsan City Government in a PRC court within thirty days.⁹²

Seeking redress, Beiqing sent a report to Qiongsan City Government on June 8, 2000, to argue that it should be compensated.⁹³ Vice Mayor Qiu Tianru, who was in charge of land affairs, wrote, “[t]his matter should be discussed further” on that report on June 13, 2000, “but in fact there was no further discussion.”⁹⁴ The Taiwan Affairs Office of Hainan Provincial People’s Government sent a letter to Qiongsan City Government, “requesting that this case be handled well”⁹⁵ to “demonstrate the support of the Communist Party and the government for Taiwan investors.”⁹⁶ On January 16, 2002, the Taiwan Affairs Office of Hainan Provincial People’s Government sent another letter to

⁸⁵ *Id.* The Romanization of its title is as follows: *guanyu xianqi kaifa shiyong tudi de tongzhi*.

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ *Id.* The Romanization of the quoted text is as follows: *shangji xingzheng zhuguan jiguan*.

⁹² *Id.*

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ *Id.* The Romanization of the quoted text is as follows: *yaoqiu tuoshan chuli gaizong tudi wenti*.

⁹⁶ *Id.* The Romanization of the quoted text is as follows: *yi tixian dang he zhengfu dui Taishang touzi de guanxin he zhichi*.

the Qiongsan City Government, requesting that the case be handled well.⁹⁷ On August 6, 2004, Beiqing submitted an emergency report, again requesting compensation for its loss.⁹⁸ On December 3, 2004, the Public Land Bureau of Haikou City sent a letter to Beiqing, acknowledging receipt of the emergency report and stating that Beiqing should dispute the confiscation decision through either administrative reconsideration or administration litigation.⁹⁹ On December 28, 2004, Beiqing submitted “an application of administrative reconsideration” (*xingzheng fuyi shenqing shu*) to the Public Land Bureau of Haikou City and the Taiwan Affairs Office of Hainan Provincial People’s Government.¹⁰⁰ On July 11, 2005, the Hainan Provincial People’s Government made “the decision not to consider the application of administrative reconsideration” because Beiqing had not applied within the sixty-day period, as prescribed by law.¹⁰¹ Beiqing then decided to sue Haikou City People’s Government in the Intermediate People’s Court of Haikou City, Hainan Province.¹⁰²

The court ruled against Haikou City People’s Government and rescinded (*chexiao*) its decision made on May 23, 2000 to confiscate Beiqing’s land without compensation.¹⁰³ On the procedural side, the court noted that Vice Mayor Qiu had written, “[t]his matter should be discussed further” on June 13, 2000, but there had in fact been no further discussion.¹⁰⁴ The court found that Beiqing had not applied for administration reconsideration or brought administrative suits within the period prescribed by the Haikou City People’s Government on May 23, 2000 because it had been waiting for the further discussion that Qiu had urged.¹⁰⁵ Therefore, the court concluded that Beiqing had not truly missed the deadline to bring administrative suit.¹⁰⁶ On the substantive side, the court noted that proceeding with the road-revamping project and the Meishe River-widening project would have made it impossible for Beiqing to develop the land in question.¹⁰⁷ Although the People’s Government of the Haikou City cited Article 25 of the *PRC Act Governing*

⁹⁷ *Id.* The request that the case be handled well was probably intentionally vague so that pressure was imposed without stating anything that may result in legal or political responsibility for the Taiwan Affairs Office of Hainan Provincial People’s Government.

⁹⁸ *Id.* The Romanization of the title of the report is as follows: *guanyu zaici qingqiu buchang huandi baohu Taishang hefa quanyi de jinji baogao*.

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.* The Romanization of the quoted text is as follows: *xingzheng fuyi buyu shouli jue ding shu*.

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

*Real Estate in Cities*¹⁰⁸ to support its power to take back the land in question without compensating Beiqing, the court noted that Article 25 made an exception for situations in which the actions of the PRC government “delayed development.”¹⁰⁹ The court concluded that because this case concerned a situation in which the actions of the PRC government would delay development, Haikou City People’s Government could not take back the land in question without compensating Beiqing.¹¹⁰ Haikou City People’s Government appealed to the High People’s Court of the Hainan Province, the PRC, but the court affirmed the judgment of the Intermediate People’s Court of Haikou City for the reasons discussed above.¹¹¹

3. Handling of Investment Disputes

A 2003 case, concerning a dispute between Lei, a person from Hong Kong, and Zhang, a person from Taiwan, about their joint venture in Xiamen of the PRC, illustrates the handling of investment disputes in the PRC.¹¹² Lei Yuansi was chairman of Xiamen Wangjiang Real Estate Development Corporation (hereafter referred to as Wangjiang Corporation) and vice chairman and chief executive officer of Xiamen Yuandong Real Estate Development Corporation (hereafter referred to as Yuandong Corporation).¹¹³ Zhang Qiongyue was chairman of Yuandong Corporation.¹¹⁴ Lei and Zhang each owned fifty percent of Yuandong Corporation.¹¹⁵ In 1998 and 1999, Lei asked Xiamen City Bureau of Foreign Investment¹¹⁶ (hereafter referred to as the City Bureau) to help resolve his dispute with Zhang, while Zhang asked the Taiwan Affairs Office of Xiamen City People’s Government¹¹⁷ (hereafter referred to as the Taiwan Affairs Office) to do the same. On September 15, 1999, both offices decided to “audit the books” (*dui zhangmu jinxing shenji*) of Wangjiang Corporation and Yuandong Corporation, and ordered the corporations to submit books, receipts, and other relevant materials to Xiamen City Center Handling Grievances of Taiwan Compatriots (*taibao tousu shouli zhongxin*) within five days. Lei declined to comply and sued the City Bureau

¹⁰⁸ *Id.* The Romanization of its title is as follows: *zhonghua renmin gongheguo chengshi fangdichan guanli fa*.

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² *Li v Zhang*, High People’s Ct., Fujian Province, Admin. Judgment No. 3 (2003).

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ *Id.* The Romanization of its title is as follows: *xiamen shi waishang touzi ju*.

¹¹⁷ *Id.* The Romanization of its title is as follows: *xiamen shi renmin zhengfu Taiwan shiwu bangongshi*.

and the Taiwan Affairs Office in the Intermediate People's Court of Xiamen City.

The Intermediate People's Court of Xiamen City ruled against the City Bureau and the Taiwan Affairs Office,¹¹⁸ finding that the powers of the City Bureau and the Taiwan Affairs Office were limited to those of "handling grievances" (*jieshou tousu*) and "mediating disputes" (*jinxing tiaojie*), and therefore cancelled "the order to audit" (*shenji jue ding han*) that the offices had issued. When both the City Bureau and the Taiwan Affairs Office appealed, the High People's Court of Fujian Province reversed the judgment and dismissed Lei's suit, finding that the power to conduct investigations was implied in the duty of the City Bureau and the Taiwan Affairs Office to handle grievances and resolve disputes. The court also noted that the plaintiff Lei had once suggested that the City Bureau find experts to "evaluate the assets of the companies."¹¹⁹

The handling of the investment disputes through "auditing books" by Xiamen City Center Handling Grievances of Taiwan Compatriots seems to discriminate against business partners who are not Taiwan Compatriots, such as Lei from Hong Kong. The title of Xiamen City Center Handling Grievances of Taiwan Compatriots indicates its institutional mission and assumes that Taiwan Compatriots have grievances. As discussed above, Article 14 of the Investment Agreement deals with investment disputes that arise under private contracts and allows businesses to submit their disputes to arbitration. The extent to which Article 14 of the Investment Agreement replaces the handling of investment disputes by institutions such as Xiamen City Center Handling Grievances of Taiwan Compatriots is an issue worthy of further investigation.

4. Regulating the Direct Investment from Taiwan

A 2002 case demonstrated a strategy through which investors from Taiwan evade PRC's regulation of outside direct investment in the PRC. Huang Yifa, "a man of the Taiwan Province" (*Taiwan sheng ren*) born in 1964, had been living (*xian zhu*) in Zhuhai City, Guangdong Province, the PRC, as of 2004. Yang Xiaoyan was a PRC woman born in 1978 whose domicile (*zhusuo di*) was also in Zhuhai City. Huang argued that Yang should return RMB¥690,000 because their contract to establish "a computer school" (*diannao peixun xuexiao*) was null and void for violating the PRC's ban on Taiwan residents establishing schools in the PRC. Yang argued that the contract between them was not intended to establish a joint venture but rather

¹¹⁸ Intermediate People's Court of Xiamen City, Xia Xing Chu Zi, Administrative Judgment No. 6 (2002).

¹¹⁹ *Id.* The Romanization of the quoted text is as follows: *dui gongsi de zichan gongtong weituo pinggu*.

an agency relationship, and therefore their contract should be legally valid. Yang also sued Huang for the return of the expenses she had paid on Huang's behalf during the agency relationship.

The court did not discuss its jurisdiction explicitly. On the issue of choice of law, the court noted that because Huang was a Taiwan resident, this case concerned "a civil or commercial dispute related to Taiwan" (*shetai minshang shi jiu fen*); that the parties had not chosen the law that should govern the disputes arising out of their contract; and that both the place where the contract had been signed (*qian yue di*) and the place of performance (*luxing di*) were "in the PRC."¹²⁰ Citing Article 145, Section 2 of the General Provisions of the PRC Civil Code,¹²¹ the court concluded that it should apply "the PRC law"¹²² because it had the closest connection to the contract.

Applying PRC law, the court dismissed both Huang's claim and Yang's counterclaim, citing Article 40 of the PRC *Act Governing the Establishment of Schools by Chinese and Foreign Joint Ventures*,¹²³ which prohibits any offshore (*jingwai*) organization or individual from serving as the sole sponsor of a school or any other educational institution in the PRC (*zai jingnei*) that targets "the citizens in the PRC" (*zhongguo jingnei gongmin*). The court interpreted the contract between Huang and Yang as an agency contract, and therefore Huang, a Taiwan resident, was the sole sponsor, violating Article 40 of the PRC *Act Governing the Establishment of Schools by Chinese and Foreign Joint Ventures*. Citing Article 51, Section 5 of the PRC Contract Law, the court concluded that the contract between Huang and Yang was null and void. The court found both parties to be at fault (*shuangfang junyou guocuo*) because both Huang and Yang had known that Huang could not establish a school on his own. Based upon its finding that both parties were at fault and that both lacked evidence concerning the amount of loss suffered by each side, the court dismissed both Huang's and Yang's claims.

This case demonstrated a strategy through which investors from Taiwan evade PRC's regulation of outside direct investment in the PRC, and the limits of such a strategy. Huang Yifa and Yang Xiaoyan signed a contract in violation of the PRC law. But for the fact that their dispute that ended in court, they would have succeeded. The PRC court dismissed both Huang's and Yang's claims, but Huang seemed to have suffered more as the amount of RMB¥690,000 is significant, whereas amount of Yang's claims were not high enough to be mentioned by the court judgment. Therefore, the case between

¹²⁰ The Romanization of the quoted text is as follows: *zhonghua renmin gonghe guo jingnei*.

¹²¹ Fadian 145, § 2. The Romanization of its title is as follows: *zhonghua renmin gonghe guo minfa tongze*.

¹²² The Romanization of the quoted text is as follows: *zhonghua renmin gonghe guo falu*.

¹²³ P.R.C. Laws on Joint Ventures Using Chinese and Foreign Investment, Art. 40. The Romanization of its title is as follows: *zhonghua renmin gonghe guo zhongwai hezuo banxue tiaoli*.

Huang and Yang demonstrates the usefulness and limits of the strategy of finding business partners to help evade government regulations. A business partner may be willing to help evade government regulations, and the strategy works well in that sense. However, the problem is that a business dispute with that business partner can hardly be settled favorably in the court system.

B. *On the Side of Taiwan*

1. Overview

Through an examination of statutes and cases, this section discusses the legal history of the China-Taiwan investment relationship on the side of Taiwan. The most important statutory provision in the ROC that concerns outward direct investment in the PRC is Article 35 of the *Act Governing Relations between Peoples of the Taiwan Area and the Mainland Area* (hereafter referred to as the *Act*).¹²⁴ The *Act* was enacted by the Legislative Yuan with the authorization from the Eleventh Constitutional Amendment¹²⁵ of the “Amendments to the ROC Constitution.”¹²⁶ The Eleventh Amendment states that “[t]he rights, responsibilities, and other affairs between the people of the free area and the people of the Mainland Area, can be governed by special legislations.”¹²⁷ The *Act*, valid since September 18, 1992, is the ROC’s most important legislation on the PRC-ROC relationship.

Article 35 of the *Act* authorizes the MOEA to promulgate administrative regulations with regard to outward investment in the PRC. According to Section 1, investments of smaller amounts require filing with the MOEA but not advance approval, while investments of larger amounts require advance approval of the MOEA. Section 1 also authorizes the MOEA to determine the maximum amount of investment that does not require its advance approval, which is US\$ 1 million as of July 2013.¹²⁸ In addition, Section 1 authorizes the MOEA to determine “based on considerations of national security and the

¹²⁴ The Romanization of its title is as follows: *Taiwan diqu yu dalu diqu renmin guanxi tiaoli*. English translations of this statute can be found at the Web site of the ROC Mainland Affairs Council, <http://www.mac.gov.tw> (last visited July 26, 2013). For some theories behind this statute, see Chi Chung, *Conflict of Law Rules between China and Taiwan and Their Significance*, 22 ST. JOHN’S J. LEGAL COMMENT. 559 (2008).

¹²⁵ The Eleventh Amendment was the Tenth Amendment before July 21, 1997.

¹²⁶ The Romanization of its title is as follows: *zhonghua minguo xianfa zengxiu tiaowen*.

¹²⁷ The term “free area” indicated the ROC’s self-perception shortly after the end of the Cold War that the ROC was part of the free world.

¹²⁸ MAINLAND AFFAIRS COUNSEL: PRINCIPLES OF INVESTMENT OR TECHNICAL COOPERATION IN MAINLAND CHINA, available at <http://www.mac.gov.tw/ct.asp?xItem=62893&ctNode=5666&mp=1> (last visited July 26, 2013).

development of domestic industries”¹²⁹ whether an industry should be prohibited from investing in the PRC and, if the industry is not prohibited from doing so, whether a particular investment project should be approved. Section 1 requires the MOEA to promulgate the list of industries prohibited from investing in the PRC (*xiangmu qingdan*) as well as the guiding principles by which it abides in its determination of whether a particular investment in the PRC should be denied approval (*ge an shencha yuanze*).

Article 35, Section 2 permits “individuals, corporations, and other organizations”¹³⁰ of the Taiwan Area to “engage in business transactions” (*congshi shangye xingwei*) with individuals, corporations, and other organizations of the Mainland Area, subject to prohibitions or the requirement of project-specific approval per regulations publicly promulgated by the MOEA. Section 3 permits individuals, corporations, and other organizations of the Taiwan Area to “engage in trade between the Taiwan Area and the Mainland Area”¹³¹ and authorizes the MOEA to regulate the relevant procedural issues. Section 4 authorizes the MOEA to regulate any procedural issues related to Sections 1 and 2.

Section 5 requires all investors who had invested in the PRC before July 1, 2002, the date on which the revised Article 35 took effect, to apply to the MOEA for approval within six months of July 1, 2002. Investors who should have applied for approval within six months of July 1, 2002 but failed to do so (*jieqi wei shenqing*) or whose application is denied approval (*shenqing wei hezhun zhe*) will be fined or prosecuted as a criminal crime for investing in the PRC without approval (*yi weijing xuke lun*) pursuant to Article 86 of the *Act*.

Pursuant to Sections 3 and 4 of Article 35, the MOEA promulgated a number of administrative regulations to govern the process authorizing investments in the PRC.¹³² ROC investors who are interested in investing in

¹²⁹ *Id.* The Romanization of the quoted text is as follows: *yiju guojia anquan ji chanye fazhan zhi kaolu*.

¹³⁰ *Id.* The Romanization of the quoted text is as follows: *renmin faren tuanti huo qita jigou*.

¹³¹ *Id.* The Romanization of the quoted text is as follows: *congshi Taiwan diqu yu dalu diqu jian maoyi*.

¹³² These regulations include the Regulations on Approving Investments or Technology Transfers in the Mainland Area (*zai dalu diqu congshi touzi huo jishu hezuo xuke banfa*), the Principles on Reviewing Investments or Technology Transfers in the Mainland Area (*zai dalu diqu congshi touzi huo jishu hezuo shencha yuanze*), the Guidelines on the Administrative Punishment for Illegal Investments and Technology Transfers in the Mainland Area (*weifa zai dalu diqu congshi touzi huo jishu hezuo anjian caifa jizhun*), the Regulations on Approving the Engagement in Business Transactions in the Mainland Area (*zai dalu diqu congshi shangye xingwei xuke banfa*), the Principles on Reviewing the Establishment of Agencies in the Mainland Area to Engage in Business Transactions (*zai dalu diqu sheli banshichu congshi shangye xingwei shencha yuanze*), the Principles on Reviewing and Monitoring Investments in the Mainland Area to Establish Semiconductor Wafer Factories (*zai dalu diqu touzi jingyuan chang shencha ji jiandu zuoye yaodian*), the Principles on Coordinating the Policy Review of Large Investments in the Mainland Area (*zai dalu diqu zhongda touzi anjian zhengce mian shencha xietiao zuoye yaodian*),

the PRC must apply to the Investment Commission¹³³ of the MOEA for approval. The Investment Commission is composed of government officials from various government departments.¹³⁴

2. “Indirect” Investment in the PRC?

The question of what constitutes “an investment in the Mainland Area” and therefore requires approval by the ROC government is at the heart of the ROC’s regulation of outward direct investment in the PRC. The leading case is *Cheng-yu Investment Company v. the MOEA*. On February 7, 2003, the MOEA fined the Cheng-yu Investment Company (hereafter referred to as Cheng-yu)¹³⁵ NT\$1 million for violating Article 35, Section 1 of the *Act*. According to the MOEA, Cheng-yu, a corporation established in the ROC, had invested US\$2 million in September 2001 in the Semiconductor Manufacturing International Corporation (hereafter referred to as the Cayman SMIC), incorporated in the British Cayman Islands, which wholly owned another corporation also named the Semiconductor Manufacturing International Corporation but established in Shanghai, the PRC (hereafter referred to as the Shanghai SMIC). The MOEA asserted that Cheng-yu had violated Article 35, Section 1 because the MOEA considered its investment in the Cayman SMIC in effect “an investment in the Mainland Area” (*zai dalu diqu congshi touzi*) that was made by Taiwan residents without the approval of the ROC government.

Cheng-yu disagreed and sued the MOEA in an administrative court to recoup the administrative fine. The basis of its suit was Article 4 of the *Regulations Governing the Permission of Investment or Technology Cooperation in the Mainland Area*,¹³⁶ an administrative regulation

and the List of Industries Prohibited from Investing in the Mainland Area (*nongye zhizaoye ji fuwuyue deng jinzhi fu dalu touzi chanpin xiangmu*).

¹³³ <http://www.moeaic.gov.tw> (last visited July 26, 2013).

¹³⁴ *Id.* The Chairperson of the Investment Commission is the Vice Minister of the MOEA. The other members of the Investment Commission are the Vice Ministers of the Ministries of Finance, Foreign Affairs, Transportation, Interior Affairs, and Defense; the Vice Chairperson of the Overseas Compatriot Affairs Commission; the Vice President of the Central Bank; the Vice Chairpersons of the Council for Economic Planning and Development, the Financial Supervisory Commission, the Mainland Affairs Council, the Council of Labor Affairs, the Council of Agriculture, and the National Science Council; the Minister of the Department of Health; the Vice Minister of the Environmental Protection Administration; the Chief of the Department of Economic Development of the Taipei City Government; and the Chief of the Department of Economic Development of the Kaohsiung City Government.

¹³⁵ The Romanization of its title is as follows: *cheng yu chuanyue touzi gufen youxian gongsi*.

¹³⁶ The Romanization of its title is as follows: *zai dalu diqu congshi touzi huo jishu hezuo xuke banfa*.

promulgated by the MOEA and authorized by Article 35 of the *Act*. Article 4 has two sections. Section 1 defines “investing in the Mainland Area” (*zai dalu diqu congshi touzi*) as the act of Taiwanese people, corporations, organizations, or other institutions establishing new businesses in the Mainland Area, investing additional funds in existing businesses in the Mainland Area, acquiring shares of existing businesses in the Mainland Area (but not acquiring shares of businesses that are listed and traded publicly), and establishing branches or expanding businesses in the Mainland Area. In other words, investments by Taiwanese people, corporations, organizations, or other institutions that invest in “corporations formed in third places” (*di san diqu gongsi*), i.e., neither the PRC nor the ROC, fall outside the scope of Article 4, Section 1. In addition, Cheng-yu argued that Article 4, Section 2 was not applicable. Article 4, Section 2 states that “investing in the Mainland Area” includes Taiwanese people’s investments in “corporations formed in third places” if such corporations invest in the Mainland Area and the Taiwanese investments “have a controlling impact on” (*juyou zhipai yingxiang li*) those corporations formed in third places. Cheng-yu argued that its 0.2% ownership of the Cayman SMIC did not amount to a controlling impact; therefore, as it had performed none of the acts prescribed in Article 4, Cheng-yu had not required the approval of the ROC government.

On February 17, 2005, the High Administrative Court ruled in favor of Cheng-yu,¹³⁷ stating that Article 4, Section 1 governs investment in the PRC, whereas Article 4, Section 2 governs investment in all areas outside of the PRC and the ROC. The MOEA appealed to the Supreme Administrative Court, which reversed the lower court’s judgment and ruled in favor of the MOEA¹³⁸ on July 13, 2006. The Supreme Administrative Court ruled that Article 4, Section 2 applies only when people of the Taiwan Area invest in corporations incorporated in areas outside of the PRC and the ROC and these corporations, while having no investments in the PRC when the people of the Taiwan Area initially invested in them, subsequently invested in the PRC. In such circumstances, in the words of the Supreme Administrative Court, the Taiwanese investment in the PRC is “*ex post facto*, passive, and indirect” (*shihou beidong jianjie*) and the MOEA should apply the controlling-impact test. The court ruled that only in such circumstances could the controlling-impact test apply, and Article 4, Section 1 would govern all other circumstances, including the immediate case. The Supreme Administrative Court stated that Article 4, Section 1 is not limited to “direct” investment in the PRC but rather encompasses “indirect” investment in the PRC that are made through corporations incorporated in areas outside of the PRC and the ROC. In its judgment, the Supreme Administrative Court acknowledged that

¹³⁷ Taipei High Administrative Court, Su Zi Judgment No. 200 (2005).

¹³⁸ Supreme Administrative Court, Pan Zi Judgment No. 1065 (2006).

the interpretation “appeared broader than that suggested by the statutory language” (*kuoda wenyi jieshi zhixian*) but nonetheless asserted that its interpretation could better achieve the purpose of the *Act* than the interpretation of the lower court.

Applying this interpretation to the immediate case, the Supreme Administrative Court found that the Cayman SMIC was a paper company without any business operations in the British Cayman Islands; that Cheng-yu Investment Company had invested in this paper company with knowledge of its wholly owned company in Shanghai, the PRC; and therefore that Cheng-yu should pay a fine for investing in the Mainland Area without approval from the ROC government.

3. Investing Special Skills in the PRC?

Should a Taiwan resident seek ROC government approval before being hired as the chairman of a company incorporated in the PRC in which a Taiwan resident should seek ROC government approval before investing? If no, then a loophole could potentially be created by offering high salary, instead of stock, to lure that Taiwan resident. If yes, ROC government approval may appear to be unduly affecting the freedom to choose one's occupation outside of the ROC. Two leading cases exemplify the court's analysis.

In *Cai Rui-zhen v. the MOEA*, the court ruled that a Taiwan resident should seek ROC government approval before being hired as the chairman of a technology company in the PRC. On February 7, 2003, the MOEA fined Cai Rui-zhen, chairman of the Grace Semiconductor Manufacturing Corporation in Shanghai, the PRC, NT\$2 million for violating Article 35, Section 1 of the *Act* and ordered him to divest his holdings in the corporation within six months.¹³⁹ Cai sued the MOEA in administrative court, arguing that because he was only an employee of the Grace Semiconductor Manufacturing Corporation, which had been incorporated in the British Cayman Islands, he had neither established nor invested in any business in the Mainland Area. The court ruled against Cai, finding that Cai had experiences in managing technology companies and therefore special management skills and that he had used his special management skills as chairman to help establish (*chuangshe*) the operations of the Grace Semiconductor Manufacturing Corporation in Shanghai during a two-year period.

In *Ling An-hai v. the MOEA*, the court ruled that a Taiwan resident does not need to seek ROC government approval before being hired as the chairman of a technology company in the PRC.¹⁴⁰ On February 20, 2006, the MOEA

¹³⁹ Taipei High Administrative Court, Su Zi Judgment No. 1063 (2004).

¹⁴⁰ Taipei High Administrative Court, Su Zi Judgment No. 3566 (2007).

fined Ling An-hai NT\$2 million for violating Article 35, Section 1 of the *Act*. The MOEA alleged that, as a shareholder and director of Cando Investment Limited (hereafter referred to as Cando), incorporated in the British Virgin Islands, Ling had invested US\$31,380,000 in the Jianteng Liquid Crystal Display Corporation (hereafter referred to as Jianteng) in Shanghai, the PRC, without governmental approval. To dispute the fine, Ling sued the MOEA in an administrative court, contending that because he had become a U.S. citizen in 1984 and had not registered his residence in the ROC, he was not a Taiwan resident (*Taiwan diqu renmin*) as defined by the *Act*. He also contended that it was Cando, not him, who had invested in Jianteng, and that he had not been chairman of Cando when Cando had invested in Jianteng.

On July 5, 2007, the administrative court ruled against the MOEA, finding that Offshore Incorporations Limited, not Ling, had founded Cando on July 23, 2001. In addition, the court found no evidence that Ling had been a shareholder and director of Cando on May 13, 2002, the date on which Cando had invested in Jianteng. The court also refuted the argument that the type of investment Ling had provided Jianteng was his special skills (*zhuanmen jishu*) applied in his capacity as Jianteng's chairman. The court ruled that the position of chairman itself did not entail special skills and that the MOEA had to prove, with more than the single fact that Ling served as Jianteng's chairman, that Ling had "special skills." Although the MOEA cited High Administrative Court Judgment No. 1063 (2004), which states that the position of chairman entails the performance of "special skills," the court found that as the facts of the two cases were different, that the High Administrative Court Judgment No. 1063 (2004) was not a precedent (*panli*) and therefore not binding on the court's adjudication of the immediate case. Ultimately, although the court found that Ling An-hai was indeed a Taiwan resident, the MOEA lost its case for lack of evidence.

4. The Basis of Regulation: ROC Nationality

May a person relinquish his or her ROC nationality (*guoji*) and thereby avoid being fined by the ROC government for investing in the PRC? The leading case on this issue is *Zhang Rujing v. the Ministry of the Interior*. In order to relinquish (*fangqi*) his ROC nationality, Zhang Rujing applied to the ROC representative office in Los Angeles, California, the United States, on July 6, 2005. On September 13, 2005, the Ministry of the Interior (hereafter referred to as the MOI) rejected Zhang's application due to his failure to have paid a fine of NT\$5 million imposed by the MOEA on March 31, 2005. In reaction, Zhang sued the MOI in the Taipei High Administrative Court.

Zhang argued that he should have been allowed to relinquish his ROC nationality in accordance with Article 13 of the ROC Nationality Law, which allows an ROC national to relinquish his or her nationality provided that the ROC national does not fit any of the six enumerated categories, which are as follows: (1) the ROC national is “under criminal investigation or trial”;¹⁴¹ (2) the ROC national is “sentenced to prison and had not finished his or her sentence”;¹⁴² (3) the ROC national “is a defendant in civil litigation”;¹⁴³ (4) the ROC national is “subject to a government enforcement proceeding”;¹⁴⁴ (5) the ROC national has been “declared bankrupt and had not yet emerged from bankruptcy”;¹⁴⁵ or (6) the ROC national “has not paid all taxes due or all fines for evading taxes.”¹⁴⁶ When Zhang had applied to relinquish his ROC nationality on July 6, 2005, he had not fit any of these six categories.

On February 15, 2007, the Taipei High Administrative Court ruled against Zhang, having found that the purpose of Zhang’s suit was to ask the court to oblige the MOI to allow Zhang to relinquish his nationality and, in litigation concerning the imposition of obligations (*keyu yiwu susong*), a court should consider whether it should impose obligations on one of the litigating parties “at the end of the trial debate.”¹⁴⁷ The court noted that after Zhang had refused to pay the fine of NT\$5 million, the MOEA had initiated an enforcement proceeding against Zhang’s property on September 12, 2005 that had not been completed at the end of the trial debate. Therefore, at the end of the trial debate, Zhang had fit the fourth of the six categories, and the court ruled that the MOI did not have to allow Zhang to relinquish his ROC nationality because he was subject to a government enforcement proceeding that was still ongoing at the end of the trial debate. In other words, Zhang lost the suit.

CONCLUSION

The China-Taiwan Investment Agreement is a milestone for both the China-Taiwan relationship and Taiwan’s relationship with the outside world. As discussed earlier, some of the disputes between China and Taiwan concerned not only political and economic interests, but also the use of words.

¹⁴¹ The Romanization of the quoted text is as follows: *wei zhencha huo shenpan zhong zhi xingshi beigao*.

¹⁴² The Romanization of the quoted text is as follows: *shou youqi tuxing yishang xing zhi xuangao shangwei zhixing wanbi zhe*.

¹⁴³ The Romanization of the quoted text is as follows: *wei minshi beigao*.

¹⁴⁴ The Romanization of the quoted text is as follows: *shou qiangzhi zhixing wei zhongjie zhe*.

¹⁴⁵ The Romanization of the quoted text is as follows: *shou pochang zhi xuangao wei fuquan zhe*.

¹⁴⁶ The Romanization of the quoted text is as follows: *you zhina zushui huo shou zushui chufen fahuan wei jiaoqing zhe*.

¹⁴⁷ The Romanization of the quoted text is as follows: *shishi shen yanci bianlun zhongjie shi*.

In the Investment Agreement, China and Taiwan avoided politically charged words and phrases, such as *China* and *Taiwan*. As defined in Article 1, the natural person of one Contracting Party is the natural person who possesses the “document that proves his status” (*shenfen zhengming wenjian*) issued by one Contracting Party. In Article 13, Section 4, and Article 14, Section 1, for example, the phrase “relevant rules” (*xiangguan guiding*) is chosen over the word “law.” In fact, the word *law* does not appear in the Investment Agreement at all. In Article 16, for another example, the phrase “relevant procedure” (*xiangguan chengxu*) is used instead of other terms, such as *legal procedure*. Together with the dozens of other agreements signed by the heads of the SEF and the ARATS between China and Taiwan, the Investment Agreement demonstrates the possibility that China and Taiwan may deal with each other peacefully and practically. The China-Taiwan Investment Agreement is also a milestone for Taiwan’s relationship with the outside world, as it demonstrates for the world that China does not protest Taiwan’s use of private-sector associations to create legal relationships with other countries. In July 2013, Taiwan and New Zealand, also through private-sector associations, signed the Agreement between New Zealand and the Separate Customs Territory of Taiwan, Penghu, Kinmen, and Matsu on Economic Cooperation, a free trade agreement (FTA).¹⁴⁸ If these prove to be not isolated instances but part of a broader trend, Taiwan will become better connected to the world.

In addition, China-Taiwan Investment Agreement addresses some problems in the bilateral investment relationship. For example, as discussed in Part I, Article 1 defines the term *investor* (*touzi ren*) and stipulates that any entities that are established in accordance with the rules of a third party (*di san fang*) but are owned or controlled by a natural person or enterprise of one Contracting Party are also considered enterprises of that Contracting Party. This definition is a result of Taiwan’s past prohibition of outward direct investment in the PRC and of Taiwanese business people’s evasion of such prohibition.¹⁴⁹ The case between the Cheng-yu Investment Company and the MOEA of the ROC, for example, involved corporate efforts to evade the ROC government’s regulation of outward investment in the PRC.¹⁵⁰

Nationalization also is an important issue in the investment relationship between China and Taiwan. As demonstrated by the case between Beijing Real Estate Development Corporation and Haikou City People’s

¹⁴⁸ AGREEMENT BETWEEN NEW ZEALAND AND TAIWAN ON ECONOMIC COOPERATION, available at http://www.nzcio.com/webfm_send/59 (last visited February 10, 2014).

¹⁴⁹ Zeng Zhi-Chao, *An Analysis of the Cross-Strait Agreement on Investment Protection and Promotion and Recommendations for Taiwanese Businesspeople* (*haixia liang an touzi baozhang he cujin xieyi pingxi yu taishang de jianyi*), NATIONAL POLICY FOUNDATION (Sept. 20, 2012) (*faren guojia zhengce yanjiu jijinhui*), <http://www.npf.org.tw/post/2/11355>.

¹⁵⁰ See *supra* text accompanying notes 135–38.

Government,¹⁵¹ nationalization may take the form of rescinding development licenses. PRC courts ruled that the Haikou City People's Government cannot rescind development licenses without compensating Beijing. According to a policy analysis written by a think tank in Taiwan,¹⁵² the local governments in the PRC in the past had often nationalized the land and other assets of Taiwanese businesses and that Article 7 of the Investment Agreement should be able to address the issue.

The extent to which the Investment Agreement lives up to its promise is an important issue. On the one hand, the Investment Agreement has not been unambiguously categorized as a treaty binding upon both China and Taiwan. On the Web site of the Taiwan Affairs Office of the State Council, PRC, the Investment Agreement appeared in the category of *Cross-Strait Dialogue and Exchange (liang an duihua yu shangtan)*,¹⁵³ rather than in the category of *Taiwan-Related Legal Norms (shetai falu guifan)*.¹⁵⁴ On the Web site of the Mainland Affairs Council, Executive Yuan, ROC, the Investment Agreement appeared in the category of *Cross-Strait Negotiation (liang an xieshang)* rather than in the category of *Law of Mainland, Hong Kong, and Macau Affairs (dalü ji gangao shiwu fagui)*. In addition, the Investment Agreement has not appeared in the database of bilateral investment treaties maintained by the United Nations Conference on Trade and Development.¹⁵⁵ Moreover, China has not recognized Taiwan (or the ROC) as a state with whom it concludes a treaty to which the Vienna Convention on the Law of Treaties applies.¹⁵⁶ Therefore, whether Investment Agreement can impose meaningful obligations on or constitute meaningful behavioral restraints on China, the more powerful and resourceful Contracting Party, is a question that needs to be considered.

¹⁵¹ See *supra* text accompanying notes 83–111.

¹⁵² Zeng, *supra* note 149.

¹⁵³ TAIWAN AFFAIRS OFFICE OF THE STATE COUNCIL, STRAIT DIALOGUE AND NEGOTIATIONS, <http://www.gwytb.gov.cn/lhjl/> (last visited July 29, 2013).

¹⁵⁴ TAIWAN AFFAIRS OFFICE OF THE STATE COUNCIL, TAIWAN RELATED LAWS & REGULATIONS, http://www.gwytb.gov.cn/guide_rules/ (last visited July 29, 2013).

¹⁵⁵ UNITED NATIONS CONFERENCE ON TRADE & DEVELOPMENT, BILATERAL INVESTMENT TREATIES, http://www.unctadxi.org/templates/DocSearch___779.aspx (last visited July 29, 2013).

¹⁵⁶ Vienna Convention on the Law of Treaties art. 1, May 23, 1969, 1155 U.N.T.S. 331, (“The present Convention applies to treaties between States.”); *Id.* at art. 3, (“The fact that the present Convention does not apply to international agreements concluded between States and other subjects of international law...shall not affect (a) the legal force of such agreements;...”), available at <https://treaties.un.org/doc/Publication/UNTS/Volume%201155/volume-1155-I-18232-English.pdf>. Although it may seem possible to argue that Article 3 implies that Taiwan may possibly be treated as one of the “other subjects of international law” and therefore the legal force of China-Taiwan agreements is not affected by the fact that Vienna Convention, China has not supported this view and does not consider Taiwan a subject of international law. As of 2013, it seems unlikely that China will change its view in the near future.

On the other hand, the effectiveness of the Investment Agreement may also be considered from the perspective of *compliance* in international legal scholarship. As there is no central authority to enforce international law, some international legal scholars have offered theories¹⁵⁷ to explain why “almost all nations observe almost all principles of international law and almost all of their obligations almost all of the time.”¹⁵⁸ Neither is there a central authority to enforce the Investment Agreement against either China or Taiwan. Therefore, whether the Investment Agreement will be complied with by both China and Taiwan and improve their investment relationship is a question of not only practical importance, but also theoretical importance.

¹⁵⁷ See, e.g., Harold Hongju Koh, *Why Do Nations Obey International Law?*, 106 Yale L.J. 2599 (1997); ABRAM CHAYES & ANTONIA HANDLER CHAYES, *THE NEW SOVEREIGNTY: COMPLIANCE WITH INTERNATIONAL REGULATORY AGREEMENTS* (Harvard U. Press, 1995); THOMAS M. FRANCK, *FAIRNESS IN INTERNATIONAL LAW AND INSTITUTIONS* (Clarendon Press, 1995).

¹⁵⁸ LOUIS HENKIN, *HOW NATIONS BEHAVE: LAW AND FOREIGN POLICY*, 47 (2d ed. 1979).

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THE NEW “SINGLE-MEMBER LIMITED LIABILITY
ENTERPRISE” IN THE BRAZILIAN LEGAL SYSTEM: CREDITOR
PROTECTION IN A COMPARATIVE PERSPECTIVE

Luana F. Joppert Swensson *

INTRODUCTION

For many decades scholars and governments around the world have discussed the possibility of limiting the liability of a single entrepreneur, either through the creation of a limited liability company with only one member, or through a non-corporate instrument.

Before the eighties, the single-member company (SMC) was treated within company law doctrine almost as a “theoretical curiosity”, was not recognized in legislation, and was surrounded by prejudices and conceptual barriers.¹

In recent decades, however, the situation has changed. This change has been driven mainly by practical reasons represented by the increasing presence in almost all legal systems of the *de facto* SMC and by the recognition of the importance of the limitation of the liability of single entrepreneurs to foster the development of small and medium-sized business.²

Due to the lack of a legal instrument to limit the liability of the single entrepreneur *de facto* SMC was the instrument adopted by many single entrepreneurs to develop their business and take advantages of the benefits of the limitation of personal liability. These are companies formed by a “fictitious” plurality of people, but with their only aim being to pursue the interests of, and limit the liability of, a single entrepreneur.³

The need to accept this reality and to offer proper regulation has led several legislatures, including legislatures in Europe, and recently, Brazil to provide a legal instrument to limit the liability of a single entrepreneur and to address the problems that SMC poses in practice.⁴

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¹ These conceptual barriers included, in particular, the theory of indivisibility of assets and the conception of the company as a contract as established by the traditional contract theory. For an in depth view on contract theory and its influence on the acceptance of single-member companies *see* Calixto Salomão Filho, *A Sociedade Unipessoal* (São Paulo: Malheiros, 1995).

² *Id.*

³ *See Id.* *See also* Guilherme Duque Estrada de Moraes, “Sociedade Limitada e a Nova Lei,” *Gazeta Mercantil*, no. 1 (2003).

⁴ Council Directive 89/667, art. 7, 1989 O.J. (L395/42) (EC); Brazilian Law n. 12441/2009.

As it is well known by company law doctrine, the main problem of SMC is represented by the higher possibility of mix, or confusion, between the company and the sole-member assets, as both belong economically to the same individual, but legally to two different entities.⁵ As it is discussed further below, with the end of the plurality of shareholders it becomes very easy for the single shareholder not to respect the separation between its own and the company's assets, to behave opportunistically and to use the company's assets to pursue its personal interests in disadvantage of the interests of the company and of the company's creditors. As a result creditors find themselves in a riskier position as they become significantly more vulnerable to single-shareholder opportunistic behavior.⁶

Nevertheless, the awareness of this higher risk of SMC to creditors does not represent an obstacle to the recognition of SMC by the legislature. On the contrary it just highlights the need and importance of providing specific rules to compensate these major risks and offset the imbalance formed by the lack of plurality of shareholders.⁷ It is in this context that creditor protection rules acquire a fundamental importance in the recognition and regulation of single-member companies.

Against this background the European Union (EU) regulated the limitation of the liability of a single-entrepreneur in 1989 with the XII Directive 89/667/EEC (EU XII Directive).⁸ On one hand the EU legislature recognized the economic importance of SMC and aimed with the new instrument to foster the development of small and medium-sized businesses in the EU market. On the other hand, recognizing the particular risks to creditors that may characterize SMC (in particular, the possibility of mix or confusion of personal assets), the EU XII Directive aimed to provide the necessary guidelines to protect SMC creditors through proper regulation.⁹

⁵ See Carlo Angelici, "Società Unipersonali: L'Esperienza Comparatistica", *Le Società* 7 (1993); Filho, *supra* note 1; Roberto Weigman, "L'impresa Individuale a Responsabilità Limitata", in F. Galgano, F. Ferrari, and G. Ajani (eds.), *Atlante Di Diritto Privato Comparato* (Bologna: Zanichelli, 1999).

⁶ Weigman, *supra* note 5; Angelici, *supra* note 5; Filho, *supra* note 1.

⁷ As affirmed by Angelici, from a technical point of view there is no doubt that the problem of single-member company is mainly to verify if and which adaptations are needed to the general rules of company law: that is, to determine in what sense the situation of single ownership requires modifications to the company rules which were originally elaborated to deal with a plurality of members and interests. Angelici, *supra* note 5. For contrary view see Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499 (1976), Luca Enriques & Jonathan R. Macey, *Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules*, 86 CORNELL L. REV. 1165 (2001); Marco Saverio Spolidoro, "Il Capitale Sociale," in *Il diritto delle società per azioni: problemi, esperienze, progetti*, ed. Pietro Abadessa and Angel Rojo (Milano: Giuffrè, 1993).

⁸ In 2009 the EU XII Directive was substituted by the Directive 2009/102/EC.

⁹ Gian Domenico Mosco, "La Dodicesima Direttiva CEE Sulle Società Unipersonali a Responsabilità Limitata", *Giurisprudenza Commerciale* 18, no.1 (1991).

In many countries, however, despite the long-standing awareness of the importance of limiting the liability of single entrepreneurs and of regulating the practical situation of *de facto* SMCs, it took much longer for formal recognition to take place. This was the case of Brazil.¹⁰

Despite the wait, characterized by long debates and a large number of proposed draft laws, at last, in 2012, with the introduction of the EIRELI—*Empresa Individual de Responsabilidade Limitada*—Brazil formally recognized a legal instrument to limit the liability of the single entrepreneur. However, the superficiality of its legislation and the lack of an appropriate regulation of creditor protection give cause for concern.

This paper develops a comparative and critical analysis of the new Brazilian legislation on EIRELI, with a focus on the regulation of creditor protection. The object of comparison is the Italian legal system, within the context of the EU XII Directive.

This article proceeds in two main parts. The first part will introduce the problem regarding the protection of creditors in SMC. After explaining the motivations for choosing the Italian legal system as the subject for the comparative analysis, the second part will proceed with an analysis of the Italian and European regulations regarding creditor protection in single-member companies. This article will conclude with a comparative and critical analysis of the key provisions adopted in the recent Brazilian law, highlighting the weaknesses of this new law in adequately addressing creditor protection and its consequences for the effectiveness of the law in reaching its main aims; (i) to provide an instrument to limit the liability of the single entrepreneur and foster the development of small and medium-sized businesses in Brazil and (ii) to regulate and confront the problems of the *de facto* single-member company.

¹⁰ The only form of single-member company recognized by the Brazilian legislature before 2012 was the *subsidiária integral*, which was compulsorily formed by a single public company (*sociedade anônima*) and conceived as a model organization for groups of companies and not for single entrepreneurs.

I. THE PROBLEM REGARDING CREDITOR PROTECTION IN SINGLE-MEMBER COMPANIES (SMCS)¹¹

A. *Creditor protection as one of the main agency problems faced by company law*

The protection of corporate creditors is at the basis of one of the three main ‘agency problems’—dealt with by company law.¹² This problem arises from the conflict of interest between the company (in particular, its shareholders) and other stakeholders with whom the firm contracts, including its creditors.¹³

The core difficulty of agency problems, including the corporation-creditor one, is that in most cases there is a wide asymmetry of information between the agent (in this case, the company and/or its shareholders) and the principal (i.e. the company’s creditor).¹⁴ As the agent commonly has better information on the relevant facts than the principal does, the principal cannot easily assure himself that the agent’s performance matches with what was promised initially by the agent.¹⁵ As a result the corporation and its shareholders have a strong incentive to act opportunistically on its own behalf, but to the detriment of its creditors.¹⁶

This problem becomes very relevant in the case of companies with limited liability. The fact that shareholders benefit from the firm’s successes, but that their personal assets are shielded from the consequences of its failure by the rule of limited liability, increases the incentive for shareholders to act in

¹¹ Although the Brazilian legislator has not adopted—and it has been criticized for this—the legal form of company as the instrument to limit the liability of the single entrepreneur, practically all the rules of limited liabilities companies apply to this new form of business organization. Therefore, I will often use in this text the term “single-member company” generically, as is often done in the doctrine, to refer, in a general sense, to the problems regarding both to the single-member private-limited liability adopted by the Italian legal system, but also to the single-member limited liability enterprise, adopted by the Brazilian legal system.

¹² Reinier Kraakman et al., *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* (Reinier Kraakman, et al. eds., 2d ed., 2009); see also John Armour et al., *Agency Problems and Legal Strategies, What is Corporate Law*, in *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* (Reinier Kraakman, et al. eds., 2d ed., 2009) (defining agency problems as emerging “whenever the welfare of one party, termed the ‘principal’, depends upon actions taken by another party, termed the ‘agent’”). There are three main agency problems or “source of opportunisms” dealt with by corporate law: conflicts between managers and shareholders, conflicts among shareholders, and conflicts between shareholders and the corporation’s other constituencies, including creditors and employees. *Id.*

¹³ Armour et al., *supra* note 12.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

their own interest, and to manipulate limited liability at the expense of creditors.¹⁷

As a result, despite contrary views,¹⁸ company law doctrine has, on the whole, traditionally conceived corporate creditor protection as necessary trade-off for the principle of limited liability and for the increased risks it brings to creditors.¹⁹ The protection of a company's creditor is, in fact, addressed in all company law systems, although with different levels of intensity.²⁰ These creditor protection devices can be understood as a compensation for the loss of the creditor's right to hold equity holders personally liable for business debts. They include minimum capital and capital maintenance requirements, minimum mandatory number of shareholders to form a company and related rules, as well disclosure requirements.²¹

B. *Creditor protection in SMCs*

When it comes to SMCs the problem regarding creditor protection becomes even more complex. With the disappearance of the plurality of members, also disappears the indirect protection for third parties that result

¹⁷ John Armour, Gerard Hertig, & Hideki Kanda, *Transaction with Creditors*, in THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 115, 116–19 (Reinier Kraakman, et al. eds., (2009)).

¹⁸ Contrary views can be found especially among scholars of the economic analysis of law. Among them are Posner, who contends that the principle of limited liability does not constitute a valid justification for the traditional company law rules regarding creditor protection. According to the author, in fact, “[f]ar from externalizing the risks of business ventures, the principle of limited liability in corporation law facilitates a form of transaction advantageous to both investors and creditors; in its absence the supply of investment and the demand for credit might be much smaller than they are.” In this sense, according to the author, “the primary utility of corporation law lies in providing a set of standard, implied contract terms, for example, governing credit, so that business firms do not have to stipulate these terms anew every time they transact, although they could do so if necessary. To the extent that the terms implied by corporation law accurately reflect the normal desires of transacting parties, they reduce the cost of transactions.” Posner, *supra* note 7, at 503, 506. See also Armour, Hertig, & Kanda, *supra* note 17; Spolidoro, *supra* note 7; Peter Mankowski, *Does Contract Suffice to Protect the Creditors of a Company and their Interest?*, EUR. CO. & FIN. L. REV. Special Vol. 1 (2006); Enriques & Macey, *supra* note 7.

¹⁹ As affirmed by Kraakman: “Adding limited liability to the basic features of the corporate form in the early and mid-nineteenth century exacerbated concern over the rights of contractual creditors. Personal liability had long served as the principal form of creditor protection attending the general partnership form, and it performed much the same role in the early history of the corporate form”. Reinier Kraakman, *Concluding Remarks on Creditor Protection*, EUR. BUS. ORG. L. REV. 7, no. 1 (2006).

²⁰ Armour, Hertig, & Kanda, *supra* note 17; John Armour et al., *How Do Legal Rules Evolve? Evidence from a Cross-Country Comparison of Shareholder, Creditor and Worker Protection*, 57 AM. J. COMP. L. 579 (2009).

²¹ Kraakman, *supra* note 19.

from the action of minority shareholders to safeguard both their own and the company's interests against the majority shareholders interests.²²

With the aim to avoid the opportunistic behavior of the majority shareholders, company law provides different devices that are used by the minority shareholder as an instrument of control. These devices include appointments rights, mandatory disclosure, and independent directors. Although they were not conceived to protect creditors directly, they represent an important indirect instrument to preserve the interests of the company creditors as well.

Once these measures disappear, with the end of the plurality of shareholders, creditors find themselves in a riskier position as they become significantly more vulnerable to single-shareholder opportunistic behavior. In particular, without the control of other shareholders, it becomes very easy for the single shareholder not to respect the separation between its own and the company's assets and to use the company's assets to pursue its personal interests.²³ As already affirmed this is, in practice, the main issue of SMC.

Faced with this increased risk to creditors, legal systems developed special rules to deal with this issue and to pay off the higher risks it brings to creditors. These rules, which represent the core of the regulation of SMC, are exactly the creditor's protection rules.

C. *Instruments and legal strategies available to protect SMC creditors*

There is not only one type of instrument or legal strategy available to respond to the problem of the increased risk SMCs present to creditors.²⁴ There are, furthermore, still controversies regarding the efficiency of the different legal strategies that can be adopted in protecting creditors.²⁵

²²Angelici, *supra* note 5; Maria de Fátima Ribeiro, A Tutela dos Credores da Sociedade por Quotas e a Desconsideração da Personalidade Jurídica (Coimbra: Almedina, 2009).

²³See Angelici, *supra* note 5; Filho, *supra* note 1; Weigman, *supra* note 5.

²⁴This distinction among the different legal strategies regarding creditor protection also applies to the "regular" types of companies. According to Armour et al, in fact, two fundamental distinctions in regulatory style can be identified, namely that between mandatory rules and that concerning the facilitation of contractual mechanisms. Armour et al., *supra* note 20; Armour et al., *supra* note 12.

²⁵Regarding companies in general and the effectiveness of creditor protection rules see generally 7 EUROPEAN BUS. ORG. L. REV. 5 (2006), which has published the proceeding of the conference on "Efficient Creditor Protection and European Company Law" hold in Munich (Particularly, see the works of John Armour, *Legal capital: an Outdated Concept?*; Kraakman, *supra* note 19; William W. Bratton, *Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process*; Hanno Merkt, *Creditor Protection through Mandatory Disclosure*; Peter O. Müllbert, *A Synthetic View of Different Concepts of Creditor Protection, or a High-Level Framework for Corporate Creditor Protection*). For a discussion regarding specifically single member companies see Luana F. Joppert Swensson, "La Tutela dei Creditori e la Limitazione della Responsabilità degli Imprenditori Individuali: una Analisi

We can divide creditor's protection strategies in three main groups.

1. Doctrine of corporate disregard

Legal systems, in particular those in which the single-member companies are not yet recognized or regulated, but exist *de facto*, rely on the work of jurisprudence and on the application of the doctrine of corporate disregard to address the problem. This strategy consists of an *ex post* solution, imposed by the court and external to the organizational structure of the corporation. It will take place when the abuse of the legal personality or the confusion of assets had already happened and the creditor was already damaged by the consequent lack of the company resources to pay its credit.²⁶

This was the case of Brazil before 2012.²⁷ Due to the high number of *de facto* SMC and lack of a proper regulation on SMC the Brazilian courts have employed this theory (also known as piercing the corporate veil) as the main instrument to protect the creditors of *de facto* SMC and put remedy to the mix between the company and the *de facto* sole-member assets that had damaged creditors.

In 2002, after a long period with no formal recognition, the civil code incorporated this doctrine in its art. 50 and established *abuse* of the legal personality—characterized by “deviation of purpose” or by “confusion of assets”—as the main condition for its application. As a result in case of deviation of purpose and of confusion of assets judges can make shareholders personally liable for the company's debts.

On the one hand the application of the disregard doctrine is an important instrument to protect creditors, especially in the case of *de facto* SMC and precisely in the cases of lack of separation of assets. Its importance is recognized also by legal system in which the single-member companies are recognized and regulated, such as in Germany.²⁸ In these cases the doctrine of corporate disregard represents a *complementary* strategy offering an *ex post* solution for those cases in which the confusion of assets could not be prevented by an *ex ante* strategy.²⁹

On the other hand, its unmeasured application can lead to a high degree of legal uncertainty in the corporate system, especially in the case of small

Comparatistica tra gli Ordinamenti Giuridici Italiano e Brasiliano" (Università degli Studi di Roma "La Sapienza," 2011).

²⁶ Filho, *supra* note 1. For an analysis of the use of the disregard doctrine as an instrument to protect creditors in *de facto* single-member companies in Brazil, see Swensson, *supra* note 25.

²⁷ Bankruptcy law, too, can provide similar types of *ex post* solutions.

²⁸ Filho, *supra* note 1.

²⁹ *Id.*

businesses. This is the case of Brazil. Despite the regulation of the doctrine of corporate disregard by the civil code and the requirement of explicit condition for its application, a broad interpretation of the causes of abuse by Brazilian tribunals, as well as the approval of other special laws,³⁰ has meant that, especially in tax and labor cases, a mere lack of assets to pay the company's debt has become enough to justify the application of the disregard doctrine and, therefore, to determinate the end of the principle of limited liability.³¹

This situation, which has long been severely criticized within the national legal system,³² is responsible for a high degree of legal uncertainty in the Brazilian corporate system, especially in the case of small businesses for which the distinction between control and ownership is quite tenuous.³³

Furthermore the corporate disregard doctrine is not able to regulate other organizational issues of the SMC, which may have an impact on creditors protection.

Due also to these limitations of the corporate disregard doctrine, the great majority of legal systems, upon the formal recognition of single-member companies with limited liability, opt to develop special rules within company law to regulate the specialties and increased risks of this type of business organization.³⁴

These rules can be substantive mandatory rules or be based on the facilitation of contractual self-protection.

2. Contractual self-protection strategy

Several scholars, especially from the doctrine of economic analysis of the law, argue that the core issue of creditor protection in single-member

³⁰ Some examples are law n. 8078/90 on consumer protection, law n. 8.884/94 on infringements against the economic order, law n. 9605/98 on environmental crimes and the national tax code and the labour law code.

³¹ As affirmed by Forgioni, in fact, the rapidity with which the Brazilian judges, in particular those in the area of labour law, apply the doctrine of corporate disregard of the legal entity, causes great consternation among foreign investors. Paula A. Forgioni, "Introduzione" in Luana F. Joppert Swensson, "Il Diritto delle Società Commerciali nell'Ordinamento Giuridico Brasiliano alla Luce delle Recenti Riforme", *Rivista di Diritto Societario*, 3 (2008).

³² See Heleno T. Tôrres, "Regime Tributário da Interposição de Pessoas e da Desconsideração da Personalidade Jurídica: os limites do art. 135, I e III, do CTN, 21," in *Desconsideração da Personalidade Jurídica em Matéria Tributária*, ed. Heleno T. Tôrres and Maria Helena Queiroz (São Paulo: Quartier Latin, 2005); Rachel Sztajn, "Desconsideração da Personalidade Jurídica," *Revista Direito do Consumidor* 2 (1992).

³³ It is interesting to mention in this sense the statement made by Forgioni that "the rapidity with which the Brazilian judges, in particular those in the area of labour law, apply the doctrine of disregard of the legal entity causes great consternation among foreign investors." Forgioni, *supra* note 31.

³⁴ This is the case of all European countries after the implementation of the EU XII Directive.

companies lies in information and in self-protection through contract.³⁵ Assuming the free negotiation of risk among the contractual parties, for these scholars it is of fundamental importance in regulating SMC to create mechanisms to fully inform creditors of the increased risk that SMC raise so they can negotiate through contract the higher risk, requiring appropriate compensation, such as higher interest rates. Within this context legal systems may adopt a regulatory strategy based on disclosure rules and on the facilitation of contractual mechanisms.

3. Mandatory rules

Mandatory rules are the most common strategy adopted to protect SMC creditors. They mostly impose restrictions on the activities of the companies in order to compensate the disequilibrium created by the lack of a plurality of shareholders and interests within the company.³⁶ Mandatory rules are internal to the organizational structure of the company and, unlike the doctrine of corporate disregard, they represent an *ex ante* solution. As such they can protect creditors mainly by *preventing* the single member opportunistic behavior.³⁷

Unlike the other two strategies (corporate disregard doctrine and contractual self-protection) mandatory rules also play a key role in regulating the procedures for some company activities that must be adjusted due to the absence of a plurality of members. This is the case, for example, of the rule that requires decisions taken by the sole member to be recorded in writing, when acting in his capacity as a general meeting provided by the EU Directive. Examples include also the particular regulation of the operations between the single-member and the company, which are not prohibited, but need to be especially regulated and registered as discussed above.

Following the common understanding of the traditional company law doctrine on the importance of mandatory rules to regulate the specificities of SMC and compensate its higher risks to creditors, mandatory rules was the main strategy that the EU XII Directive adopted in the formal recognition of SMC.

Following the EU XII Directive, the mandatory rules regarding creditor protection, accompanied also by disclosure and contractual self-protection mechanisms, occupy a central position in the regulation of this new type of company also in Italy.³⁸

³⁵ See, e.g., Posner, *supra* note 7.

³⁶ See Angelici, *supra* note 5.

³⁷ Filho, *supra* note 1.

³⁸ See legislative decree n. 88/1993, legislative decree n. 6/2003 and Italian civil code.

The same central role of the rules regarding creditor protection cannot be seen in the recent legislation adopted in Brazil to regulate the EIRELI.

II. THE REGULATION OF THE PROBLEM: BRAZIL VERSUS ITALY

A. *Comparing the Brazilian and the Italian regulations on SMC*

The Italian legal system is a good basis for comparison for the analysis of the new Brazilian law on the EIRELI, especially in relation to the regulation of creditor protection.

First of all, being part of the EU, the study of the Italian legal system allows the analysis not only of one individual country's legal system, but also of EU regulation, and in particular, of the EU XII Directive. While many European countries, such as Germany, France, Denmark, Belgium, the Netherlands and Portugal,³⁹ had individually developed an instrument to limit the liability of the single entrepreneurs before the EU XII Directive, Italy's formal recognition came only after the imposition of the EU legislator. Therefore, the Italian law on single-member companies was significantly influenced by the EU XII Directive and constitutes an interesting example of its implementation.

One of the most interesting aspects of the Italian legislation is the rules on creditor protection. The Italian legislator adopted all the creditor protection provisions in the EU XII Directive, not only the mandatory ones, but also all those that were optional or that were simply suggestions. It is possible, therefore, to analyze practically all the instruments proposed by the EU regarding the protection of SMC's creditors.

Secondly, this "rigorous approach"—i.e., the adoption of a large number of creditor protection devices, undertaken by the Italian legislator in the implementation of the EU XII Directive—reveals the traditional and long lasting "mistrust" of this legal system towards the limitation of the liability of the single-entrepreneur.⁴⁰ Such mistrust and resistance in accepting a single-member company with limited liability can be explained by the strong influence of contract theory in this company-law system.⁴¹ This theory has among its main characteristics the conception of the company as a contract and the complete identification of the company's interests and objectives with

³⁹ For an overview regarding the discipline of single-member companies in Europe before the XII Directive, see Weigman, *supra* note 5. For the French experience see Barbara De Donno Sforza, *Le Società Unipersonali nell'Esperienza Francese e Comunitaria: Un'Analisi Comparatistica* (Milano: Giuffrè, 2001).

⁴⁰ Sforza, *supra* note 39.

⁴¹ Roberto Rosapepe, "Società Unipersonale," in *Studi in Onore di Modestino Acone* (Napoli: Jovene Editore, 2010).

those of the shareholder.⁴² According to contract theory when the plurality of shareholders disappears, the rights and obligations between the shareholder and the company which guarantees the separation of assets and justifies the limitation of the liability also disappear.⁴³ As a consequence this theory makes an indissoluble connection between SMC and unlimited liability.

In both Italy and Brazil, contract theory was strongly developed, both in the doctrine and in the legislation. This is a significant aspect, linking the Italian and the Brazilian legal systems. This strong development influenced the acceptance of a company formed by only one member and provided with limited liability. It also justifies why, despite the development of a vast number of *de facto* single-member companies, both in Italy and in Brazil there was a strong reluctance to recognize a legal instrument capable of limiting the liability of the single entrepreneur in particular under the corporate form.

Once Italy recognized the SMC the attachment of this legal system to the contractual theory led to a rigorous approach regarding the adoption of several rules to protect creditors. The same, however, did not happen in Brazil. Despite the similar background as regards the development of contract theory, the Brazilian legislator undertook a very different approach in regulating the SMC and, in particular, the protection of SMC's creditors.

B. The choices made by the Italian legislator (within the European context)

Italy recognized the single-member limited liability company in 1993, implementing the EU XII Directive through the legislative decree n. 88/1993. This legislation was successively modified by the legislative decree n. 6/2003, which provided a broad reform of corporate-law.⁴⁴

The Italian legislature opted not to create a new and *ad hoc* set of rules for the single-member company. Instead, the Italian legislature decided to utilize and integrate the traditional and already existing rules of the *società a responsabilità limitata* (and successively, also of the *società per azioni*) in the situations considered relevant as a result of the reduction of the shareholders to just one and the higher risks that such reduction could cause to creditors.⁴⁵

⁴² For an in depth view on contract theory and its influence on the acceptance of single-member companies, see Filho, *supra* note 1.

⁴³ *Id.*

⁴⁴ Before this period, despite the large number of *de facto* single-member companies, and the great debate surrounding this in both the doctrine and jurisprudence, the concentration of the shares of a company in the hands of only one person was sanctioned, with the personal liability of the single member for the company's debts in case of insolvency, as stipulated by art. 2362 of the civil code.

⁴⁵ Marco Saverio Spolidoro, "Riflessioni Sulla Srl Unipersonale Con Unico Socio Illimitatamente Responsabile Per Le Obbligazioni Sociali", *Giurisprudenza Commerciale* 20, no. 4 (1993).

Following the EU XII Directive, the Italian legislature identified four main points, or relevant situations, on which to intervene with special regulation in order to guarantee adequate protection for creditors. These main points are (i) mandatory disclosure, (ii) documentation of the (contractual) operations between the sole member and the company, (iii) legal capital, and (iv) the shareholder's liability.⁴⁶

1. Mandatory disclosure

The EU XII Directive provides that "the fact that all the shares have come to be held by a single shareholder and the identity of the single member must be disclosed by an entry in a register accessible to the public." The Italian legislature implemented the EU requirement through the art. 2470 of the civil code, which requires that the fact that the company has only a single member and the identity of the single member are entered in the *Registro delle Imprese*.

The purpose of the art. 2470 is to allow those who come in contact with the company, in particular the creditors, to know that the company is a single-member limited liability company and who is its single member. Through this disclosure requirement creditors can be aware of the particular characteristics (in particular, the lack of plurality of members) and associated risks of this type of company and would be able, therefore to negotiate and protect themselves contractually.⁴⁷

The importance of disclosure requirements, as devices for creditor protection in the regulation of the SMC, has been particularly taken up by the Italian legislature. Italy has gone beyond the EU disclosure requirements and introduced an additional and innovative disclosure requirement. Art. 2250 of the Italian civil code requires documents, correspondence and website of the company to disclose that the company is formed by a single member.⁴⁸

2. Documentation of the (contractual) operations between the single member and the company

Another important protection of creditors in the Italian law regulating SMCs, and closely related to the disclosure requirements, is the special

⁴⁶ Italian Civil Code Art. 2470.

⁴⁷ Report to the legislative decree draft, art. 4.

⁴⁸ It is interesting to note that this norm was proposed by the European Parliament, but was not taken into consideration in the final version of the XII Directive. See Carlo Ibbà, *La Società a Responsabilità Limitata con un Solo Socio: Commento al D.lg. 3 Marzo 1993 n. 88*, ed. Carlo Angelici and Giorgio Marasà, *Quaderni di Diritto Commerciale Europeo* (Torino: Giappichelli, 1996); Spolidoro, *supra* note 7.

regulation of the contractual operations between the sole member and the company.

Although SMCs have an internal corporate structure—represented by a general meeting and an administrative body—like in any other company, it is evident that the existence of a single member reduces the dialectic between these two organs responsible for the main decisions and administration of the company.⁴⁹ Being aware of the greater influence and domination of the single-member over the company administrative bodies both the European and the Italian legislature provide for a special regulation of the contractual operations between the sole member (as a private contractor) and the company. The aim of this special regulation is to guaranteeing a greater transparency among these contractual relationships, avoid the opportunistic behavior of the single-member and as such offer a greater protection to SMC creditors.⁵⁰

Both legislatures did not prohibit the contractual relationships between the single member and the company. The single member, as a private person, can buy, sell, rent, etc. something to or from the SMC. Nevertheless the legislatures recognize that, due to the domination of the single-member over the company, these economic operations present a higher risk to creditor and must, therefore, be carefully regulated and documented.⁵¹

Art. 5 of the EU XII Directive states that, “the contract among the sole member and his company as represented by him shall be recorded in minutes or drawn up in writing.”⁵² Member States may choose to attenuate this provision and, according to the EU XII Directive need not apply this provision “in the case of current operations concluded under normal conditions.”⁵³

The Italian legislature did not adopt the choice offered by the European legislator to attenuate the norm and went also beyond the EU XII Directive. The Italian provision states that not only the contracts between the sole member and the company, but any economic operations (including non-contractual ones) concluded to benefit the single member, shall be recorded in minutes or drawn up in writing.⁵⁴ As a result all these operations (which include, for example, unilateral acts or contracts in which the single-member is not a part, but benefits from it) can be claimed against creditors only and exclusively if properly documented.⁵⁵

The Italian law does not require that the operation is concluded by the single member itself, as representative of the company, as does the EU XII

⁴⁹ Giovanni Cabras, “Le Società Unipersonali”, *Giustizia Civile*, 2 (1994).

⁵⁰ *Id.*; Giovanna Scognamiglio, “La Disciplina della S.r.l. Unipersonale: Profili Ricostruttivi,” *Giurisprudenza Commerciale* 21, no. 2 (1994).

⁵¹ Scognamiglio, *supra* note 50. *See also* Ibba, *supra* note 48.

⁵² EU XII Directive Art. 5 (December 21, 1989).

⁵³ *Id.*

⁵⁴ Italian Civil Code Art. 2478.

⁵⁵ Cabras, *supra* note 49.

Directive. In the Italian legal system, it is enough that the operation, even if concluded by a third party (such as a director of the company), benefits the single member to trigger the requirement of recording it in minutes or drawing up it in writing the operations.⁵⁶

The justification provided by the Italian legislature is that through this norm they “ensure a more rigorous and protective regulation for third parties.”⁵⁷ As such, the economic interests of third parties, and, of the company’s creditors in the first place, are better guaranteed by the possibility of reconstructing, *a posteriori*, all the economic operations concluded between the company and the sole member, and not only the contractual ones.⁵⁸

The documentation requirement, although it may appear to be a mere formality, is, instead, an important strategy for the protection of creditors. This measure in fact touches upon one of the most problematic points of limited liability single-member companies, namely the mix, or confusion, between the company and the sole-member assets. Allowing the documentation and reconstruction of all the economic relations between the SMC and single-member can be particularly effective in preventing the confusion between these two entities’ assets and in avoiding the single-member opportunistic behavior.⁵⁹

Furthermore, unlike the disclosure and contractual self-protection mechanisms the documentation requirement can be especially efficient especially in the protection of the category of small creditors which do not have the capacity to protect themselves contractually.⁶⁰

Nevertheless, despite both the EU and the Italian legislature recognized the relevance of the documentation of the contractual operations between the sole member and the company as an important legal instrument to protect SMC’s creditor, the Brazilian legislature did not.

3. Legal capital

The EU XII Directive does not impose any specific obligation regarding the capital of the SMC, but provides only that, “Member States are free to lay down rules to cover the risks that single-member companies may present as a consequence of having single members, particularly to ensure that the subscribed capital is paid.”⁶¹

This provision is justified given that Member States already had different rules relating to legal capital, including rules to ensure the payment of the

⁵⁶ See *id.*; Scognamiglio, *supra* note 50; Ibba, *supra* note 48.

⁵⁷ Report to the legislative decree draft.

⁵⁸ See Cabras, *supra* note 49; Scognamiglio, *supra* note 50; Ibba, *supra* note 48.

⁵⁹ Angelici, *supra* note 5.

⁶⁰ See Sforza, *supra* note 39.

⁶¹ EU XII Directive.

subscribed capital.⁶² It also demonstrates the awareness of the EU of the increased risks of single-member companies.

The Italian legislature followed the EU XII Directive by adopting a capital subscription rule.⁶³ Art. 2464 of the civil code provides that in the case that the company is formed by only one member, as well as in the case that all its shares come to be held by a single person, the single member is liable for the full payment of the subscribed capital, in cash, at the moment of subscription, or after 90 days in the latter case.⁶⁴ The civil code reform introduced a new paragraph to art. 2464, inspired by the German legislation, which allows for the payment to be replaced by an insurance policy or bank guarantee. Nevertheless, the characteristics of this insurance policy or bank guarantees should be determined by a new decree. As this decree has not yet been issued, the doctrine affirms that this new provision is not yet operational.⁶⁵

According to art. 2481-bis of civil code, the same rule applies to capital increases carried out in the period in which the company is formed by a single member.

The rules aim to ensure that the capital subscription is carried out both integrally and effectively and demonstrate the importance that the Italian legal system attributes to capital as a means of protecting creditors.

On the one hand the justification for these rules can be found in the aim to offer a greater guarantee to creditors. On the other hand it can be found in the legislature's suspicion about the possibility that the single member could influence the calling-in of the remaining contributions due to the lack of control of other shareholders and its domination over the company governing bodies.⁶⁶

As the single member has, as already discussed, absolute control over the company governing bodies, how and when to pay the subscribed capital would depend exclusively on the single-member's will. As such the company could be left, for a long period, without the complete payment of the legal capital, thereby decreasing the creditor's guarantees represented by the company's legal capital.⁶⁷

⁶² This was the case, for example, of Germany and France. See Elisabetta Sorci & Alberto Stagno D'alcontres, "Società Unipersonale a Responsabilità Limitata", *Enciclopedia del Diritto* 6, Aggiornamento (2002).

⁶³ Legislative decree n. 88/1993.

⁶⁴ In the case of contributions in kind and credits from the sole shareholder, the general rules of the articles 2464 and 2465 of the civil code applies. See Pietro Masi, "Commento all'Art. 2464" in *Società di Capitali*, ed. Giuberto Niccolini and Alberto Stagno D'alcontres (Napoli: Jovene, 2004).

⁶⁵ See Rosapepe, *supra* note 41; Sorci & Stagno D'alcontres, *supra* note 62.

⁶⁶ Angelici, *supra* note 5.

⁶⁷ See Ibba, *supra* note 48; Sforza, *supra* note 39; Fabrizio Kustermann, "Osservazioni sulla S.r.l. Unipersonale Italiana", *Le Società* 6 (1993).

The importance of this rule within the Italian legal system is such that, as discussed below, the noncompliance with the art. 2464 of civil code constitutes one of the two causes for the SMC loss of the benefit of limited liability.⁶⁸

4. Liability

The Italian legal system's distrust regarding SMC can still be observed in the new law and, in particular, in the great number of exceptions that the legislature provided for the limitation of the liability of the single member.

Legislative decree n. 88/1993 provided four exceptions to single-member limited liability.⁶⁹ According to this legislative decree and the previous art. 2475-bis, the single member would be personally liable for the company's debts in case of bankruptcy if (i) the single member was a legal person, (ii) the single member was also the single member of another company, (iii) the single member did not comply with the special rules on capital subscription, and (iv) the single member did not observe the specific disclosure requirements.⁷⁰

With the law's reform, and recognition also of the single-member joint stock company, the first two exceptions were eliminated. These exceptions were designed to limit the use of single-member companies for small businesses and prevent its use as an organizational instrument for corporate groups. The possibility of using SMC as an organizational instrument for corporate groups, however, was recognized by the law's reform.⁷¹

The other two exceptions to the limited-liability principle (i.e. non-compliance with the capital subscription and disclosure requirements) remained. These exceptions formulated by the Italian legislature have no precedent either in the EU XII Directive, or in other Member States' legislation.⁷² The justification for these exceptions, which have been the object of criticism and controversy,⁷³ is found in the general provision of the EU XII Directive, which states that the Member States are free to lay down rules to cover the risks that single-member companies may present.⁷⁴ According to the Italian legislature, therefore, these increased risks emerge from non-compliance with the requirement of full payment in cash of the subscribed

⁶⁸ Italian Civil Code Art. 2462.

⁶⁹ Legislative decree n. 88/1993.

⁷⁰ Legislative decree n. 88/1993 and previous art. 2475-bis of Italian Civil Code.

⁷¹ This possibility of limiting the use of SMC to small business purpose was in line with the EU XII Directive. Art. 2 of the XII Directive, in fact, provided that "Member States may, pending coordination of national laws relating to groups, lay down special provisions or sanctions for cases where: (a) a natural person is sole member of several companies; (b) a single-member company or any other legal person is the sole member of a company."

⁷² Legislative decree n. 88/1993.

⁷³ See *Ibba*, *supra* note 48; *Sforza*, *supra* note 39; *Angelici*, *supra* note 5.

⁷⁴ Report to the legislative decree draft.

capital as established in art. 2464 of the civil code and non-compliance with the mandatory disclosure requirements of art. 2470 c.c.

Another innovative rule of the Italian legal system, without precedent, either in the EU Directive, or in the other Member States' legislations, regards the liability of the company's founder for transactions carried out before the registration of the company.

The Italian legislature has decided to increase, in the case of single-member companies, the category of persons liable for the operations carried out in the name of the company before its registration.

The current art. 2331 c.c., provides that for transactions carried out in the name of, and on behalf of, the company prior to its registration, the single member is jointly and unlimitedly responsible, together with the persons who have effectively performed the transaction, towards the creditors. In 2003 the legislative decree n. 6/2003 added a similar provision for limited liability companies with more than one member.

Despite the great discussion and criticism that followed the art. 2331,⁷⁵ the Italian legislature again finds its justification in EU XII Directive provision, which, as previously mentioned, allows the Member States to create special rules to deal with the risks that the single-member companies may present.⁷⁶ This rule reaffirms the great sensibility of the Italian legislature in ensuring appropriate protection for creditors in the regulation of single-member companies.

C. Remarks on the choices made by the Italian legislator (within the European context)

It is possible to affirm that both the Italian and the European legal systems have given great importance to the provision of special regulations for the protection of creditors when regulating single-member companies.

The major risks that this form of company presents are, in fact, seriously taken into consideration first by the EU Directive and, with particular care, by the Italian one. This, in fact, did not present an obstacle to their recognition of the single-member company with limited liability, but made them conscious of the fact that special rules are needed to compensate these major risks and the particularities of this new type of business organization.

⁷⁵ See Sforza, *supra* note 39; Ilaria Chieffi, *La Società Unipersonale a Responsabilità Limitata* (Torino: Giappichelli, 1996); Ibba, *supra* note 48; Carlo Ibba, "Srl. Unipersonale e Responsabilità del Fondatore: Dalla Giurisprudenza Tedesca alla Legge Italiana", *Giurisprudenza Commerciale* 23, 4 (1996); Rosapepe, *supra* note 41; Sorci & Stagno D'alcontres, *supra* note 62; Carlo Angelici, *Società Prima dell'Iscrizione e Responsabilità di "Coloro che Hanno Agito"*: *Giurisprudenza Tedesca e Diritto Italiano*, ed. Bernardino Libonati and Paolo Ferro-Luzzi, Quaderni Romani di Diritto Commerciali (Milano: Giuffrè, 1998).

⁷⁶ Report to the legislative decree draft.

In both cases the rules provided were based not only on disclosure requirements—which would mostly allow creditors to be aware of the major risks and to protect themselves contractually—but are also substantive mandatory rules which aim to prevent single-member opportunistic behavior, the confusion of assets and also to regulate other practical aspects that a single-member company may require.

D. *The choices made by the Brazilian legislature*

1. Background

The Brazilian and the Italian company-law legal systems share important similarities, in particular regarding the long-standing distrust of an instrument limiting the liability of the single entrepreneur, as well as the strong influence of contract theory, which, for a long time, also justified the resistance of both legal systems to accepting single-member companies. Nevertheless the Brazilian and the Italian legislatures made very different choices for the regulation of SMC—or in the Brazilian case single enterprise—in particular regarding the protection of creditors.

In recent years, there had been several drafts of legislation aimed at introducing an instrument to limit the liability of the single entrepreneur into the Brazilian legal system. The first legislative efforts towards the limitation of liability of the individual entrepreneur in Brazil date back to the 1940s. Several other draft laws followed, the most recent ones being draft law n. 2730/2003, draft law n. 3667/2004, draft law n. 4605/2009 and draft law n. 4.953/2009.

Most of these drafts, in particular the first ones, have only a few rules regarding the protection of creditors and, ignoring the vast relevant international and Brazilian company-law doctrine, seems not to take into serious consideration the need to regulate the specificities of this particular type of business organization.⁷⁷

This “superficiality” and, in particular, the small number of creditor protection rules can clearly be seen in the first project submitted after the advent of the 2002 civil code (draft law n. 2730/2003). In this draft law the only rule provided with the aim of protecting creditors of the proposed *sociedade limitada unipessoal* (single-member private limited liability company) was a disclosure rule, which imposed that the corporate name should indicate that the company was formed of only one member. The other three paragraphs of this draft law said no more than that (i) the single-member

⁷⁷ It is important to mention in this regard the work of Salomão Filho, which treats in great depth and also through a comparative perspective the subject of the single member company. Filho, *supra* note 1.

company could be formed by a natural or by a legal person, (ii) that it could also be formed by concentration of the shares in the hands of a single shareholder, and (iii) that only the company's assets would be responsible for the company's debts.⁷⁸

The lack of concern regarding the provision of appropriate creditor protection rules can be observed also in the draft Law n. 3667/2004. This draft law provided only two rules to regulate the new SMC: (i) that the SMC can be formed and exist with only one member, who must be a natural person resident in Brazil, and (ii) that this new legal form could also be used for non-commercial purposes.⁷⁹

These draft laws demonstrate that the increased risks of the single-member companies, expressly recognized by the EU legislator, were not taken into serious consideration by the Brazilian legislature in attempting to adopt an instrument to limit the liability of a single entrepreneur.

In 2009, two other drafts were presented proposing the limitation of the liability of the single entrepreneur through non-corporate instruments: draft law n. 4953/2009 and draft law n. 4605/2009. These draft laws represent a step forward as regards the regulation of SMC in Brazil. Nevertheless a closer look reveals, especially in the case of the approved draft law n. 4605/2009, that although it present more rules, these rules are still not sufficient or adequate to regulate SMC and, in particular, to protect its creditors from the higher risks this type of business organization imposes.

The draft law n. 4953/2009 was significantly more complete and detailed than any other draft legislation previously presented in Brazil and provided several rules regarding the regulation of the specificities of this new type of business organization, and many regarding creditor protection. The draft law n. 4605/2009 was, instead, much more succinct, with only three articles and a few rules on creditor protection. These rules included mandatory disclosure and restrictions to the limited liability of the single-member (successively vetoed as discussed further below).

The *Comissão de Constituição e Justiça e de Cidadania* (Commission on Constitution and Justice and Citizenship) of the Brazilian national congress, nevertheless, opted for the text of draft law n. 4605/2009.⁸⁰ The Commission made, however, two significant changes to the draft law. First, it chose to adopt the legal form and nomenclature of *Empresa Individual de*

⁷⁸ Draft law n. 2730/2003.

⁷⁹ It is very interesting to note in the case of draft law n. 3667/2004 that the argument explicitly used by the national congress to reject the project was incompatibility with the contract theory adopted by the Brazilian legal system through art. 981.

⁸⁰ Report of the Commission on Constitution and Justice and Citizenship.

Responsabilidade Limitada (EIRELI) or “limited liability single enterprise”.⁸¹ Secondly, it added a specific creditor protection rule regarding legal capital requirement, which is discussed further below.

In 2011 the draft law n. 4605/2009 was enacted and became the law n. 12441/2011 which introduced the EIRELI into the Brazilian legal system.⁸²

2. The draft law n. 4605/2009: main aims and the use of comparative law

As with the EU and the Italian legislation, among the main aims of the draft law n. 4605/2009 was to confront the problems of the *de facto* single-member company—widely present in Brazil—and to foster the development of small and medium-sized businesses.⁸³

The draft law expressly affirms that the absence of a proper legal instrument had led single entrepreneurs in Brazil to set up a vast number of *de facto* SMC with the only purpose of limiting their individual liability. The use of *de facto* SMC requires, according to the draft law n. 4605/2009, “exacerbated and unnecessary bureaucracy, plus additional administrative costs, especially in the case of micro, small and medium enterprises, and often also unnecessary litigation arising from disputes with the partner who has only insignificant participation in the company” and may also lead to the dissolution of healthy companies in the case of the death or withdrawal of the other shareholder(s).⁸⁴

The introduction of the EIRELI would therefore greatly contribute to the organization of small and medium enterprises and encourage the regularization of thousands of entrepreneurs, with positive effects on overall economic activity and tax revenue in Brazil.⁸⁵ Furthermore, the adoption of an instrument to limit the liability of the single entrepreneur would put Brazil in line with a large group of “first world countries” that had adopted SMCs.⁸⁶

The draft law explicitly refers to the use of comparative law (in particular of European countries) to assist the legislature in the development of proper regulation and to take the necessary care that this new form of business

⁸¹ This name and legal form was originally proposed by draft law n. 4953/2009. The Commission considered it “topologically better” than *Empreendimento Individual de Responsabilidade Limitada—ERLI*, proposed by draft law n. 4605/2009. *Id.*

⁸² It is interesting to note that the Commission considered all the rules proposed by the first draft law, including the creditor protection ones, merely “variations, just formally different and more detailed, of the civil code”—a consideration that I do not share. Report of the Commission on Constitution and Justice and Citizenship.

⁸³ Draft law n. 4605/2009.

⁸⁴ *Id.*

⁸⁵ *Id.* According to data provided by the Commission, in fact, small and medium enterprises represent around eighty percent of business organizations present in Brazil.

⁸⁶ Draft law n. 4605/2009.

organization requires.⁸⁷ As mentioned before, this proper regulation includes mainly the creditor protection rules.

Nevertheless, despite this affirmation, an analysis of both the draft law and the law n. 12441/20011 clearly shows that the Brazilian legislature did not take account of the European experience mentioned, neither regarding the legal form adopted nor, which is of particular concern, the regulation of creditor protection.⁸⁸

3. The Law n. 12.441/2011: strategies adopted to protect creditors under a comparative perspective

The Law n. 12.441/2011 provides only a few and controversial rules to protect the EIRELI creditors which were introduced in the new art. 980-A of the Brazilian civil code. They include (a) legal capital and (b) disclosure requirements. As already mentioned, the liability rule presented in the draft law was vetoed. These rules are discussed below.

a. Legal Capital

The *caput* of the new art. 980-A of the Brazilian civil code establishes two specific requirements regarding the capital of the EIRELI. These requirements were not part of the original draft law (Draft law n. 4605/2009),

⁸⁷ As affirmed by Estrada de Moraes—quoted in the draft law—with the adoption of SMCs by European countries like France, Spain, Portugal, Italy, Belgium, Netherlands, Germany and the U.K., as well as by Chile in South America, there would be no lack of comparative law references for the Brazilian legislature to consult in order to take the necessary care that this new form of business organization requires. *Id. See also Moraes, supra* note 3.

⁸⁸ One interesting aspect of law n. 12441/2012 that demonstrates its distance from the foreign experiences mentioned, including the Italian and European ones, regards the legal form adopted to limit the liability of the single entrepreneur. As already mentioned, the Brazilian legislature chose the wording “enterprise”, rather than company as suggested by the European Directive, or *Estabelecimento Individual* (Individual Establishment) as adopted in Portugal, as the most appropriate legal form to limit the liability of the single entrepreneur in Brazil. Brazil also attributed legal personality to the single enterprise by including it among the legal persons recognized by art. 44 of the Brazilian civil code. This choice has been severely criticized, as according to this legal system an enterprise is not a *subject* of law, but an *activity*. The subjects of law recognized by the Brazilian legal system in this case are entrepreneurs and the companies. The choice of the name “limited liability single-enterprise” and its recognition as a legal person represents, therefore, a significant theoretical imprecision. As Verçosa affirms, “In Brazil, through another autochthonous and unfocused invention, we remained halfway between the Portuguese model and the single-member company. The EIRELI is neither one thing nor the other: it is not a company, but, instead, an atypical entity owned by a single person.” Haroldo Malheiros Duclerc Verçosa, “A Empresa Individual de Responsabilidade Limitada,” *Migalhas* (2013). The theoretical imprecision is also clear within the draft law that provides that it has as its aims to “legally institute the ‘single-member company’ known in the doctrine also as ‘limited liability single-member enterprise’”. Draft law n. 4605/2009.

which provided no rule regarding the capital of an EIRELI. They were, instead, proposed by the *Comissão de Constituição e Justiça e de Cidadania* (Commission on Constitution and Justice and Citizenship) in its analysis of the draft prior to its approval.

The first of these requirements concerns the payment of the subscribed capital of the EIRELI.⁸⁹ With a rule that has no precedent in Brazilian company legislation the legislature requires that subscribed capital of the EIRELI must be completely paid up at the moment of the constitution of the enterprise.⁹⁰ This provision, which is line with the Italian regulation, demonstrates the intent of the legislator to guarantee a proper subscription of capital in the case of the EIRELI due to, as already mentioned, the domination of the single-member over the company's administrative bodies and the possibility of choosing on a discretionary basis the conditions and time for the payment of the subscribed capital.

Art. 980-A of the civil code, however, does not specify the terms of the payment of the subscribed capital. In most legal systems, including the Italian one, specific rules provide for the type⁹¹ of payment, the possibility of presenting warranties, the liability of the single entrepreneur in the case of breach of payment, and whether the rules also apply in the case of an increase in capital.⁹² The Brazilian law, instead, gives no clarification in regard to these questions. It only provides the application of the same conditions as provided by the general rules on capital subscription for the *sociedade limitada*.⁹³

This lack of specific subscribed capital rules for SMCs causes concerns, especially due to the importance that the new law gave, with no antecedents in the Brazilian legal system, to the minimum capital of the EIRELI. In fact, the second and most controversial requirement for the EIRELI is the minimum capital requirement of one hundred times the minimum wage.⁹⁴

The choice made by the Brazilian legislature imposing a minimum capital for the EIRELI represents a significant rupture with the traditional position of the Brazilian legal system.

Despite controversies, most European countries traditionally recognize legal capital as an important instrument to protect creditors and as a payoff for

⁸⁹ Brazilian civil code Art. 980-A.

⁹⁰ *Id.*

⁹¹ In cash or also in kind, and in the latter case specific rules regarding its evaluation, liability etc.

⁹² It is interesting to note that the previously mentioned draft law n.4.953/2009 provided a series of interesting specifications in this regard, which included that the subscribed capital could be paid by cash or in kind, and also unlimited liability of the single member for 5 years for default in payment. Draft law n. 4.953/2009.

⁹³ Brazilian Civil Code Art. 980-A.

⁹⁴ Currently officially set by the Brazilian government at R\$ 678,00.

limited liability.⁹⁵ As such these countries impose minimum capital rules for all types of companies with limited liability. In the SMC, as already mentioned, although the EU Directive did not provide specific rules, it allowed member States to choose, according to their own legal systems, the most appropriate rules on legal capital.

This, however, is not the case of Brazil. Following a system similar to the North-American one, Brazil does not require a minimum capital for the constitution of practically no type of limited liability companies.⁹⁶ It did, however, for the EIRELI.

The minimum capital requirement for the EIRELI can, and has been, severely criticized in Brazil for two main reasons.⁹⁷

Firstly, the minimum capital of one hundred times the minimum wage (currently around twenty five thousand Euros) is too high considering the economic reality of small enterprises in Brazil.⁹⁸ According to national scholars, it exceeds the value of the assets employed in the organization of most small businesses in Brazil.⁹⁹

Secondly, the minimum capital rule as designed by the Brazilian legislature is unsuitable in a legal system that does not traditionally require minimum capital for other types of business organization. Entrepreneurs do not have to invest a minimum capital to constitute any other type of company, but must to do it only in the EIRELI case.¹⁰⁰ In this context the Brazilian

⁹⁵ The use of legal capital rules as an effective instrument for the protection of corporate creditors is part of one of the biggest debates in corporate law, and that opposite positions can be found among legislatures and most prominent doctrines. For an overview of the debate see, among many, Francesco Denozza, "A che Serve il Capitale? (Piccole Glosse a L.Enriques – J.R. Macey, Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules)," *Giurisprudenza Commerciale* 1 (2002); John Armour, *Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law?*, 63 *Modern L. Rev.* (2000); Luca Enriques & Jonathan Macey, "Capitale Sociale, Informazione Contabile e Sistema del Netto: Una Risposta a Francesco Denozza" *Giurisprudenza Commerciale* 1 (2005); Armour, *supra* note 25; Peter O. Müllbert & Max Birke, "Legal Capital: Is There a Case against the European Legal Capital Rules?," *id.* 3, no. 4 (2002); Wolfgang Schön, "The Future of Legal Capital," *id.* 5, no. 3 (2004); Enriques & Macey, *supra* note 7.

⁹⁶ There are a few exceptions regarding companies that exercise specific activities that are subject to specific authorization, such as, financial intermediation, insurance and private pension funds.

⁹⁷ See Verçosa, *supra* note 88; Cássio Cavalli, "Projeto Reduz Capital Mínimo Para Eireli" (Jus Brasil, 2012).

⁹⁸ In Portugal, for example, the amount of the minimum capital was fixed at only five thousand Euros, while in Italy at ten thousand Euros. See Verçosa, *supra* note 88.

⁹⁹ Cavalli, *supra* note 97; Verçosa, *supra* note 88. Recognizing this limitation, although the law has been in effect for a short time, a draft law was presented during 2012 to reduce the minimum capital of the EIRELI from one hundred to fifty times the minimum wage, with the aim of making the EIRELI more attractive to small firms. Draft law n. 2468/ 2011.

¹⁰⁰ Other problems regarding the rules on capital as provided by the Brazilian legislator regards tying the amount of minimum capital to the value of the national minimum wage. This, in fact, goes against the Brazilian Constitution, which explicitly forbids such types of bond to the national

legislature adopted a rule that fits in the context of other legal systems which traditionally adopt legal capital rules for all types of limited liability companies, but that does not fit in the Brazilian context.

As a result, the imposition of a minimum capital requirement, especially of a high value and only and exclusively for the EIRELI, makes it a non-competitive legal form of business organization. Single entrepreneurs may find it more advantageous to continue to form *de facto* SMC to get around the minimum capital requirements, especially in the case of a large number of single entrepreneurs whose businesses do not require an initial investment of as much as one hundred times the minimum wage.

This may determine, therefore, the ineffectiveness of the new law which, as mentioned before, has among its aims that of providing a proper instrument for the limitation of the liability of the single entrepreneur, eradicating, therefore, the use of *de facto* single-member companies for this purpose and stimulating the development of new small and medium businesses in the country.

b. Mandatory Disclosure

The second device for creditor protection developed by the Brazilian legislature is a mandatory disclosure rule.¹⁰¹ According to the art. 980-A of the civil code, the *nome empresarial* (business name) of a single-member limited liability enterprise must include the expression “EIRELI” after the *firma* or *denominação social* (corporate name).¹⁰² This rule, along the lines of most disclosure requirements, is very much connected with the concept of giving the creditors the appropriate information in order that they be aware of, and that they protect themselves contractually against, the increased risks of the single-member enterprise.

Compared to the Italian system, a similar rule cannot be found neither in the Italian legislation, nor in that of the EU. In the Italian jurisdiction there has been much debate regarding the necessity of including within the *denominazione sociale* (corporate name) of the single-member company the

minimum wage (art. 7, IV of the Brazilian constitution). In this sense, an *Ação Direta de Inconstitucionalidade* (Direct Action for Unconstitutionality) has been recently proposed by the *Partido Popular Socialista* claiming the unconstitutionality of the rule, both regarding art. 7, IV, of the constitution, and also regarding the constitutional principle of free initiative as, according to the PPS, the high value of the minimum capital represents a “clear restriction to the possibility of small entrepreneurs to found limited-liability single enterprises”.

¹⁰¹ Brazilian Civil Code Art. 980-A.

¹⁰² *Id.*

information that it is formed of only one member.¹⁰³ The Italian legislature was clear regarding the insertion of this information in the documents, correspondence and website of the company, but did not provide any specific rule regarding the *denominazione sociale* of the single member company. In this regard, a court has decided that the requirement to include a single-member designation within the company name is illegitimate.¹⁰⁴

Nevertheless, disclosure rules, despite their importance, are not considered sufficient instruments alone to deal with the increased risks of single-member companies.¹⁰⁵ This is especially clear in the case of small creditors due to their limited possibility of negotiating risks and imposing further guarantees through contract.¹⁰⁶ Most legal systems, including the European ones, do not rely on this regulatory strategy alone in the regulation of single-member forms of business organization for purposes of creditor protection.¹⁰⁷

c. Liability

Law n. 12441/2011 provides no explicit rule regarding the liability of the single entrepreneur.¹⁰⁸ However, the draft law prior to its approval provided a specific rule regarding single member liability, which was vetoed by the Brazilian President of the Republic. The veto of this specific rule, and especially the justification used for it, is very meaningful. It demonstrates the (over-) attachment of this legal system to the application of the corporate disregard doctrine, and its clear intent to maintain the application of this theory also in the case of the EIRELI.

¹⁰³ Among the authors that are contrary to this inclusion, are Ibba, *supra* note 48; Angelici, *supra* note 75; Marco Saverio Spolidoro, “La Legge sulla S.r.l. Unipersonale”, *Rivista delle Società* 38 (1993). In favor, is Luca Amadei, “Cause di Perdita del Beneficio della Responsabilità Limitata”, *Le Società* 12, no. 9 (1993).

¹⁰⁴ Sentence of the Tribunale di Napoli in Loredana Nazzicone, “Denominazione Sociale della S.r.l. Unipersonale,” *Le Società* 18, no. 5 (1999). One of the main problems regarding the insertion of the expression “unipersonale” in the corporate name of the single-member company in the Italian system is linked with the possibility of the single-member company becoming a company with more shareholders, at a successive moment and vice versa—a problem that does not exist in the specific case of the Brazilian single enterprise, as it would have to completely change its legal form to become a private limited liability company. According to the Tribunal of Naples, in fact, this indication would generate the false belief that the company cannot have other shareholders. Furthermore, it would require excessive bureaucracy (a decision of the extraordinary shareholders meeting) in order to change the *denominazione sociale* and therefore exclude or include the indication that the company is formed of only one member.

¹⁰⁵ See Filho, *supra* note 1.

¹⁰⁶ See Swensson, *supra* note 25.

¹⁰⁷ See Filho, *supra* note 1.

¹⁰⁸ Law n. 12441/2011.

The original version of the draft law provided that “only the assets of the enterprise are liable for the debts of the EIRELI, and shall not be confused in any situation with the assets of the natural person that owns it, in accordance with the annual asset declaration submitted to the competent authority.”¹⁰⁹ This rule contained the main principle of this new legal instrument, i.e. the limitation of the liability of the single entrepreneur and the separation between the assets of the EIRELI and of the entrepreneur.¹¹⁰

The Brazilian President excluded the entire paragraph, claiming that

despite the merits of the proposal, the device contains the expression ‘in any situation’, which can lead to divergences regarding the application of the general hypotheses of corporate disregard, provided for by art. 50 of the civil code. Thus, and according to paragraph 6 of the law, the rules of the *sociedade limitada* will be applied to the EIRELI, including those regarding the separation of assets.¹¹¹

As a result the EIRELI was left with no explicit rule establishing the limited liability of the single entrepreneur or that the personal assets of the entrepreneur should not be confused with the assets of the EIRELI. Although these rules apply to the EIRELI because of the supplementary application of the general rules on limited liability companies, it would be more appropriate to have it explicitly as the confusion of assets is, as already discussed, the main problem of SMCs.

Furthermore, as already mentioned, the lack of separation of assets is one of the causes explicitly provided in art. 50 of civil code for the application of the doctrine of corporate disregard.¹¹² Therefore, even with the original version of paragraph four of art. 980-A, it would still be possible to apply art. 50 to the EIRELI in cases in which there were abuse of legal personality, and, especially, in cases of confusion of assets.¹¹³

The great concern that the veto of this paragraph causes is that it may give rise to a disproportionate application of corporate disregard doctrine, as has frequently occurred in Brazil leading to a high degree of legal uncertainty in the Brazilian corporate system. In the case of the EIRELI, this could have as a consequence the rise of uncertainty regarding the real limitation of the

¹⁰⁹ Draft law n. 4605/2009.

¹¹⁰ Article 1, § 3º, draft law n. 4605/2009.

¹¹¹ “Mensagem de Veto n. 259”, Diário Oficial da União, 12 July 2011.

¹¹² Brazilian Civil Code Art. 50.

¹¹³ With the same opinion, see Verçosa, *supra* note 88.

liability of the single entrepreneur which, as already mentioned, should be exactly the main characteristic of this legal instrument.

Furthermore, the great reliance of the Brazilian legal system on corporate disregard doctrine seems to act as a justification for the legislature for the lack of concern in providing other rules, in particular, mandatory rules, to protect EIRELI creditors. However, although the disregard doctrine can be an important *complementary* instrument in creditor protection in single-member companies, providing an *ex post* solutions in those cases in which the *ex ante* one did not work, it cannot be accepted as a justification for the lack of other types of rules on this issue. As recognized by the EU XII Directive and most of the traditional company law doctrine, including the Brazilian one, the creation of specific norms, internal to corporate organization, is very important and necessary for single-member companies because of their particular characteristics and well-known riskiness. As already mentioned, they play a fundamental rule in preventing single-member opportunistic behavior, as well as in regulating the procedures for some company activities that must be adjusted due to the absence of a plurality of members.

CONCLUSION

While recognizing the important step taken by the new Brazilian law in finally developing a formal instrument to limit the liability of the single entrepreneur with the aim of developing small and medium-sized businesses in Brazil and to regulate and confront the problems of the *de facto* single-member company, the incompleteness and superficiality of the new law are serious causes for concern.

From a comparative analysis, this paper demonstrates that the long-lasting “mistrust” of the Brazilian legal system of accepting the single-member company did not lead, as in the case of Italy, to a detailed regulation protecting the creditor, as one could expect. Far from it.

The importance of creditor protection rules to deal with the SMC main problem, namely, the higher possibility of mixing the company’s and the single-member assets, and to pay off the imbalance formed by the lack of plurality of shareholders was recognized by the European legislature and, even more rigorously, by the Italian one. The key role of creditor’s protection rules in regulating SMC is also largely recognized by the most traditional international company law doctrine, including the Brazilian one, which has discussed for decades the subject in the country.

Nevertheless, from the analysis of this paper, the importance of SMC creditor protection rules seems to be, in practice, ignored by the Brazilian legislature in the Law n. 12441/2011.

As a result we can conclude by affirming that the Brazilian legislature has lost an important opportunity to provide a proper and complete regulation for this new legal instrument represented by the EIRELI. Disregarding most comparative experience, an important part of the national doctrine and also some fundamental characteristics of its own legal system, it has created a law

full of gaps and uncertainty where the rules on creditor protection, despite their importance, have very little space.

The first main consequence of these several weakness of this new law is that the EIRELI's creditors cannot count on appropriate *ex ante* protection capable of preventing single-member opportunistic behavior. Practically, creditors will only be able to count on the application of the doctrine of corporate disregard, after the damage has already occurred, and with all the consequences that the vast application of this doctrine can bring to the company law systems in terms of legal uncertainty. A second and fundamental consequence of the inadequacy of this new law is that it is likely that the EIRELI will be an instrument unable to achieve the important aims for which it was conceived, i.e., to provide an instrument capable of limiting the liability of the single-entrepreneur and fostering the development of small and medium-sized business in Brazil, and eradicating the use of *de facto* SMC. With all the gaps, uncertainties, and, in particular, inadequate minimum capital requirements of the Law n. 12441/2011, single-entrepreneurs may still prefer to form *de facto* SMCs, despite of all of its problems, instead of adopting the EIRELI.

THE GERMAN BANK GUARANTEE: LESSONS TO BE DRAWN
FOR CHINA

Dr. Jens Nielsen
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INTRODUCTION

NOMENCLATURE

England courts in particular use the term guarantee to describe many different instruments. We will refer to guarantees as payment undertakings that are independent from an underlying transaction. Payment undertakings that are dependent will be called suretyship.

British courts distinguish guarantee and suretyship—as we defined it above—by asking whether the payment obligation is *primary* or *secondary*. A primary obligation is synonymous with an independent promise to pay.

The parties will be called:

- *guarantor*, i.e., the financial institution that issues the guarantee,
- *beneficiary*, i.e., the (legal) person that is entitled to payment upon presentation of a complying demand,
- *applicant* means the party who gives instructions to issue a guarantee.¹

An instrument that is comparable to a standby, i.e., it creates a primary liability² and is not subject to defenses that arise out of the relationship between the guarantor and the principal will be called *guarantee*. This decision is in contradiction to English courts that treat as guarantees instruments that are ancillary, i.e., the beneficiary's claim for payment can be defeated based on facts arising out of his relationship with the principal. In this analysis the latter of these instruments will be consistently and repetitively called *suretyship*. No substantive difference exists between a U.S. style standby and a guarantee.

¹ This nomenclature follows the ISP98.

² England and Wales High Court (Chancery Division) [2003] EWHC 762 (TCC).

I. BASIC PRINCIPLES

A. *Independent Payment obligation*

1. Historical background

The guarantee is an instrument that has not been codified in Germany or in many other countries. It has been recognized by courts all over the world as a consequence of the principle of freedom of contract.³

The essence of a bank-guarantee consists of the guarantor promising the beneficiary, independent of any underlying transaction, to pay in case a specified event does not occur or to cover the risk of a future damage.

Compared to a suretyship the bank-guarantee is not “accessorial”. This term as used in German jurisprudence means that the bank cannot refuse its obligation to pay the beneficiary based on the relationship between the bank and the applicant.⁴ This independence obligates a bank to fulfill its payment obligation even if the underlying transaction never materialized or was later extinguished. The exception to the independence is if the bank or applicant can prove that the beneficiary fraudulently demands payment.

The guarantor is responsible for all typical but also *atypical* accidents.⁵ Regardless of whether the obligation in the underlying transaction was not performed due to *force majeure* (earthquake, fire, high water), bankruptcy of suppliers, or reasons that were unpredictable or unimaginable for the applicant or outside his control, the guarantor remains liable for payment.

³ Chinese law e.g. recognizes this principle according to its Article 4 of the General Principles of Chinese Law (the “GPCL”) by emphasizing that, “Civil activities are voluntary.” GPCL art. 4 (1986) (China). “In civil activities, the principles of voluntariness, fairness, making compensation for equal value, honesty and credibility shall be observed.” *Id.*

⁴ German law states the principle of “accessory” in several articles: Section 767 of the German Civil Code (Bürgerliches Gesetzbuch) (the “BGB”), Extent of the suretyship debt: “(1) The currently applicable amount of the main obligation determines the duty of the surety.”; also Section 768 BGB Defenses of surety: “(1) The surety may assert the defenses to which the principal debtor is entitled. If the principal debtor dies, then the surety may not invoke the fact that the heir has only limited liability for the obligation. (2) The surety is not deprived of a defense by the fact that the principal debtor waives it.” The chapter of the German Civil Code has been attached as an appendix.

⁵ Friedrich von Westphalen, Martin Spitzer & Brigitta Jud, *Die Bankgarantie im internationalen Handelsverkehr*, RIW-Buch, 215 (Frankfurt am Main: Verl. Recht und Wirtschaft, 3rd ed. 2005), ISBN 978-3-8005-1221-8; Jens Nielsen, *Bankgarantien bei Außenhandelsgeschäften*, in: Herbert Schimansky et al., 2 (Bankrechts-Handbuch München: C.H. Beck, Vol. 2, 2007), ISBN 9783406542923; Johannes Carl Detloff Zahn, Dietmar Ehrlich & Gregor Haas, *Zahlung und Zahlungssicherung im Aussenhandel*, 472 (Berlin: de Gruyter, 8th ed. 2010), ISBN 3899496787.

2. Pay first, sue later

One of the typifying characteristics of a guarantee is that the beneficiary will be paid “on first demand.” If the guaranteed event has occurred the beneficiary is entitled to payment without the guarantor examining or approving the claim from the underlying transaction. Even if the guarantee requires presentation of further documents or statements, the decisive criterion of a bank guarantee is that the guarantor pays independently of the settlement of the obligations. This essence of the bank guarantee is epitomized by the axiom “Pay first, sue later.” If the parties litigate, the bank guarantee has failed since the beneficiary has not been able to timely obtain payment.

3. From cash deposit to bank guarantee

Historically, the bank guarantee has replaced cash deposits, where the applicant places cash or liquid securities at the disposal of the beneficiary. In a cash deposit situation, the beneficiary receives access to the deposit once he considers the guaranteed event to have occurred.⁶ The disadvantage for the applicant is the immediate decrease in liquidity or reduction of assets that can serve as collateral. The beneficiary on the other hand will only accept a bank guarantee if it is certain to satisfy his requirements for payment.⁷

The use of bank guarantees in international commerce cannot be analyzed in isolation since it is only one of a multitude of obligations in a typical transaction. Diluting the guarantee will affect other payment conditions as well. In the context of a construction contract the beneficiary will not make a down-payment if his claims under an advanced payment guarantee are shirked. Without a performance bond the buyer of a construction project will simply retain part of the purchase price. For this reason all well-intentioned attempts that limit the beneficiary’s claims for payment will fail.⁸

⁶ Stefan Arnold, *Die Bürgschaft auf erstes Anfordern im deutschen und englischen Recht*. Zugl.: Erlangen, Univ., Diss., 2007, Volume 196, Studien zum ausländischen und internationalen Privatrecht, (Tübingen: Mohr Siebeck, 2008), ISBN 3161495500, p. 11; also Nielsen, *supra* note 5, mn 4.

⁷ The independence of the guarantee combined with “pay on first demand” and “pay first, sue later” is referred to as the “liquidity function” of the guarantee. The guarantee’s objective is to substitute liquidity in the form of cash.

⁸ An example of buyers circumventing measures perceived as putting them at a disadvantage is England and Wales High Court (Chancery Division), *British Arab Commercial Bank PLC v. Bank of Communications & Commercial Bank of Syria*, [2011] EWHC 281. The Syrian beneficiary simply did not accept a guarantee from Bank of China but forced the Chinese contractor to provide the desired guarantee through an English bank. It can be assumed that the Syrian beneficiary did not analyze in detail Chinese law, however, the simple appearance of opacity suffices to shun laws perceived as being unfavorable. *Id.*

4. Who can issue guarantees

Payment obligations that are payable on first demand can be issued by banks or companies doing international business. The German Federal Supreme Court (Bundesgerichtshof) (the “BGH”) however has limited the capacity of individuals to become thusly obligated, basing its decision on the German law on terms and conditions (Gesetz zur Regelung des Rechts der Allgemeinen Geschäftsbedingungen) (the “AGBG”).⁹

Before the enactment of the AGBG, German courts had analyzed the fine print of terms and conditions based on principles of equity.¹⁰ The AGBG was intended to protect mainly consumers who cannot defend themselves against terms and conditions that were pre-formulated by corporations. To that end the AGBG classified clauses according to their risk for consumers, designating some clauses as void, others voidable, and authorized the courts to subject all clauses to a general review.¹¹

Outside the scope of the AGBG *anyone*, i.e., not only banks or merchants, can issue payment obligations that are payable on first demand.¹² The BGH however protects consumers who are inexperienced regarding payments on first demand by voiding their obligations.¹³ This protection only extends to first demand payment obligations that are included in a contract of adhesion (the AGBG applies to “terms and conditions”, the U.S. concept of contract of adhesion differs insofar as the decisive criterion is the “take it or leave it” and not the fact that the terms and conditions have been pre-formulated for a multitude of occasions). If these clauses are negotiated individually the BGH considers them valid. The criteria to invalidate a clause are:

⁹ AGBG: German law on trade terms, now codified in §§ 305–310 BGB. See Bürgerliches Gesetzbuch [BGB][Civil Code], July 7, 2007, §§ 305–310 (Ger).

¹⁰ Section 242 BGB is considered the statutory basis for equity in civil law transactions: “Performance in good faith. An obligor has a duty to perform according to the requirements of good faith, taking customary practice into consideration.” Bürgerliches Gesetzbuch [BGB][Civil Code], July 7, 2007, § 242 (Ger). This obligation seems to be equivalent to Article 3 of the Guaranty Law of the People’s Republic of China, (adopted at the 14th Meeting of the Standing Committee of the Eighth National People’s Congress on June 30, 1995 and promulgated by Order No. 50 of the President of the People’s Republic of China on June 30, 1995) (the “GLPLC”): “Article 3 Guarantee activities shall be in conformity to the principle of equality, voluntariness, fairness, honesty and trustworthiness. This law also applies to courier-guarantees,” whose plea for fairness mimics the German requirement of good faith. GLPLC art. 3 (1986) (China).

¹¹ Barbara Grunewald and Karl-Nikolaus Peifer, *Verbraucherschutz im Zivilrecht*, Springer-Lehrbuch, (Berlin and Heidelberg: Springer-Verlag Berlin Heidelberg, 2010), ISBN 3642144209, pp. 17 seq.

¹² Nielsen, *supra* note 5, at mn. 7.

¹³ This protection encompasses CEOs in case they issue guarantees on behalf of themselves and not the legal entity they represent. See BGH 92, 184; Wertpapier Mitteilungen (German legal magazine specializing in banking law) (“WM”) 99, 895, 899; WM 00, 692.

- Unilateral claim
- Clause not individually negotiated
- Risk of abuse
- Excessive collateralization.

B. *Direct and Indirect Guarantee*

1. Concept

An indirect guarantee¹⁴ is not a special type of guarantee. Rather, the guarantor issues through a secondary bank. The obligations of the secondary bank towards the beneficiary and the first bank towards the secondary bank are identical.

The issuance of indirect guarantees is the result of attempts to dilute the liquidity function of the guarantee. These attempts to weaken guarantees encompass well-meaning courts which are prone to quickly issue injunctions prohibiting payments to the beneficiary as well as reforms by law-makers aimed at reducing fraudulent demands.¹⁵

2. Complete transfer of risk

The indirect guarantee aims at replacing a law that the beneficiary considers unfavorable with a law the beneficiary likes. The domestic bank has to mandate a secondary bank to execute the guarantee promise. This usage of a secondary bank transfers the applicable law and any risk associated with the guarantee to a foreign jurisdiction. This transfer is intended to and actually has the following consequences:

- The guarantee of the secondary bank is subject to the law of the secondary's bank residence. The courts located in the jurisdiction of the first bank cannot enjoin the secondary bank from paying or in any other way exert influence over the processing of the guarantee.

¹⁴ Also referred to as counter guarantee, England and Wales High Court (Chancery Division), *British Arab Commercial Bank PLC v. Bank of Communications & Commercial Bank of Syria*, [2011] EWHC 281.

¹⁵ Nielsen, *supra* note 3, at mn. 7.

- The payment of the secondary bank is independent of any measures taken in the country of the first bank regarding currency control.¹⁶

Due to the inherent risks of indirect guarantees, some authors have called them a “suicide guarantee.”¹⁷ Despite these risk, indirect bank guarantees account for far more than fifty percent of all guarantees issued in international commerce.¹⁸ The reasons are that some countries, in order to protect their domestic banks or exercise control over their international trading, have enacted laws that require local banks to issue guarantees if the beneficiary is domiciled domestically.¹⁹ Another reason is that when international buyers enjoy a buyer’s market, they can dictate the conditions they seek.

II. DISTINCTION OF A GUARANTEE TO RELATED TRANSACTIONS

A. *Guarantee/Letter of credit*

1. Same function/different purpose

A letter of credit—like a guarantee—is a payment obligation which is independent of the underlying transaction.²⁰ The purposes of guarantees and Letters of Credit (“LCs”) however, are different. A documentary credit serves

¹⁶ Eberhardt Goerke, *Kollisionsrechtliche Probleme internationaler Garantien*, diss. jur., (Universität Konstanz, Konstanz, 1982), p. 120; Beat Kleiner, *Bankgarantie: Die Garantie unter besonderer Berücksichtigung des Bankgarantieggeschäfts* (Zürich: Schulthess 4th ed. 1990), p. 120, ISBN 9783725527335; Andreas Heldrich, *Kollisionsrechtliche Aspekte des Mißbrauchs von Bankgarantien*, in Festschrift für Gerhard Kegel zum 75. 175 (Hans-Joachim Musielak, Klaus Schurig & Gerhard Kegel eds., 1987), ISBN 9783170095694; Dietrich Schefold, *Die rechtsmißbräuchliche Inanspruchnahme von Bankgarantien und das Kollisionsrecht*, IPRax, 1995, p. 119.

¹⁷ Claus-Wilhelm Canaris, *Bankvertragsrecht*, 3rd edition. (Berlin and New York: W. de Gruyter, 1988), ISBN 3110116863, mn 1102.

¹⁸ Nielsen, *supra* note 3, at mn. 9.

¹⁹ Christoph Bark, *Rechtsfragen und Praxis der indirekten Garantien im Aussenwirtschaftsverkehr*, Zeitschrift für Wirtschaftsrecht (German legal magazine covering commercial law, law of corporations, and bankruptcy law) (“ZIP”), No. 4, at 406 (1982) (lists Algeria, mostly Argentina, Bahrain, Chile, Iraq, Iran, Jordan, Kuwait, Lebanon, Libya, Madagascar, Nigeria, Yemen, Oman, Qatar, Sri Lanka, Syria, Thailand, Turkey, United Arab Emirates).

²⁰ German law recognizes this type of obligation in Section 780 BGB: “For a contract by means of which performance is promised in such a way that the mere promise is intended to establish the duty (promise to fulfill an obligation) to be valid, to the extent that no other form is specified, it is necessary for the commitment to be made in writing. The commitment may not be made in electronic form.” Bürgerliches Gesetzbuch [BGB] [Civil Code], July 7, 2007 § 780 (Ger.). For letters of credit this principle has been stipulated in Uniform Customs and Practice (UCP) 500, Art. 2 (1993) & UCP 600, Art. 4a (2007).

to assist in the proper performance of purchases, service contracts, etc. The beneficiary of an LC must prove to the bank by presenting complying documents that he complied with his obligations incurred in the underlying transaction. Drawings under an LC are the standard situation as is the fulfillment of contractual obligations. The guarantee protects the beneficiary from non-fulfillment of contractual obligations of the applicant. Payment demands under a guarantee consequently are the exceptions as is the non-fulfillment of contractual obligations.

2. Guarantor's limitation to payment

The liability of a guarantor is limited to payment of a sum certain. The guarantor is not obligated to fulfill the obligations of the underlying contracts whose non-fulfillment triggered the payment demand. Rather, the guarantor's liability towards the beneficiary is limited by the guarantee amount, which limits and specifies the damages incurred through the default in the underlying contract.²¹ Only in exceptional circumstances will the guarantor reserve the right to fulfill the applicant's obligation in an attempt to reduce the liability under the guarantee. This is, e.g., the case when insurance companies issue "completion guarantees" regarding the construction of buildings. Apart from this exception the guarantee is the fulfillment of the guarantor's own obligation and the compensation for the default of another.²²

B. *Guarantee/Standby letter of credit*

Standby Letters of Credit ("standby" or "standbys") and guarantees are both independent payment obligations. Standbys, however, are used to assure many different purposes as can be seen from their labels: performance standby, advance payment standby, financial standby, insurance standby, commercial standby. For each demand for payment, the beneficiary must present documents.²³

²¹ Canaris, *supra* note 17, at mn 1102. See also BGH WM 61, 204, 206; Hartwig Sprau, *BGB §§ 631–853*, in: Otto Palandt and Peter Bassenge, editors, *Bürgerliches Gesetzbuch*, Volume 7, Beck'sche Kurz-Kommentare, (München: Beck, 2013), ISBN 978–3–406–63000–2, Introduction before § 783, 5b.

²² Kleiner, *supra* note 16, at mn 4; Mathias Habersack, *Schuldrecht Besonderer Teil III: §§ 705–853*, in *Münchener Kommentar zum Bürgerlichen Gesetzbuch*, mn 14 (Franz Jürgen Säcker, Roland Rixecker & Kurt Rebmann, eds.).

²³ Jens Nielsen & Nicolai Nielsen, *Standby Letters of Credit and the ISP98: A European perspective*, 16 B.F.L.R. 163, 166 (2001) available at <http://letterofcreditforum.com/docs/Nielsenarticle.pdf>; cf. ISP98, Rule 4.08 ("If a standby does not specify any required document, it will still be deemed to require a documentary demand for payment").

Standbys are heavily used in the United States because of American banking legislation. The American banking system is characterized by the strict separation of investment and commercial banking, which was implemented by the Glass-Steagall Act of 1933. Under to the Glass-Steagall Act, most banks were not permitted to issue bank guarantees or suretyships.²⁴ Consequently, banks issued guarantees in the form of a letter of credit making them payable against any document.

In 1996 the Office of the Comptroller of the Currency (“OCC”) liberated American banks from this prohibition when issuing its final revised Interpretive Ruling Section 7.7016 (61 Fed. Reg. 4865) (Feb. 9, 1996). This ruling authorizes national banks to issue and commit to issue letters of credit and “other independent undertakings” to pay against documents—such as bank guarantees—that are within the scope of applicable law or legally recognized rules of practice. The OCC has described the purpose of the change as being “to reflect modern market standards and industry usage and replace the term ‘letters of credit’ with ‘independent undertakings.’”

Even with this legislative change the established practice for standbys has not changed.

The proximity of standbys and letters of credit can still be seen in the Uniform Customs and Practice (UCP) which allow to apply the UCP to standbys.²⁵

For German banks the question arises whether they should subject the issuance of bank guarantees under the ISP98 (ICC-Publ. No. 590). Generally banks are cautious to embrace these rules of practices tailored towards the U.S. market. Opponents of the ISP98 “criticized the ISP for their excessive and unnecessary detail, legalistic style inappropriate to worldwide practice, and

²⁴ See, e.g., John F. Dolan, *The Law of Letters of Credit: Commercial and Standby Credits* at ¶ 12.03 (Warren, Gorham & Lamont banking/financial services series, Rev. ed., 1996) ISBN 0791326365; Kenneth C. Kettering, *Securitization and its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1662 (attributes the existence of the standby to the failure of the National Bank Act—or the equivalent state bank code—to list the issuance of guarantees as an enumerated power of banks). The Office of the Comptroller in its Interpretive Letter No. 1022, dated February 15, 2005, confirms that U.S. banks still “have no power to issue guarantees solely for the benefit of another party” unless the guarantee is incidental to an authorized activity. In previous Interpretive Letters, the Office of the Comptroller had e.g. found that guaranteeing loans made by bank’s foreign subsidiaries was permissible. See Office of the Comptroller Interpretive Letter No. 542 (Feb. 6, 1991). See also *Western Petroleum Co. v. First Bank Aberdeen*, 367 N.W.2d 773 (S.D. 1985) (voiding a guarantee since it considered the issuance of the guarantee ultra vires to the powers of a bank).

²⁵ UCP 600, Art. 1 (2007) (“The Uniform Customs and Practice for Documentary Credits, 2007 Revision, ICC Publication No. 600 (“UCP”) are rules that apply to any documentary credit (“credit”) (including, to the extent to which they may be applicable, any standby letter of credit) when the text of the credit expressly indicates that it is subject to these rules. They are binding on all parties thereto unless expressly modified or excluded by the credit”).

their failure to follow traditional ICC rules drafting style.”²⁶ It seems that European and U.S. banks subject their guarantees neither to the UCP 600 nor the ISP98, but rather use their standard forms and rely that these forms will be interpreted according to the general understanding of the standard clauses contained therein.²⁷

C. *Guarantee/Suretyship*

Contrary to a guarantee, a surety²⁸ is dependent on the (continued) existence of the payment obligation of the parties in the underlying transaction. The surety is to protect creditors against the default of the debtor but does not possess a liquidity function beyond this objective.²⁹ The distinction between a dependent suretyship and an independent guarantee can be difficult, since the term bank guarantee can comprise both types of contracts. German speakers, who could clearly distinguish between the two, often use these terms synonymously.³⁰ In cases of doubt the naming of the instrument should step back behind an analysis of the payment clause. In a guarantee the payment clause should reflect that the obligated party undertakes a “primary obligation.”³¹

D. *Guarantee/Suretyship payable on first demand*

In contrast to English law, whose nomenclature is unclear, the Germans have the statutory definition of a suretyship and the institute of the guarantee that has been developed by the markets. The rather clean distinction between the two however was challenged when banks developed the “suretyship payable on first demand.” The question is whether this instrument was more akin to a suretyship or a guarantee. The BGH has recognized suretyships that are payable on first demand, equaling them to guarantees.³² The beneficiary

²⁶ Georges Affaki, *How do the ISP standby Rules fit in with other uniform Rules?*, INSIGHT 5:1 at 3 (1999).

²⁷ Nielsen, *supra* note 5, at mn. 13.

²⁸ Bürgerliches Gesetzbuch [BGB] [Civil Code] Aug. 18, 1896 § 765 (Ger).

²⁹ Norbert Horn & Heinz-Peter Mansel, §§ 765–78 (*Bürgerschaft*), Vol 2. ¶¶ 765–78, (2013); J. von Staudingers, *Kommentar zum Bürgerlichen Gesetzbuch*, Introduction to § 765 (Gruyter, Ed. 2013); Mathias Habersack, *Schuldrecht Besonderer Teil III: §§ 705–853*, in: Münchener Kommentar zum Bürgerlichen Gesetzbuch, (Franz Jürgen Säcker et al., eds.).

³⁰ BGH WM 70, 159, 160; Oberlandesgericht (Court of Appeals) (“OIG”) Hamburg WM 83, 188, 189 (in cases of doubt courts will assume the parties intended a suretyship as the less rigorous payment instrument. This assumption does not hold if the parties are sophisticated); BGH WM 62, 550; WM 75, 348; *see also* von Westphalen, et al., *supra* note 5, at 50.

³¹ Reinhard Welter, *Bankgarantie*, in Münchener Kommentar zum Handelsgesetzbuch, Vol. 5, mn J 149 (Deutschland Schmidt & Karsten Schmidt, eds. 2005–2009) ISBN 978–3–406–52627–5.

³² BGH WM 94, 106.

has to expound that the obligation emanating from the underlying transaction and secured by the suretyship exists. The BGH emphasizes that the requirements for the payment demand that trigger payment needs to be strictly formalized in order to provide liquidity to the beneficiary.³³ All disputes, whether factual or legal, whose answer is not obvious, need to be decided in a suit for recovery of the funds. Also, regarding the defense of abuse of law, the BGH does not distinguish between guarantee and suretyship payable on first demand: only if the beneficiary obviously lacks the position of a creditor, is the suretor entitled to a defense of estoppel. This principle applies in analogy to a guarantee payable on first demand.³⁴ In the most recent cases however, the BGH has loosened the strict equalization between guarantee and surety payable on first demand.

Similar to English law, the BGH intended to only allow *financial institutions* to issue suretyships payable on first demand.³⁵ This limitation was intended to protect consumers from the strict obligation to “pay on first demand.” This position, however, was deemed untenable and hence the BGH changed to allow a stock corporation that engaged in international commerce to enter into suretyships payable on first demand if the contract was the result of individual negotiation and not the result of a contract of adhesion. The criterion “engaged in international commerce,” however, proved unsuitably vague, and hence the BGH conceded that, at least in individually negotiated contracts, anyone, i.e., not only merchants, can be the issuer of a suretyship payable on first demand. The headnote of this judgment reads: outside the applicability of the AGBG the freedom to contract permits everyone to issue suretyships that are payable on first demand.³⁶

The discomfort of the BGH regarding suretyships payable on first demand remains up to this day. First demand suretyships are invalid when created on the basis of a contract of adhesion. Furthermore, tendencies are discernible to subject the payment demand under first-demand suretyships to closer scrutiny than under a guarantee. The beneficiary under a first-demand

³³ BGH WM 94, 106 *citing* BGH WM 84, 44, NJW 84, 923; WM 89, 1496, 1497; OIG Düsseldorf WM 94, 588.

³⁴ BGH WM 88, 934 *citing* BGH WM 84, 511, ZIP 85, 470, 471.

³⁵ TTI Team Telecomm. Int'l Ltd v. Hutchison 3G UK Ltd. [2003] EWHC 762 (TCC) (distinguish guarantees and suretyships according to the following criteria: “where an instrument: relates to an underlying transaction between the parties in different jurisdictions; is issued by a bank, contains an undertaking to pay “on demand”, (with or without the words “first” and/or “written”), does not contain clauses excluding or limiting the defenses available to a guarantor, it will almost always be construed as a demand guarantee.”) *See also* Marubeni Hong Kong & South China Ltd. v. Gov't of Mongolia [2005] EWCA Civ. 395 (the court specifically mentioned that the institution issuing the payment instrument was not a bank and hence classified the instrument as a surety).

³⁶ BGH ZIP 98, 905.

surety has the onus of proof to show that the secured obligation covers the payment demanded under the first-demand suretyship.

E. Reforms and international guidelines

1. ICC Rules for Contract Guarantees

a. Erroneous attempts to combat fraudulent availments

The possibility of fraudulent availment is the backside of the liquidity function of a guarantee and typical of virtually all abstract payment obligations.³⁷ Similarly, acknowledgment of indebtedness,³⁸ draft,³⁹ or letter of credit are characterized by a tendency to overly secure, i.e., they permit availment independent of the degree of fulfillment of the underlying contract. The bank guarantee however has been criticized after the number of reported fraud cases increased in connection with the Iran hostage crisis.⁴⁰ The allegation against certain countries was that they misunderstood the guarantee as an *ex post* discount.

The ICC reacted to these concerns with the publication of the “Uniform Rule for contract guarantees” (ICC publication No. 325), which addressed the issue of abuse. These were however little successful, so the ICC published “Uniform Rule for Demand Guarantees” (ICC publication No. 458/1), which were similarly spurned by practitioners.

i. ICC publication 325: Uniform Rule for Contract Guarantees

The 1978 Uniform Rule for Contract Guarantees (URCG) addressed the issue of fraudulent availment of guarantees by requiring the beneficiary to present the decision of a court or an arbitrator. The payment obligation under ICC Pub. 325 lacked the essence of a guarantee: its liquidity function. The URCG were not accepted by the marketplace since they regulated a type of

³⁷ Jens Nielsen, *Rechtsmißbrauch bei der Inanspruchnahme von Bankgarantien als typisches Problem abstrakter Zahlungsverprechen*; ZIP 85, 1101 *et seq.*

³⁸ The acknowledgment of a debt is a legal concept provided for in Bürgerliches Gesetzbuch [BGB] [Civil Code] Aug. 18, 1896 § 781 (Ger.) (“For a contract by which the existence of an obligation is acknowledged (acknowledgement of debt) to be valid, the declaration of acknowledgement must be made in writing. The declaration of acknowledgement may not be made in electronic form. If another form is prescribed to create the obligation whose existence is being acknowledged, then the acknowledgement contract requires this form.”). Like the other instruments listed it is independent of the underlying transaction.

³⁹ In English legal parlance: “Bill of Exchange.”

⁴⁰ Theodor Heinsius, *Zur Frage des Nachweises der rechtsmißbräuchlichen Inanspruchnahme einer Bankgarantie auf erstes Anfordern mit liquiden Beweismitteln*, in *Festschrift für Winfried Werner* zum 65, 230 (Walther Hadding et al., eds., 1984).

guarantee, that the parties in an international transaction—characterized by a buyer's market—did not need.

ii. ICC publication 458/1: Uniform Rules for Demand Guarantees (URDG)

The ICC acknowledged that the URDG 325 were unsuccessful⁴¹ and attempted to correct this by the publication of URDG 458. The URDG 458 mostly reflects standard forms of guarantee practice, however the rules for availment are incompatible. According to article 20 URDG 458:

- a) Any demand for payment under the Guarantee shall be in writing and shall (in addition to such other documents as may be specified in the Guarantee) be supported by a written statement (whether in the demand itself or in a separate document or documents accompanying the demand and referred to in it) stating:
 - i. that the Principal is in breach of this obligation(s) under the underlying contract(s) or, in the case of a tender guarantee, the tender conditions; and
 - ii. the respect in which the Principal is in breach.

The requirement to provide written statements that the Principal is in breach and the respect in which the Principal is in breach is void according to German law.⁴²

Banks attempt to avoid this element of surprise by including the requirement of article 20 URDG 458 into the text of the guarantee.⁴³ This practice however leads to beneficiaries rejecting the guarantee unless the underlying contract contains these requirements regarding the issuance of a guarantee.

⁴¹ Uniform Rules for Demand Guarantees (URDG) 458, ICC Publ. No. 458/1, p. 4 (Though publication No. 325 was used, and continues to be used, to some extent, the requirements proved too removed from prevailing banking and commercial practice to gain general acceptance.).

⁴² Rolf A. Schütze, *Bankgarantien, unter besonderer Berücksichtigung der einheitlichen Richtlinien für'auf erstes Anfordern'zahlbare Garantien der Internationalen Handelskammer*, Internationale Wirtschaftspraxis Vol. 4, at 39 (1994) (the URDG 458 will be subject to the AGBG—the German law on preformulated trade terms—which voids surprising clauses). The requirements for writings according to Art. 20 will be considered surprising since they deviate substantially from the standard bank guarantee. See URDG 458 Art. 20.

⁴³ The inclusion in the text of the guarantee avoids that courts apply the law on preformulated trade terms, since the individually worded text of the guarantee is not subject to the AGBG. See, e.g., Credit Suisse, Bank Guarantees, 8 (10th ed. 2010).

iii. ICC publication 758: Uniform Rule for Demand Guarantees (URDG)

To address some of the criticism regarding the URDG 458, the ICC published the URDG 758 which were effective as of July 1st, 2010. Even though the ICC meticulously prepared the revision over a period of two and a half years the problematic requirement for availment however survived any attempts of reform and can now be found in Article 15:

A demand under the guarantee shall be supported by such other documents as the guarantee specifies, and in any event by a statement, by the beneficiary, indicating in what respect the applicant is in breach of its obligations under the underlying relationship. This statement may be in the demand or in a separate signed document accompanying or identifying the demand.

Since the basic problem has not been addressed, i.e., the surprising requirement to state the extent of the applicant's breach, German law still considers guarantees issued under the URDG 758 as void.

2. ISP98, ICC publication 590

a. Controversial adoption

On January 1, 1999 the ISP98, published as ICC-Publ. No 590, came into force. The basis for the new guidelines were drafts of the U.S. based "Institute of International Banking Law & Practice." The ISP98 were adopted in 1998 by the ICC Banking Commission against the votes of the German delegation. The need to adopt guidelines, applicable to guarantees and letters of credit, was disputed. Indeed, in the vote to adopt the new guidelines, there were more abstentions than votes for and against combined.⁴⁴

Whether it was right or necessary to approve U.S. standby practices by issuing new ICC guidelines seems questionable. Proponents emphasize the commercial importance of standbys, "a product whose current outstanding value of USD 750 billion dwarf that of any other letter of credit-product."⁴⁵ Furthermore, the UCP, which is also applicable to standbys, to a large degree are not tailored towards guarantees.

⁴⁴ Winfried Holzwarth & Dan Taylor, *Were the new ISP Rules on standbys fairly adopted and will they be useful?*, *INSight*, 4, No. 4, 12 (1998).

⁴⁵ *Id.* at 14.

b. Term and applicability

The ISP98 define a standby as “an irrevocable, independent, documentary, and binding undertaking when issued and need not so state.”⁴⁶ This broad definition, which is similar to Art. 2 UCP 600 and Art. 5 of the Uniform Commercial Code (UCC), allows to apply the ISP98 to standbys, letters of credit, as well as guarantees.

The ISP98 however use the term “standby” with several meanings. Rule 1.01 a. and b. ISP98 refer to “standby letters of credit” without defining it due to the difficult distinction to a letter of credit.

This Rule uses the term ‘standby’ in two distinct senses, Subrules (a) and (b) refer to a ‘standby letter of credit’. No definition of a standby letter of credit is provided in these Rules. A precise definition has not been given because the distinction between commercial letters of credit and standby letters is not precise.⁴⁷

In contrast to a “standby letter of credit”, “[a] standby is an undertaking subject to these Rules. Thus, an independent guarantee subject to the ISP98 would be a ‘standby’ for purposes of these Rules.”⁴⁸

Hence, according to the nomenclature of the ISP98, an international bank guarantee is not identical with a “standby letter of credit.” A standby letter of credit can only be made subject to the ISP98 as a miscellaneous, independent payment obligation. Despite this initial distinction, the commentator in the following gives up this distinction and uniformly employs the term “standby.” The practical relevance of the initial distinction is not easily discernible, particularly since the Official Commentary informatively notes: “A ‘standby letter of credit’ is the type of letter of credit which is understood to be a letter of credit.”⁴⁹

c. Comparing ISP98 and UCP 600

The adoption of the ISP98 contravenes the original objectives of the ICC when revising the UCP to harmonize as broadly as possible the rules for

⁴⁶ See *International Standby Practices 1998: ISP98*, Rule 1.06, in *LC Rules & Laws*, Inst. of Int'l Banking L. & Prac., at 58 (James E. Byrne, ed., 4th Ed., 2007).

⁴⁷ James E. Byrne, *The Official Commentary on the International Standby Practices*, at 2–3 (James G. Barnes ed., 1998); ISP98 Rule 1.01, mn. 3.

⁴⁸ Byrne, *supra* note 47.

⁴⁹ *Id.*

documentary credit and standby. Additionally, it is up to the parties to select which of the various ICC rules they want to use in individual transactions, since no generally valid selection criteria exist.⁵⁰

The authors suggest that in cases of doubt the UCP is preferable. The ISP98 differs from the UCP—apart from some mostly superfluous technical rules—in the following:

- Electronic presentation of documents permissible. (Rule 1.09 c., 3.06 b., d.)
- The language of all documents issued by the beneficiary is to be that of the standby. (Rule 4.04).
- Notice of dishonor given within three business days is deemed to be not unreasonable and beyond seven business days is deemed to be unreasonable. (Rule 5.01 a. i.)
- Provisions for “extend or pay” requests. (Rule 3.09).

The drafters saw the applicability of the ISP98 as follows:⁵¹ “Like the UCP and the URDG, the ISP will apply to any independent undertaking issued subject to it.”

Examples of standbys are listed in the preface of the ISP98:

- A “Performance Standby” supports an obligation to perform other than to pay money, including for the purpose of covering losses arising from a default of the applicant in completion of the underlying transactions.
- An “Advance Payment Standby” supports an obligation to account for an advance payment made by the beneficiary to the applicant.
- A “Bid Bond/Tender Bond Standby” supports an obligation of the applicant to execute a contract if the applicant is awarded a bid.
- A “Counter Standby” supports the issuance of a separate standby or other undertaking by the beneficiary of the counter standby.

⁵⁰ International Standby Practices: ISP98 in force as of 1 January 1999: ICC-Pub. No. 590 7, (Paris and New York: ICC Publishing, 1998), 7 (“The choice of which set of rules to select is, therefore, left to the parties as it should be. One may well choose to use the ISP for certain types of standbys, the UCP for others, and the URDG for still others.”); *see also* Nielsen et al., *supra* note 4, at 164.

⁵¹ Byrne, *supra* note 47; ISP98 Rule 1.01, mn. 3.

- A “Financial Standby” supports an obligation to pay money, including any instrument evidencing an obligation to repay borrowed money.
- A “Direct Pay” Standby supports payment when due of an underlying payment obligation typically in connection with a financial standby without regard to a default.
- An “Insurance Standby” supports an insurance or reinsurance obligation of the applicant.
- A “Commercial Standby” supports the obligations of an applicant to pay for goods or services in the event of non-payment by other methods.

3. ISP98 - UNCITRAL Draft Convention on Independent Guarantees and Standby Letters of Credit

The UN through its United Nations Commission on International Trade Law (UNCITRAL) has passed the above mentioned convention whose goal was to harmonize the national laws. The intention was that, similar to the United Nations Convention on Contracts for the International Sale of Goods (CISG), signatory states would transform the United Nations Convention on Independent Guarantees and Standby Letters of Credit (UN Convention) into national law.

A need for the UN Convention does not exist, however. The old disputes in guarantee transactions relate to improper demands; these cannot be addressed by new rules. The UN Convention furthermore does not address the legal relationships of the parties in direct and indirect guarantees. It is not expected that the UN Convention will be of considerable importance in commercial transactions.

F. Types of Guarantees

1. Standards for typical risk areas

International guarantee business has developed standard transactions which cover the typical risks encountered in international business. The best-known three basic types are:

- Bid bond: serves to ensure that the winner in a public bid will honor his bid.
- Advance Payment bond: serves to ensure that a party that has received a down-payment delivers on the contract.
- Performance bond: (sub-categories: delivery bond, warranty bond) ensures that contractual obligations are fulfilled.

Apart from these classic guarantee types, more exotic forms exist which are in substance variations of a performance bond. The differentiating criterion is the objective of the guarantee: bill of lading guarantee, payment guarantees, customs guarantees. Another type of guarantee are guarantees for bonds, as e.g., issued by parent companies to their subsidiaries in order to obtain better ratings and thus lower interest rates.⁵²

For these types of guarantees international practice has developed standard texts that considerably facilitate their frictionless processing. These standard texts are based on uniform international views regarding the underlying law that are independent of national laws. The three classic basic forms of a guarantee are identical to the types of standbys listed in the preface to the ISP98 (i.e., bid bond, advanced payment standby, and performance standby). In regards to the payment obligation and the legal qualification German style guarantees and American style guarantees are identical. The differences between the two consist of their respective form and the fact that a standby, unlike a guarantee which is payable on first demand, *always* requires the presentation of a document: Rule 1.06 d. ISP98: Because a standby is documentary, an issuer's obligations depend on the presentation of documents and an examination of required documents on their face.

U.S. special forms of guarantees are, among others: Financial standby, Direct Payment Standby, and Insurance Standby.

Also these special forms are identical to German/European-style guarantees in regards to the payment obligation and the legal qualification being independent promise to pay. According to the drafters, the ISP98 are applicable to German/European-style guarantees.

2. Standard Forms

a. Bid Bond, Participation Guarantee, Tender Guarantee

Governments who issue requests for tender, or private entities who issue requests for proposal for international projects typically demand that participants provide bid bonds. The bid bonds are intended to protect the issuers against the risk that the winning bidder does not sign the contract or does not provide the contractually required performance guarantee. The amount of the bid bond typically is between one and five percent of the contract value, in exceptional cases it can be ten percent. The bond is supposed to compensate the beneficiary of the bond for the unavailing examination of

⁵² Welter, *supra* note 31 (emphasizing the role of guarantees in new financial instruments, e.g. swaps).

the bids as well as the fact that the beneficiary can no longer accept bids from other companies which have expired.

b. Advance Payment Guarantee (bank refundment guarantee/garantie d'acompte/garantia de pago anticipado)

Advance payments are typical in custom-made installation contracts where the exporter cannot otherwise use the goods if the buyer reneges on the contract. The advance payment shall prevent the buyer from canceling the contract and facilitate financing for the seller. The advance payment guarantee in turn secures the buyer's claim against the seller to finish the contract or pay back the advance.

The amount of the advance payment guarantee is a matter of negotiation since no international standards exist. The advance can amount to up to thirty percent of the total contract value. The insured event is the non-performance or non-delivery. The term of the guarantee typically exceeds the time for delivery so that the beneficiary has sufficient time to draw. The beneficiary may however demand payment before the time for delivery has expired; e.g., in case of the seller's bankruptcy or in case of difficulties for the seller in obtaining the necessary materials. Hence, the demand for payment before expiration of the time for delivery by itself does not constitute fraud.⁵³ The advance payment guarantee hence does not cover any warranty. If the seller has to provide a warranty guarantee he should only have it issued after return of the advance payment guarantee.

c. Performance Bond

i. Classification Performance

Classification Performance is a broad collective term for guarantees, that ensure the performance of individual or all contractual obligations. In everyday transactions the parties do not always clearly distinguish whether a guarantee secures:

- only the obligation to deliver;
- only the obligations regarding warranty; or
- all obligations emanating from the underlying contract.

⁵³ Zahn, et al. *supra* note 5.

The intentions of the parties commonly cannot be deduced from the title of the guarantee alone; rather, one has to read the guarantee's content (preamble, payment clause, and reduction clause). If a guarantee is intended to ensure the obligations of a contract referenced in the preamble of the guarantee without limiting or specifying the purpose, then the guarantee will cover all contractual obligations; the beneficiary can demand payment not only in case of non-delivery but also for delays and contractual penalties.⁵⁴

ii. Delivery guarantee

The delivery guarantee (German: Liefer-garantie/French: garantie de livraison/Spanish: garantia de suministro) is a guarantee with a limited objective. For contracts involving merchandise it only covers non-delivery. Insofar it is similar to a performance guarantee (French: garantie d'exécution) which secures the performance of contractual service obligations, e.g., non-performance of construction or installation. The delivery guarantee typically amounts to five to ten percent of the contract value. According to their limited objective delivery guarantees should expire after delivery or satisfaction of the service obligation. Since a bank cannot check the contractually agreed upon delivery, delivery guarantees will remain in effect until returned *unless* the guarantee clauses provide for presentation of specified documents, as, e.g., documents evidencing delivery or acceptance certificates, which terminate the guarantee.

iii. Guarantee for warranty obligations

The guarantee for warranty obligations guarantee (French: garantie de bon fonctionnement/Italian: garantia del buen funcionamiento) ("warranty guarantee")—like the delivery guarantee—has a limited objective: secure the seller's compliance with his warranty obligations. Typically a warranty guarantee amounts to five to ten percent of the contract value; the beneficiary can only demand payment after delivery. When issuing a warranty guarantee the applicant should pay attention that delivery and warranty guarantee do not overlap. The applicant should negotiate that the warranty guarantee only becomes effective after the delivery guarantee has been returned.

iv. Fulfillment guarantee (all risks or combined guarantee)

A fulfillment guarantee covers all claims without limitation emanating from the underlying contract. Often delivery, performance, warranty and

⁵⁴ BGH WM 88, 212, WuB IK3-3.88 (Eberding); WuB IK3-4.98 (Nielsen).

advance payment guarantee are combined into one all-encompassing performance bond (French: *garantie de bonne exécution du contrat*). The amount of this type of guarantee varies between five and twenty percent of the contract value, with a majority of cases apparently around ten percent.⁵⁵

3. Special types of guarantees

a. Payment guarantee (*garnatie de paiement/garantia de pago*)

Payment guarantees serve to ensure that the buyer pay the agreed upon purchase price. It is a reversed performance bond, since the beneficiary is not the buyer but the seller. If the buyer is domiciled in a country that subjects international payments to foreign exchange control, the seller will insist that the guarantee does not only secure the payment from the buyer, but equally the conversion of funds to a currency of his choice. However, even if the guarantee covers both events, the guarantee is of little avail to the seller if the guarantor is domiciled in the buyer's country. The seller consequently should negotiate that the guarantor be domiciled outside the buyer's country.

The payment guarantee has special importance when the seller intends to forfeit his demand for payment against the buyer. In this case the payment guarantee will substitute other collateral to satisfy the bank offering forfeit financing to the seller.

b. Bill of Lading guarantee

The main use of a bill of lading guarantee is a bank trying to convince the carrier to release the goods even without presentation of a bill of lading. In order to avoid demurrage the consignee of the bill of lading will provide this type of guarantee if the original bill of lading has been lost or delayed.

A beneficiary who provides a guarantee to the benefit of a letter of credit bank also might issue a bill of lading guarantee in case he is not able to (timely) present a (clean) bill of lading in order to convince the bank to pay. A bank should however only accept bill of lading guarantees if the beneficiary was unable to present a full set of document due to difficulties in mailing documents (loss of one set when mailing several sets separately). Under no circumstances should the bill of lading guarantee lead to acceptance of non-compliant documents since this would undermine the principle of strict compliance.

⁵⁵ Zahn, et al., *supra* note 5.

c. Customs guarantees/Securing ship creditor's rights

In addition to the guarantees mentioned so far banks also issue guarantees to secure a client's payment obligation toward customs authorities. Furthermore, creditors of a ship or its cargo who have claims based on loss at sea might become beneficiary's of a guarantee to avoid sequestering the ship.⁵⁶

III. LEGAL CHARACTER OF BANK GUARANTEES

A. *Payment instrument of international trade*

1. Concordance of European and U.S. development

a. Contracts of guarantee

That a guarantee creates liability without regard to an underlying transaction is a result of the freedom to contract.⁵⁷ Due to the multitude of guaranteed events, the legislator of the German Civil Code (Bürgerliches Gesetzbuch) (the "BGB") did not include the guarantee as another type of contract. The general guarantee then further developed into the bank-guarantee as a globally recognized payment instrument. The heightening of the general guarantee to the bank guarantee improved the liquidity function of the guarantee; on the other hand, the bank guarantee restricts the unlimited multitude of insured events to standard cases which are typical of international trade. Consequently, the bank guarantee is typified by the following elements:

- Creation of an unconditional obligation to pay for the insured event including in cases of *atypical accidents*.⁵⁸ This means that the guarantor has to pay, even if the applicant's failure to comply with his obligations is not due to the applicant's fault (as e.g. in cases of force majeure or impossibility). In this regard the general guarantee and the bank guarantee are identical.
- Obligation to provide liquidity to the beneficiary by paying on the beneficiary's first demand. The payment on first demand reverses the roles in litigation since the beneficiary receives the payment immediately and the applicant or the guarantor subsequently may attempt to recover these funds

⁵⁶ *Id.* at mn. 9/67.

⁵⁷ Canaris, *supra* note 17, at mn 1104.

⁵⁸ The decisions of the BGH use the German term "nicht typische Zufälle," see, e.g., BGH WM 55, 265, 266; WM 68, 680, 682; 1982, 924, 925; 1985, 1035, 1037.

by initiating a lawsuit based on improper availment. This heightened liquidity is the crucial element that distinguished the general guarantee from the bank guarantee.

b. Degree of abstraction of international bank guarantee

Bank guarantees are accepted internationally, since national legal regimes recognize the payment clauses as a transaction that is independent of an underlying contract. German law, e.g., qualifies the guarantee as a “[p]romise to fulfill an obligation” which is provided for in § 780 BGB.⁵⁹ Similarly, the essential features of the American standby letter of credit—when used as a guarantee—correspond to European bank guarantees. Article 5-114(1) UCC 1990 phrases the independence as follows: “[a]n issuer must honor a draft or demand for payment which complies with the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract for sale of other contract between the customer and the beneficiary.”

The ISP98 in their Rule 1.06 a. repeat this principle of independence as follows: “[a] Standby is an irrevocable, independent, documentary, and binding undertaking when issued and need not so state.”

German and U.S. law concur that the independence of a guarantee need not expressly be stated with terms like “unconditional”, or “waiving all rights”. The ISP98 expressly designates these terms as superfluous.⁶⁰

Regarding the liquidity function, no difference is discernible between U.S. standbys and German guarantees. The standby (like a letter of credit) *always* requires the presentation of a document; this requirement however is simply the formalization of its availment. Since the majority of U.S. banks are not allowed to issue bank guarantees, bankers used letters of credit to accommodate their customers.

⁵⁹ “For a contract by means of which performance is promised in such a way that the mere promise is intended to establish the duty (promise to fulfill an obligation) to be valid, to the extent that no other form is specified, it is necessary for the commitment to be made in writing. The commitment may not be made in electronic form.” BGB *supra* note 20, at § 780.

⁶⁰ “A standby should not or need not state that it is: unconditional or abstract (if it does, it signifies merely that payment under it is conditioned solely on presentation of specified documents); absolute (if it does, it signifies merely that it is irrevocable); primary (if it does, it signifies merely that it is the independent of the issuer).” ISP98 Rule 1.10 a.

2. National and international qualification of independent payment obligations

a. Payment instrument *sui generis*

U.S. and European international trade practice developed guarantees independent of national laws. In view of the identity of the function of the guarantee as well the fact that it was developed independent of any legislator in several independent jurisdiction it seems appropriate to qualify the bank guarantee as a “payment instrument *sui generis*”.⁶¹ A further justification for this qualification is that the gamut of obligations under a bank guarantee as well as its independence from the underlying transaction is homogeneously established beyond national boundaries and reflects a stereotypical intention of the parties. Nevertheless, it is customary to describe the nature of the bank guarantee according to the nomenclature of the respective national laws; particularly as some authors doubt, for dogmatic reasons, that independent international legal concepts may be developed from commercial usage.⁶²

3. Independence

The majority of jurists qualify the bank guarantee as a “promise to fulfill an obligation” as § 780 BGB uses this term.⁶³ The German original version of the BGB uses the term “abstract” to describe this type of obligation which needs to be distinguished from “accessoriness”.⁶⁴ Accessoriness describes the fact that a surety obligation is dependent on the continued existence of the underlying obligation between the applicant and the beneficiary of the surety. The distinction is relevant since the BGH has recognized sureties, i.e., an

⁶¹ Jürgen Dohm, *Bankgarantien im internationalen Handel*, mn. 67 (1985); *but see* Canaris, *supra* note 17, at mn. 1004, 1134 (author opposes this view and doubts that commercial usage may lead to independent international law).

⁶² Canaris, *supra* note 17, at mn. 1004, 1134; Eugen A. Roesle, *Die internationale Vereinheitlichung des Rechts der Bankgarantien*, in 26 *Schriften zum Bankenwesen*, p. 68. (Zürich: Schulthess, 1983), ISBN 9783725523061.

⁶³ § 780 BGB, *supra* note 20 (Promise to fulfill an obligation for a contract by means of which performance is promised in such a way that the mere promise is intended to establish the duty (promise to fulfill an obligation) to be valid, to the extent that no other form is specified, it is necessary for the commitment to be made in writing. The commitment may not be made in electronic form. Ernst von Caemmerer, *Bankgarantien im Außenhandel*, in: Bernhard Aubin and Ernst von Caemmerer, eds., *Festschrift für Otto Riese aus Anlass seines siebenzigsten Geburtstages*, (C. F. Müller, 1964), p. 301; Rudolf Liesecke, *Rechtsfragen der Bankgarantie*, Wertpapier Mitteilungen, 1968, at 24; Friedrich Westphalen, *Rechtsprobleme der Exportfinanzierung*, in 11 *Schriftenreihe Recht der internationalen Wirtschaft* 76 (Heidelberg: Verlagsgesellschaft Recht u. Wirtschaft, 1975); Zahn et al., *supra* note 5, at mn 8/9.

⁶⁴ “Accessoriness” is the translation of the German term “Akzessorietät.”

accessorial obligation, payable on first demand and equates them to bank guarantees.

IV. TERMINOLOGY AND TYPICAL CLAUSES

A. *Criteria of guarantee payment obligation*

1. Irrelevance of description

a. Domestic guarantees

In German domestic transactions the labeling of the payment obligation as “guarantee” or “surety” is only an indication for the classification of the payment obligation. This indication of course can be refuted since “the parties—even a bank—may have erred in its attempt to label the payment instrument; legally not the naming of the instrument but the true content of the obligation are decisive.”⁶⁵ Consequently, a document labeled “surety” might be classified as a guarantee,⁶⁶ whereas a bank instrument entitled “payment guarantee” might turn out to be a surety.⁶⁷

b. International transactions

Certain international jurisdictions have also adopted the approach/understanding that the labeling of a payment obligation is not dispositive of its legal qualification. This is even more true since the nomenclature of abstract payment obligation under English law is rather muddled. A “guarantee” under English law is more akin to a surety under German law, whereas a “letter of indemnity” or a “Standby Letter of Credit” are guarantees according to German law.⁶⁸ Similarly in Switzerland, the term “Garantie” is not only used to designate truly independent guarantees.⁶⁹ In France the general term “sûrete” is common, even though bank guarantees are

⁶⁵ Canaris, *supra* note 17, at mn 1124.

⁶⁶ BGH WM 70,159,160; 1982,632; *cf.* Zahn, et al., *supra* note 5, at mn 9/11, who posits that the labeling of a document is only a refutable indication whether the document is a surety or a guarantee.

⁶⁷ BGHG WM 78, 1065, 1066 II; *cf.* OLG Hamburg WM 83,188,189; *cf.*, however BGH WM 62,550 with a more nuanced approach; WM 75,348 as far as the parties are versed in law. In case it is not clear what the parties intended, one has to assume that they wanted to create a surety as the less strict payment obligation (BGH WM 75,348).

⁶⁸ Norbert Horn, *Die UN-Konvention über unabhängige Garantien: Ein Beitrag zur lex mercatoria*, RIW [1997], p. 718; Jörg Käser, *Garantieversprechen als Sicherheit im Handelsverkehr*, RabelsZ, 35 [1971], p. 616; Manfred Moschner, *Bemerkungen zur Gestaltung von Bankgarantien*, ÖBA, 31 [1983], p. 129.

⁶⁹ Roesle, *supra* note 62, at p. 66; *cf.* also Kleiner, *supra* note 16, at mn 3.10/3.11.

labeled “garantie indépendante”, “garantie abstraite”, “garantie contractuelle”, “garantie (bancaire) non accessoire”, and sometimes “garantie automatique”.⁷⁰ In the U.S., guarantees are called “contracts of indemnity” and are typically issued as “Standby letters of credit”.⁷¹ Despite the ambiguities regarding the naming of a bank guarantee in international trade, the domestic criteria for distinguishing guarantee and surety cannot be applied. Only the payment clause is relevant; unless it contains reservations or limitations, it will be deemed an abstract bank guarantee.⁷²

2. Relevance of the payment clause

a. First demand

The main criterion for classifying a payment obligation as a guarantee is the clause “on first demand.” This clause is basically all that is needed.⁷³ Using this clause will determine whether the payment obligation is a guarantee or a surety.⁷⁴ This principle applies globally.⁷⁵ The wording “on first demand” is such a weighty indication for a guarantee that a “unité de doctrine” exists and binds certain/many/most foreign authors.⁷⁶ The BGH has not fully followed this idea since the BGH allows sureties payable on first demand; however, these concerns are irrelevant in practice, since a surety on first demand will be treated like a guarantee.⁷⁷

⁷⁰ Michel Vasseur, *Garantie Indépendante*, in: Louis Vogel, editor, *Repertoire de droit commercial (5 volumes & abo. 6 mois)*, (Paris: Dalloz (Abonnements et, 2000)), ISBN 9782247040582; Roesle, *supra* note 62, at p. 68.

⁷¹ Rolf Ebert, *Das Standby Letter of Credit im Recht der Vereinigten Staaten von Amerika*, Zeitschrift für Vergleichende Rechtswissenschaft, [1981], No. 80, p. 30; Thomas Hein, *Der Zahlungsanspruch des Begünstigten einer Bankgarantie ‘auf erstes Anfordern’*, (Gießen, 1982), p. 60.

⁷² Zahn, et al., *supra* note 5, at mn 9/10–9/12; von Westphalen, et al., *supra* note 5, at p. 84.

⁷³ Klemens Pleyer, *Die Bankgarantie im zwischenstaatlichen Handel*, WM Sonderbeilage 4 [1973], No. 2, p. 6.

⁷⁴ von Westphalen, et al., *supra* note 5, at p. 51 (Even if the word “surety” appears in a document (. . .) it is nevertheless an abstract payment obligation if (. . .) payment is to be eff ectuated on first demand.)

⁷⁵ Dolan, *supra* note 24, at mn 80; Erich Schinnerer and Peter Avancini, *3.-Bankverträge: Dokumenten-Akkreditiv und Dokumenten-Inkasso. Safe und Tag- und Nachttresor. Verwahrungsgeschäft. Kauf und Verkauf von Wertpapieren*, (Wien: Manz, 1976), ISBN 3214147765 9783214147761, p. 315; Zahn, et al., *supra* note 5, mn 9/19.

⁷⁶ Kleiner, *supra* note 16, at mn 5.70.

⁷⁷ BGH WM 82, 1324–25 (“Contrary to the opinion of the previous instance a general rule of interpretation does not exist, that the parties in international trade only intended a guarantee if they agreed on a ‘payment on first demand.’”; cf. von Westphalen, et al., *supra* note 5, at p. 78; Kleiner, *supra* note 16, at mn 5.71 (“According to N. 5.33 the wording ‘on first demand’ by itself is according to the unfortunate recognition of a ‘surety on first demand’ not a sufficient indication for a guarantee.”)

The difference between a surety payable on first demand and a guarantee is of no consequence for German domestic transactions (the only difference is that the BGH announced special requirements for agreeing on a surety on first demand via pre-formulated terms and conditions.) The unique payment obligation of a surety payable on first demand is unknown outside Germany, Switzerland and Austria. In international trade finance transactions the parties equate the wording “on first demand” with a guarantee.⁷⁸ A party instructing a bank to issue a “guarantee” in an international transaction cannot claim that, due to the differing nomenclature in foreign countries (particularly in English law), that he intended only a surety and not an abstract guarantee.⁷⁹

b. Similar wording

In creating a guarantee, it is immaterial whether the payment clause is worded “on first demand,” “on first written demand,” or “on simple demand.”⁸⁰ Equivalent is a wording to pay “under all circumstances,” “without any opposition,” “without necessity of any judicial or administrative action,” or “without discussion,” or “without opposition of court decision.”⁸¹ A necessary part of any similar wording is a clearly described payment demand of the beneficiary of the guarantee, e.g., by using the words “demand” or “avail.”⁸² If a bank only commits to an “unconditional” payment it is unclear as to which payment instrument it wanted to issue; in case of doubt, this wording is not sufficient to create a guarantee. But language such as the following would be sufficient: “. . . we obligate ourselves, to pay you a maximum amount of . . . against your written confirmation that . . .”⁸³ This payment clause of the guarantee clearly establishes that the payment obligation is independent from any underlying transaction and that payment will be effectuated against the beneficiary’s demand, regardless of how demand was worded.

⁷⁸ LG Frankfurt NJW, 63, 450; OLG Frankfurt WM 74, 956; OLG Hamburg WM 78, 260; OLG Stuttgart RIW/AWD 80, 729; Norbert Horn and Wolfgang Marschall von Bieberstein, *Dokumentenakkreditive und Bankgarantien im internationalen Zahlungsverkehr*, Volume 87, Arbeiten zur Rechtsvergleichung, 1st edition. (Frankfurt am Main: Metzner, 1977), ISBN 9783787501878, p. 35; Canaris, *supra* note 17, at mn 1124; Liesecke, *supra* note 63, at p. 26; Pleyer *supra* note 73, at p. 9; Zahn, et al., *supra* note 5, at mn 9/19.

⁷⁹ LG Hamburg WM 99, 1713. In this decision the court recognized that a bank may issue a surety on first demand instead of a guarantee on first demand. Issuing a surety on first demand however is not advisable in international transactions since this type of obligation is unknown outside the borders of German-speaking jurisdictions. In general it is advisable not to translate *termini technici* in international transactions.

⁸⁰ BGH WM 86,1429; BGH WM 84, 689.

⁸¹ Pleyer *supra* note 73, at p. 9.

⁸² von Westphalen, et al., *supra* note 5, at p. 51.

⁸³ Kleiner, *supra* note 16, at mn 5.18; Zahn, et al., *supra* note 5, at mn 9/19.

i. Interpretation of simple waivers

If a payment instrument does not contain the language “on first demand” or comparable wording, then the use of “waiver of objections and defenses” will not turn the instrument into a guarantee. The only way to turn a payment instrument into a guarantee is if the bank’s payment obligation is in “a tight, indissoluble connection with a clearly described demand for payment by the beneficiary, and indicated by wording such as ‘demand’ or ‘avail.’”⁸⁴

ii. Additional waivers of defenses not required

As mentioned, simple waivers of objections and defenses do not create guarantees; on the other hand this type of language is not suited to strengthen a payment obligation “on first demand”. Nevertheless bank guarantees, particularly when issued by U.S. banks, often contain language like “without any objection” or “without any contestation”.⁸⁵ Contrary to the views of some Austrian and Swiss authors who even consider this type of waivers necessary, the following applies: When using the wording “on first demand” the additional emphasis that objections/defenses are waived is superfluous.⁸⁶ Following this approach, the ISP98 consider terms like “unconditional”, “abstract”, “absolute”, “primary”, “payable from the issuer’s own funds”, “clean”, or “payable on demand” as unnecessary.⁸⁷

B. Structure of a bank guarantee

1. Preamble

a. Relating payment and underlying transaction

Even though a guarantee is independent it nevertheless serves an underlying transaction: “[e]very guarantee secures a specific risk. The beneficiary cannot avail himself of the guarantee for another risk.”⁸⁸ Nevertheless, a bank has to satisfy the payment demand of a beneficiary,

⁸⁴ von Westphalen, et al., *supra* note 5, at p. 52.

⁸⁵ Pleyer *supra* note 73, at p. 9.

⁸⁶ Zahn, et al., *supra* note 5, at mn 9/19; *cf.* BGH, Betriebs Berater (German legal magazine specializing in business law) (“BB”) 1998, 1124.

⁸⁷ See Rule 1.10.

⁸⁸ Kleiner, *supra* note 16, at mn 18.05; Y. Poulet, *Les garanties contractuelles dans le commerce international*, *Droit et pratique du commerce international*, 5 [1979], No. 3, mn 165 (“... its categorical classification hence is not the valid payment obligation of the guarantor towards the beneficiary, but the existence of a commercial operation of partners.”)

which goes beyond the purpose of risk management originally envisioned by the parties; this does not apply where the payment demand is obviously fraudulent, uncontested, or easily provable that the payment demand is outside the scope of the risk the guarantee was supposed to secure. The typical mention in the preamble of the purpose of the guarantee and the risk it is supposed to cover does not make this language part of the payment clause. This corresponds to a draft/bill of exchange which mentions the underlying transaction for which it is being paid.⁸⁹

b. Separation of preamble and payment clause

In order to optically emphasize the legal difference between the preamble, which only serves to inform the reader, and the payment clause, which establishes the payment obligation of the guarantor, both should be separated by a paragraph.

2. Payment clause

a. Demand

The core of the guarantee is the payment clause, often referred to as “tenor”; it must be complete, comprehensible in itself, and contain the conditions under which the guarantor is obligated to pay. Drafters should avoid references to circumstances outside the guarantee document since such references endanger the independence of the guarantee. The most frequently used payment clause, which can be considered the trademark of an international bank guarantee, is the obligation to pay “on first demand.”⁹⁰ This clause or their above-mentioned equivalents are international standards which, due to long uniform usage, are treated similarly around the globe. Hence, additions or modifications of the standard wording, as e.g., “on simple demand,” “on demand,” etc., should be avoided.

⁸⁹ German law requires certain formalities for issuance of a draft; hence a draft that mentions the underlying transaction in the payment clause is void. In order to relate a draft correctly to a specific L/C transaction, it is recommended to write the L/C number in the upper left corner of the draft. This notation has to be made in such a way, that it is clear that it is not part of the draft and only serves clerical processing. See BGH WM 60, 374; Zahn, et al., *supra* note 5, at mn 5/14.

⁹⁰ Albrecht Stockmayer, *Zur unzulässigen Rechtsausübung bei Zahlung auf eine mißbräuchlich angeforderte Bankgarantie*, Die Aktiengesellschaft [1980], p. 327; Pleyer *supra* note 73, at p. 8; von Westphalen, et al., *supra* note 5, at p. 79; Zahn, et al., *supra* note 5, at mn 919; BGH WM 84, 689.

b. Harmful additional language

Language in addition to the payment clause “on first demand” which vaguely references an underlying transaction leads to ambiguity, since it creates a contradiction to the unconditional payment obligation.⁹¹ Since these types of clauses render the text of the guarantee contradictory the question arises whether this renders the guaranty void or whether these clauses should be ignored because they conflict with the payment clause. In most cases the parties add these clauses by negligence, i.e., they do not intend to limit the payment clause. In this vein, the Oberlandesgericht (Court of Appeals) (“OLG”) München decided that a surety payable on first demand “[i]n as far the applicant has not complied with his contractual obligations” did not obligate the beneficiary when demanding payment to prove that the applicant had breached the underlying contract.⁹² The BGH had to decide on a guarantee payable on first demand referencing payments due under a construction contract. The BGH decided that this simple reference did not impair the payment obligation “on first demand.”⁹³

These examples show that any addition to the payment clause “on first demand” will lead to ambiguities; consequently, these additions should be avoided.

3. Documentary extension of the payment clause

a. Reason for the extension

The risk of a beneficiary improperly demanding payment exists for all independent payment obligations. This risk can be alleviated by requiring the

⁹¹ Examples:

- “Payment on first demand in case the seller does not comply with its delivery obligation” or “we will pay on first demand after damages have been incurred.” In this case it is unclear how the beneficiary has to prove that the seller has not delivered or which damages he has incurred.
- We, X-Bank, obligate ourselves, to pay you an amount . . . in case that company Y in Z has not delivered an operational turbine model . . . latest by . . . (In this example it is questionable whether the beneficiary has to prove that the turbine is operational in order to avail himself of the guarantee.)
- We guarantee repayment of the loan used to finance the purchase of ship XY amounting to two thirds of the purchase price = . . . (This clause permits the conclusion that checking how the money was used is part of the guarantee.)

⁹² OLG München WM 98, 342.

⁹³ BGH BB 1996, 2586.

beneficiary to present additional documents.⁹⁴ This is the leading idea behind the ICC-published URDG.⁹⁵

The extension of a payment guarantee can only be effectuated by additions to the payment clause. Referencing the underlying transaction or facts outside the guarantee document is not suitable. The bank may only examine the text of the guarantee to decide whether the demand for payment is proper.⁹⁶ In order to accomplish this goal, drafters may consider additional declarations of the beneficiary or presentation of documentary proofs.

i. Formalized additional declarations

The beneficiary of a guarantee or surety is not obligated to show that the obligation in the underlying transaction, which the guarantee or surety are supposed to ensure, actually exists. This is internationally accepted and confirmed by the BGH.⁹⁷ It is, however, recommended to modify the payment clause “on first demand” such that the beneficiary confirms that the guaranteed case actually occurred. If this additional declaration were made part of the payment clause it would be in accordance with the URDG,⁹⁸ which suggests “that the Principal is in breach of his obligation(s) under the underlying contract(s) or, in the case of a tender guarantee, the tender conditions.” Frequently used is a declaration of the beneficiary that “the applicant has not performed its obligations under the underlying transaction.” In connection with bid bonds it is typical to require a declaration that “the applicant despite having been awarded the tender, has not signed the contract within the time period specified in the tender.”⁹⁹ It is important however, that the additional requirement be mentioned in the payment clause and not by reference to documents outside the guarantee document.

Additional declarations regarding the occurrence of the guarantee case are substantively nothing more than statements of the beneficiary and hence of limited value. A beneficiary’s intent on availing himself to the guarantee improperly will often also fabricate any required documents. Nevertheless, in

⁹⁴ Moschner, *supra* note 68, at p. 134 who recommends to negotiate a “conditional” bank guarantee against improper “extend or pay” demands.

⁹⁵ Cf. *ICC uniform rules for demand guarantees*, Volume 458, International banking, (Paris France: ICC Pub, 1992), ISBN 9284210941, prefaced with the goal to “provide a safeguard against unfair calling and a fair balance of competing interests.”

⁹⁶ Klaus Peter Berger, *Internationale Bankgarantien*, DZWir, [1993], pp. 1ff; *Friedrich von Westphalen, Die neuen einheitlichen Richtlinien für Demand Guarantees*, DB [1992]; Rolf A. Schütze & Hervé Edelmann, *Bankgarantien*, 1st edition. (Köln: Bank-Verlag, 2011), ISBN 9783865562357, p. 39.

⁹⁷ BGH WM 91, 103.

⁹⁸ *ICC uniform rules for demand*, *supra* note 95.

⁹⁹ See Zahn, et al., *supra* note 5, at mn 9/21.

practice it seems that detailed statements tend to let beneficiaries shrink away from a written lie.¹⁰⁰

b. Amount

i. Amount, Currency, Interest

Typically the guarantee amount is a maximum amount. German banks are allowed to issue guarantees in foreign currencies according to § 49 AWG (Außenwirtschaftsgesetz, the German law on foreign trade) and can consequently not pay the guarantee amount in local currency.¹⁰¹ It is recommended that banks clearly indicate whether costs and interests are covered. The emphasis here again is clarity; the undifferentiated increase of the guarantee amount to cover costs, fees, and interest has different meanings in other countries and might, due to their amount, unpleasantly surprise the bank and applicant. Banks are advised to provide for a maximum interest rate or cap the additional costs “not to exceed.”

c. Expiry

Valid letters of credit require an expiration date (see Art. 6a UCP 600). While it is highly recommended, an expiration date is not required for a guarantee. Not only the payment demand but also the guarantee case have to occur before expiration of the guarantee. If the beneficiary has not timely demanded payment, the guarantee expires, even though the guarantee document remains in possession of the beneficiary. Even though according to German international private law (see Article 4, Rome I¹⁰²), guarantees are subject to the law of the guarantor, foreign courts domiciled in the country of the beneficiary do not always follow this view when deciding the date of expiration. This might lead to an undesirable in-between state regarding the question whether the guarantee has expired or not.

¹⁰⁰ Kleiner, *supra* note 16, at mn 17.08; the requirement to present additional statements should not be confused with the demand for payment under a standby, which always requires the presentation of a document. *See* Rule 4.08 ISP98 (“If a standby does not specify any required document, it will still be deemed to require a documentary demand for payment.”).

¹⁰¹ BGH WM 93, 2011.

¹⁰² Regulation (EC) No. 593/2008 of the European Parliament and of the Council of 17 June 2008 (OJ EU L 177 of 4.7.2008, p. 6).

4. Return of the guarantee document

After expiration, a beneficiary who has not demanded payment is obligated to return the guarantee document.¹⁰³ Typically banks insist on a return of the document because the idiosyncrasies regarding outstanding guarantees in some foreign jurisdiction pose a latent risk.¹⁰⁴ This is the reason guarantees are typically drafted so that the return of the guarantee is never the only means of having a guarantee expire (e.g., this guarantee expires, unless returned earlier, on . . .)

Since the guarantee is a contract, returning the guarantee only extinguishes the obligations of the guarantor if the beneficiary returned the guarantee for that purpose. An accidental return of a guarantee does not extinguish the obligations of the guarantor.¹⁰⁵ Nevertheless, the accidental return of a guarantee is an indication of the beneficiary that he wants to have the guarantee expire. He bears the burden of proof if he later claims otherwise.

5. Miscellaneous clauses

a. Choice of Law

Choice of law clauses are not typical and normally dispensable, since according to Article 4, Rome I, the law at the place of the guarantor applies. These rules of German international private law are identical in many European countries and even China has a similar rule.¹⁰⁶

i. Admissibility of issuance according to local laws

Sometimes banks include a clause in their guarantees in which they confirm that the issuance of the guarantee does not violate any laws applicable in the country of the issuing bank. This clause means that the issuance of the guarantee does not violate public law (as e.g. laws dealing with foreign trade

¹⁰³ von Westphalen, et al., *supra* note 5, at p. 123.

¹⁰⁴ Rolf A. Schütze, *Zur Nichtrückgabe von Garantieurkunden nach Erlöschen der Garantieverpflichtung*, WM, [1982], p. 1398.

¹⁰⁵ OLG Hamburg WM 82, 62f. Banks have to pay attention to receiving the original from the beneficiary. In recent years cases have come up where banks have received forged documents from unauthorized persons. Falsifying documents has become particularly easy through the use of computers and image editing software.

¹⁰⁶ Both Article 126 and 145 of the Chinese Civil Law provide for the law that is most closely connected to the transaction. Rules of the Supreme People's Court on Related Issues concerning the Application of Law in Hearing Foreign-Related Contractual Dispute Cases Related to Civil and Commercial Matters, adopted at the 1,429th Meeting of the Judicial Committee of the Supreme People's Court on June 11, 2007, and also referred to as Fa Shi [2007] No. 14 designate the law of the guarantor as the applicable law. *See* Article 5 (12) of the above-mentioned rule.

or currency regulations). Notwithstanding this representation, payment under such a guarantee may be blocked later if the government enforces embargoes or similar.¹⁰⁷

b. Formal requirements of availment

The demand for payment under a guarantee, absent an agreement to the contrary, does not require any specific form.¹⁰⁸ Nevertheless, commercial usage requires that the demand for payment be made in writing.¹⁰⁹ As a precaution this requirement is normally provided for in the text of the guarantee. Even if a demand for payment has to be made in writing, the authors posit that it is sufficient for this demand be made via telex or fax.¹¹⁰ ISP98 Rule 3.06 provides in this regard: “S.W.I.F.T. tested telex, or other similar authenticated means by a beneficiary that is a S.W.I.F.T. participant or a bank complies. . .”

V. FRAUD AND THE DUTY TO REFUSE PAYMENT

A. *Fraudulent availment as the typical risk of abstract payment obligations*

1. Limits of independence

a. Historical background

Before 1980, courts had few opportunities to decide cases dealing with improper demands.¹¹¹ Then, a series of court decisions seemed to indicate a rising number of fraudulent activities. Third world countries were particularly known to cavalierly demand payment. Furthermore, newcomers to the world of international trade finance were said to have misunderstood the guarantee as

¹⁰⁷ Cf. LG Essen WM 99, 178; Johannes Zahn, *Auswirkungen eines politischen Umsturzes auf schwebende Akkreditive und Bankgarantien, die zugunsten von staatlichen Stellen die zugunsten von staatlichen Stellen oder in deren Auftrag eröffnet sind*, ZIP, [1984], pp. 1303ff.

¹⁰⁸ Walther Hadding, Frank Häuser & Reinhard Welter, *Bürgschaft und Garantie: Gutachten und Vorschläge zur Überarbeitung des Schuldrechts*, (Bundesminister der Justiz, 1983), p. 747.

¹⁰⁹ Canaris, *supra* note 17, at mn 1122; Klaus J. Hopt et al., *Handelsgesetzbuch: Mit GmbH & Co., Handelsklauseln, Bank und Börsenrecht, Transportrecht (ohne Seerecht)*, Volume 9, Beck'sche Kurz-Kommentare, 34th edition. (München: Beck, 2010), ISBN 978-3-406-59034-4; Handelsgesetzbuch (Commercial Code) (“HGB”) VII, Bankgeschäfte, L/6. *See also* BGH WM 57, 130, 132.

¹¹⁰ Welter, *supra* note 31, at mn J 45.

¹¹¹ Theodor Heinsius, *Zur Frage des Nachweises der rechtsmißbräuchlichen Inanspruchnahme einer Bankgarantie auf erstes Anfordern mit liquiden Beweismitteln*, in: Walther Hadding et al., editors, *Festschrift für Winfried Werner zum 65. Geburtstag am 17. Oktober 1984*, (New York: de Gruyter, 1984), ISBN 9783110890686, p. 230, with further references in fns 1 and 2.

a belated discount.¹¹² Furthermore, *Hadding/Häusler/Welter* considered political instability and upheavals as sources of abuse and point to the change of government in Libya as well as the Iran crisis.¹¹³ The problem of abuse has entered guarantee transactions comparatively late, albeit rather virulently. The discussions in case law and academic literature even suggested restructuring the business.¹¹⁴

b. Payment function and abuse

Attempts to inoculate the guarantee against abuse must fail. An essential element of abstract payment obligations (guarantee, draft, letter of credit) is their payment function, which always includes the risk of abuse. Many international transactions take place in a buyer's market; i.e., the buyers (particularly for financially involved projects) dictate the terms. The market will not permit implementation of a no-fraud zone against these buyers. The risk of abuse is inherent to a guarantee and the substantive rights of the parties have to be decided in a trial, but after payment has been made.¹¹⁵ This result, however, does not hold true if prompt payment contradicts essential principles of a legal system, which the parties cannot negotiate around, so that it seems intolerable to refer the applicant to future lawsuit. According to German law, the objection of improper exercise of a right is based on a violation of equity (see § 242 BGB). Swiss law has enacted the same principle in Article 2 of its Civil Law Code. Other legal systems have similar provisions regarding the principle of equity.¹¹⁶ The biggest difference among the various national laws in this regard is whether the applicant has to prove a subjective element of abuse in the beneficiary, as e.g. the intention to defraud/harm/abuse.

¹¹² Hadding et al. eds., *supra* note 111, at p. 719; von Westphalen, et al., *supra* note 5, at p. 156.

¹¹³ Hadding et al., *supra* note 108, at p. 719 (it should be remembered that when colonel Ghadafi took power in Libya payment was demanded under all guarantees regardless of whether the beneficiary was entitled to the guarantee funds or not).

¹¹⁴ Ulrich Trost, *Problemlösung beim Bankgarantiegeschäft durch Umstrukturierung des Geschäftstypus ?*, RIW/AWD, [1981].

¹¹⁵ Friedrich Kübler, *Feststellung und Garantie*, Archiv für die civilistische Praxis, [1968], p. 189.

¹¹⁶ Helmut Coing, *Probleme der internationalen Bankgarantie*, ZHR, 147 [1983], No. 2/3, p. 139.

c. Elements of abuse

i. Inadmissible abuse of a formal legal position

Trying to define the elements of abuse of a right or classifying case law has its limits, since these attempts are based on equity which is administered on a case by case basis. The BGH has worked out the criteria under which a bank must refuse payment to a beneficiary in cases where the beneficiary is, from a formal point of view, entitled to payment, while, however, the payment is unwarranted according to substantive law.¹¹⁷ The following head note exemplifies the approach of the BGH:

In case it is obvious, uncontested, or evidenced by documentary proof that, even though the formal requirements of the guarantee have been met, the guarantee case has not occurred, the claim for payment based on the guarantee fails due to the objection of abuse of right. This objection however has to be limited to cases where the abuse of a formal legal position is obvious to everyone. Any disputes of factual or legal nature, which are not answerable in themselves, are to be litigated after payment in a possible trial for repayment.¹¹⁸

ii. Ascertaining the purpose of a guarantee

Critical in the context of fraud is the nonoccurrence of the guarantee case so that the beneficiary's demand for payment will be abusive. "Only the obviously lacking material entitlement justifies the objection of abuse."¹¹⁹ The problem is that the requirement of the guarantee case are not mentioned at all in the guarantee document. Only the reference in the preamble and the underlying transaction itself, which is unknown to the bank, will clarify these requirements.

Day-to-day operations rarely raise a question regarding the purpose of the guarantee since guarantees are standardized according to their purpose (payment guarantee, bid bond, etc.). More frequently the parties argue what the scope of the guarantee is, e.g., whether a performance guarantee also covers contractual penalties (a question which has to be answered in the

¹¹⁷ BGH WM 1984, 689, 690; BGH WM 1986, 1429, 1430; BGH WM 1988, 934, 935; BGH ZIP 1997, 275, 279f.; BGH BB 2000, 684, 685; BGH ZIP 2000, 2136.

¹¹⁸ BGH NJW 88, 2610.

¹¹⁹ BGH WM 85, 511. *See also* BGH WM 88, 934, 935.

affirmative).¹²⁰ Once the purpose and scope of the guarantee have been ascertained, the objection of abuse will be granted if the court finds that the performance has been effectuated. However, this does not apply if the applicant claims he was not obligated to perform based on defects of the underlying contract.¹²¹

iii. Burden of Proof

The applicant or the guarantor bears the burden of proof of proving abuse against the beneficiary. The function of the guarantee is to reverse the roles of attacker and defender.¹²² The objection of abuse has to be obvious¹²³ or the facts that justify the objection must be uncontested or provable with documentary evidence.¹²⁴ As previously mentioned, all factual or legal disputes regarding the demand for payment need to be addressed in a trial after payment. This means that typically, the proof of abuse has to be made by documents.¹²⁵ Only in exceptional cases would an expert witness be called.¹²⁶ Presenting correspondence from the beneficiary is only acceptable if the writing is ambiguous and signed by an authorized representative of the beneficiary. An acceptance protocol signed by a project manager who regularly signed this type of protocol in the past on behalf of the beneficiary may be sufficient. The same document signed by a construction group leader normally should not be acceptable.¹²⁷ Affidavits or the applicant's testimony are unsuitable as evidence.¹²⁸ Similarly, the BGH did not consider as acceptable evidence the fact that a court had issued a preliminary injunction

¹²⁰ LG Hamburg WM 1999, 1713 (the general term "performance guarantee" covers all obligations). Cf. BGH WM 1989, 212).

¹²¹ Kleiner, *supra* note 16, at mn 21.46, 21.48. Also irrelevant is whether the applicant is liable to the beneficiary without fault, or whether the beneficiary may keep the guarantee amount for all cases of *force majeure*, or only those specified.

¹²² Canaris, *supra* note 17, at mn 1139; Heinrich von Mettenheim, *Die mißbräuchliche Inanspruchnahme bedingungsloser Bankgarantien*, RIW/AWD, [1981].

¹²³ BGH WM 84, 689; BGH WM 88, 934, 935.

¹²⁴ For example: obvious (as this term is used above) is the demand for payment under a maintenance guarantee due to the failure to deliver spare parts, however, it is generally known that the country of the beneficiary imposed sanctions on foreign countries and does not issue import licenses. However, it is not sufficient when the occurrence of the guarantee case is without doubt, but the parties argue about the amount of the claim supported by the guarantee. See BGH WM NJW 94, 380.

¹²⁵ OLG Köln WM 88, 2619; Liesecke, *supra* note 63, at p. 26; von Westphalen, et al., *supra* note 5, at p. 195 (correctly mentions that correspondence, documents, receipts have to come from the sphere of the beneficiary and not the applicant).

¹²⁶ Liesecke, *supra* note 63, at p. 27; Welter, *supra* note 31, at mn J 75.

¹²⁷ Welter, *supra* note 31, at mn J 75 (considering plans, drawings, photography and sound recordings as acceptable). See also OLG Frankfurt WM 83, 575, 576; OLG Köln WM 88, 21, 23.

¹²⁸ von Westphalen, et al., *supra* note 5, at p. 196.

against the beneficiary since the decision had been made according to §§ 921 I, 936 ZPO without giving the beneficiary a chance to be heard.¹²⁹

2. Subjective elements of abuse

a. Decisions of the BGH

Since the prohibition to abuse a right has been derived from § 242 BGB, the authors believe that it is sufficient, if it is certain that the demand for payment is objectively improper. Hence, the applicant need not prove that the beneficiary has a specific *mens rea*. This view however is not shared by the majority of courts and the academic literature, which will only recognize an abuse if the beneficiary obviously demanded payment arbitrarily, fraudulently, or maliciously.¹³⁰ It seems that the BGH also requires a reprehensible subjective state of mind of the beneficiary when analyzing the objection of improper demand of the guarantee. Only this can explain the decision of the BGH regarding the demand for payment under a letter of credit which the bank originally refused, since the beneficiary delivered pirated goods that were useless for the applicant.¹³¹ A secondary beneficiary, who acted in good faith in regard to the provenance of the pirated goods, demanded payment under the LC, a demand that was granted by the BGH.

b. Foreign jurisdictions

Similar to German courts, French and English courts tend to require a showing that the beneficiary displayed a reprehensible intent when demanding payment. The French Code Civil in its Article 1382 dealing with civil torts does not provide for subjective elements. However, French courts and academic literature tend to require a subjective element in order to reject a payment demand for fraud.¹³²

English courts similarly apply the fraud exception only when the applicant or the guarantor can prove “established fraud.” Characteristic in this

¹²⁹ BGH ZIP 2000, 2156, 2159. This view is not without problems and should not be followed in cases where the preliminary injunction was based on documents coming from the beneficiary or an independent expert. *Cf. id.*

¹³⁰ von Caemmerer, *supra* note 63, at p. 303.

¹³¹ BGH WM 96, 995, 996. *Cf. also* BGH ZIP 2000, 2156, 2158 (regarding a counter guarantee).

¹³² Anna-Georgia Papamatthaiou, *La fraude dans le credit documentaire*, diss. jur., (Université Robert Schuman, Strasbourg, 2004), *available at* <http://cde.alsace.cnrs.fr/IMG/pdf/PAPAMATTHAIUO.pdf>, pp. 41f.

regard is the decision *Edward Owen Engineering Ltd. v. Barclays Bank International Ltd.*¹³³ in which the Court of Appeal found:

All this leads to the conclusion that the performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or conditions. The only exception is when there is a clear fraud of which the bank has notice.

U.S. courts base the requirement of a reprehensible intent on Article 5-109 of the UCC, which requires fraud as an exception to the independence principle.¹³⁴ American courts apply the UCC to all standby letters of credit, independent of whether the standby more closely mirrors a letter of credit or a bank guarantee. The point of departure for all fraud cases, not only in the United States, was the case of *Sztejn v. J. Henry Schroder Banking Corporation et al.*¹³⁵ which stated: “. . . where the seller’s fraud has been called to the bank’s attention before the drafts and documents have been presented for payment, the principle of the independence of the bank’s obligation under the letter of credit should not be extended to protect the unscrupulous seller.”

c. Proving *mens rea* in fraud cases

On the one hand, the court’s intentions to reduce the ability of banks and applicants to weaken the principle of independence is praiseworthy. On the

¹³³ [1978] Q.B. 159.

¹³⁴ § 5-109. Fraud and Forgery. (a) If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant: (1) the issuer shall honor the presentation, if honor is demanded by (i) a nominated person who has given value in good faith and without notice of forgery or material fraud, (ii) a confirmer who has honored its confirmation in good faith, (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer’s or nominated person’s deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person; and (2) the issuer, acting in good faith, may honor or dishonor the presentation in any other case.

¹³⁵ 177 Misc. 719, 31 N.Y.S. 2d 631 (Sup. Ct. 1941).

other hand, only allowing a bank to refuse payment in cases of fraud, i.e., when confronted with criminal behavior, is the wrong way. It is not convincing that a bank has to pay a beneficiary only because the beneficiary was unaware of the evidence that his demand is objectively abusive. The type of erroneous decision emanating from this approach is exemplified by *United City Merchants (Investments) Ltd. v. Royal Bank of Canada*¹³⁶ which ordered the bank to pay even though the beneficiary presented a bill of lading whose date had been falsified. The court reasoned that the bank was to pay, since the beneficiary did not know that the bill of lading had been backdated. Similarly, in *Offshore Trading Co. v. Citizens Nat. Bank*¹³⁷ the court ordered the bank to pay unless the bank proved that the beneficiary knew that the applicant was not in default at the time it presented its draft drawing on the letter of credit.¹³⁸ These decisions do not take into account that a beneficiary demanding payment and presenting documents is responsible for the accuracy of the presented documents. A beneficiary cannot rely on the defense that he believed the documents were correct and that he relied in good faith on the assertions of third parties.

The view that only the objective elements of abuse are the decisive criteria currently is a minority view, but one that is growing in importance. Others recognize that under no circumstances can the beneficiary be allowed to prove, even though he knew of the facts constituting the abuse, that he acted without guilt.¹³⁹

3. Typical categories of fraud

a. Demand for payment outside the purpose of the guarantee

Regarding the payment demand it is generally irrelevant whether the guarantee case has occurred. However, the beneficiary's demand is abusive if he intends the guarantee to cover claims which are not supposed to be covered by the guarantee. The guarantor bank must refuse payment under these circumstances if it knows, has received documentary proof, or if these facts are uncontested. Proving that the payment demand is abusive under this category is theoretically difficult since the beneficiary does not have to show that the guarantee case has occurred. However, this task is facilitated by the standardization of the different types of guarantees (e.g. a payment guarantee, performance guarantee, or service guarantee).

¹³⁶ (HL) House of Lords [1983] 1 A.C. 168; [1982] 2 W.L.R. 1039; [1982] 2 All E.R. 720; [1982] 2 Lloyd's Rep. 1; [1982] Com. L.R. 142.

¹³⁷ 650 F. Supp. 1487 (D. Kan. 1987).

¹³⁸ *Id.* at 1493.

¹³⁹ von Westphalen, et al., *supra* note 5, at p. 202.

In the following cases the courts found that the beneficiary abused his position by demanding payment for claims that were not covered by the guarantee: a guarantee intended to secure an advance payment for a specific import transaction (import of 600 tons of coconut oil) cannot be used to satisfy other payment claims based on loans.¹⁴⁰

A subcontractor issued a guarantee to the benefit of a general contractor to secure the subcontractor's performance. The general contractor then issued a guarantee to the benefit of the builder who demanded payment for the non-performance of the general contractor. The general contractor was not permitted to draw on the guarantee of the subcontractor since the purpose of the two guarantees were not identical.¹⁴¹ The general contractor was only permitted to demand payment under the guarantee provided by the subcontractor if general and sub agreed that payment under the general contractor's guarantee automatically triggered the pro rata or complete payment obligation of the subcontractor's guarantor.¹⁴²

A performance guarantee, which typically covers all claims emanating from the underlying transaction, may be used to cover contractual penalties. An advance payment guarantee however, which is merely intended to ensure the applicant's delivery, may not be drawn down on for purposes of covering penalties.¹⁴³

b. *Force Majeure*

A bank cannot refuse payment with the argument that performance of the underlying transaction had been rendered impossible due to *force majeure*. Typical *force majeure* events cited in this context are destruction of the production plant by fire, impossibility to deliver goods due to earthquakes or inundations, or bankruptcy of a supplier. It is furthermore irrelevant whether these causes were predictable or can be blamed on the applicant. It is the essence of the bank guarantee to also cover atypical risks.¹⁴⁴ If a bank had to investigate whether an applicant was prevented from performing his obligations due to *force majeure* a bank would be granted the role of an arbitrator, contradicting the nature of a guarantee.

A case of *force majeure* can only render the beneficiary's payment demand abusive if this allocation of risks is clearly discernible from the guarantee document.¹⁴⁵ The BGH has confirmed this result in a case where the

¹⁴⁰ Kleiner, *supra* note 16, at mn 21.37.

¹⁴¹ OIG München WM 85, 89.

¹⁴² *Id.*

¹⁴³ BGH WM 88, 212.

¹⁴⁴ Kleiner, *supra* note 16, at mn 5.67.

¹⁴⁵ von Westphalen, et al., *supra* note 5, at p. 214.

beneficiary was the owner of real estate situated in Iran. The guarantee covered the event that the applicant did not exercise a lease option and hence would be subject to a contractual penalty. The beneficiary however had been expropriated by the leaders of the Iranian revolution. The BGH reasoned that the risk of expropriation is one that the owner (beneficiary) has to bear and not the lessee (applicant) and deemed the beneficiary's payment demand abusive.¹⁴⁶

c. Export/Import bans

German courts have not clearly answered the question of how export or import bans applicable to the underlying transaction affect a bank guarantee. One has to assume that bans coming into effect after the guarantee has already been issued do not modify the bank guarantee. Support for this view stems from Article 1 Council Regulation (EEC) No 3541/92 of December 7, 1992, prohibiting the satisfaction of Iraqi claims with regard to contracts and transactions, the performance of which was affected by United Nations Security Council Resolution 661 (1990) and related resolutions. EEC 3541/92 expressly prohibited banks from satisfying payment demands after the underlying transactions already had been voided by UN Security Council Resolution 651.

On the other hand, the *Landergericht* (Superior Court) ("LG") Limburg allowed the beneficiary of a letter of credit to get paid even though the carrier could not ship the goods based on the embargo. The beneficiary correctly presented an airway bill that the carrier issued after receipt of the goods and before take off.¹⁴⁷ This, however, may not apply if the guarantee is only an immoral circumvention of domestic laws.

d. Ordre public

Article 6 of the *Einführungsgesetzes Bürgerlichen Gesetzbuche* (the Introductory law to the German Civil Code) ("EGBGB") establishes the principle of ordre public for German law.¹⁴⁸ The BGH applied this principle in the following case arguing that another result would unbearably contradict German notions of justice. The beneficiary was an Iranian bank controlled by the Iranian government which had required the applicant to personally secure

¹⁴⁶ BGH WM 81, 633.

¹⁴⁷ LG Limburg WM 92, 1399.

¹⁴⁸ Art. 6 Public policy (ordre public): A provision of the law of another country shall not be applied where its application would lead to a result which is manifestly incompatible with the fundamental principles of German law. In particular, inapplicability ensues if its application would be incompatible with civil rights.

loans for his business in Iran. After the Iranian government expropriated the applicant's business the beneficiary demanded payment under credit guarantee. The BGH denied the demand for payment of the Iranian beneficiary.¹⁴⁹

e. Extend or pay

Often banks are confronted with a beneficiary's demand to "extend or pay" the guarantee which is used to pressure the guarantor to extend the deadline of the guarantee. By itself this demand is not an indication of abuse¹⁵⁰ since the extension might give the applicant the opportunity to fulfill his contractual obligations.

As the beneficiary does not have a right to have the guarantee extended, the guarantor might reject the beneficiary's request. In this case however, the guarantor must pay if all requirements for a compliant demand for payment have been met.¹⁵¹

If the beneficiary does not fulfill the formal requirement for a payment demand when asking to extend the expiry date of the guarantee, the guarantor has to refuse payment. If the guarantee bank informs the beneficiary that is has notified the applicant of the "extend or pay" request, the guarantee bank has not tacitly extended the guarantee. Consequently, once the applicant refuses the extension the beneficiary may not amend his demand for payment if it has been defective.

APPENDIX

English Translation of German Articles on Suretyship:

§ 765 Typical contractual duties in suretyship

(1) By a contract of suretyship the surety puts himself under a duty to the creditor of a third party to be responsible for discharging that third party's obligation.

(2) Suretyship may also be assumed for a future or contingent obligation.

§ 766 Written form of the declaration of suretyship

For the contract of suretyship to be valid, the declaration of suretyship must be issued in writing. The declaration of suretyship may not be made in

¹⁴⁹ BGH WM 88, 893.

¹⁵⁰ *Id.*

¹⁵¹ BGH WM 96, 393.

electronic form. If the surety discharges the main obligation, the defect of form is remedied.

§ 767 Extent of the suretyship debt

(1) The currently applicable amount of the main obligation determines the duty of the surety. This applies in particular, without limitation, if the main obligation has been changed through no fault of or default by the principal debtor. The duty of the surety is not extended by a legal transaction that the principal debtor undertakes after assumption of the suretyship.

(2) The surety is liable for the costs of termination and prosecution of rights that are reimbursable by the principal debtor to the creditor.

§ 768 Defenses of surety

(1) The surety may assert the defenses to which the principal debtor is entitled. If the principal debtor dies, then the surety may not invoke the fact that the heir has only limited liability for the obligation.

(2) The surety is not deprived of a defense by the fact that the principal debtor waives it.

§ 769 Co-suretyship

Where more than one person enters a suretyship commitment for the same obligation, they are jointly and severally liable even if they do not assume suretyship jointly.

§ 770 Defenses of voidability and set-off

(1) The surety may refuse to satisfy the creditor as long as the principal debtor is entitled to avoid the legal transaction on which the obligation is based.

(2) The surety has the same authority as long as the creditor can obtain satisfaction by set-off against a claim of the principal debtor that is due.

§ 771 Defense of unexhausted remedies

The surety may refuse to satisfy the creditor as long as the creditor has not attempted without success to obtain execution of judgment against the principal debtor (defense of unexhausted remedies). If the surety raises the defense of unexhausted remedies, the limitation of the claim of the creditor against the surety is suspended until the creditor has attempted without success to obtain execution of judgment against the principal debtor.

§ 772 Duty of creditor of enforcement and realization

(1) If the suretyship applies to a monetary claim, then enforcement of judgment must be attempted against the movable things of the principal debtor at his residence and, if the principal debtor has a business establishment in another locality, at the latter as well, and, in the absence of a residence and a business establishment, at his place of abode.

(2) If the creditor has a pledge over or right of retention to a movable thing of the principal debtor, then he must attempt to satisfy his claim from this thing too. If the creditor has such a right to the thing for another claim as well, then this only applies if both claims are covered by the value of the thing.

§ 773 Exclusion of defense of unexhausted remedies

(1) The defense of unexhausted remedies is excluded:

1. if the surety waives the defense, including without limitation if he has assumed suretyship as principal debtor,
2. if pursuit of rights against the principal debtor is made appreciably more difficult due to a change of residence, of business establishment or of place of abode occurring after assumption of suretyship,
3. if insolvency proceedings have been opened in relation to the assets of the principal debtor,
4. if it must be assumed that enforcement of judgment against the assets of the principal debtor will not result in satisfaction of the claim of the creditor.

(2) In the cases cited in nos. 3 and 4, the defense is admissible to the extent that the creditor may satisfy his claim out of a movable thing of the principal debtor over which he has a security right or of which he has a right of retention; the provisions of section 772 (2) sentence 2 apply.

§ 774 Statutory passing of claims

(1) To the extent that the surety satisfies the claims of the creditor, the claim of the creditor against the principal debtor passes to him. The passing of ownership may not be asserted to the disadvantage of the creditor. Objections by the principal debtor under a legal relationship existing between himself and the surety are unaffected.

(2) Co-sureties are only liable to each other under section 426.

§ 775 Claim to release of the surety

(1) If the surety has provided suretyship on the instructions of the principal debtor, or if he is entitled under the provisions on agency without specific authorization, as a result of assuming the suretyship, to the rights of a

voluntary agent against the principal debtor, then he may demand that the principal debtor releases him from the suretyship:

1. if the financial situation of the principal debtor has substantially deteriorated,
2. if pursuit of rights against the principal debtor is made appreciably more difficult due to a change of residence, of business establishment or of place of abode occurring after assumption of suretyship,
3. if the principal debtor is in default of discharging his obligation,
4. if the creditor has obtained an enforceable judgment for discharge against the surety.

(2) If the main obligation has not yet fallen due, then the principal debtor may provide security to the surety instead of releasing him.

§ 776 Waiver of a security

If the creditor waives a preferential right connected with the claim, a mortgage or ship mortgage, a pledge existing for the claim or a right against a co-surety, then the surety is released to the extent that he would have been able to obtain compensation under section 774 from the right waived. This also applies if the right waived only arose after assumption of the suretyship.

§ 777 Temporary suretyship

(1) If the surety has provided suretyship for an existing obligation for a specified period of time, then at the end of the specified period of time he is released, unless the creditor effects collection of the claim without undue delay under the provisions of section 772, continues the proceedings without any substantial delay and without undue delay after the end of the proceedings notifies the surety that he is claiming payment from him. If the surety is not entitled to the defense of unexhausted remedies, then he is released at the end of a specified period of time, unless the creditor makes this notification to him without undue delay.

(2) If notification has been made in good time, then the liability of the surety in the case of subsection (1) sentence 1 is limited to the scope the main obligation has at the time when the proceedings ended, or in the case cited in subsection (1) sentence 2 to the scope the main obligation has at the end of the specified period of time.

§ 778 Credit mandate

A person who instructs another person to grant a third party a loan or financing assistance in his own name and for his own account is liable as surety to the mandatory for the obligation of the third party arising from the loan or the financing assistance.

Original German:

Bürgschaft

§ 765 Vertragstypische Pflichten bei der Bürgschaft

(1) Durch den Bürgschaftsvertrag verpflichtet sich der Bürge gegenüber dem Gläubiger eines Dritten, für die Erfüllung der Verbindlichkeit des Dritten einzustehen.

(2) Die Bürgschaft kann auch für eine künftige oder eine bedingte Verbindlichkeit übernommen werden.

§ 766 Schriftform der Bürgschaftserklärung

Zur Gültigkeit des Bürgschaftsvertrags ist schriftliche Erteilung der Bürgschaftserklärung erforderlich. Die Erteilung der Bürgschaftserklärung in elektronischer Form ist ausgeschlossen. Soweit der Bürge die Hauptverbindlichkeit erfüllt, wird der Mangel der Form geheilt.

§ 767 Umfang der Bürgschaftsschuld

(1) Für die Verpflichtung des Bürgen ist der jeweilige Bestand der Hauptverbindlichkeit maßgebend. Dies gilt insbesondere auch, wenn die Hauptverbindlichkeit durch Verschulden oder Verzug des Hauptschuldners geändert wird. Durch ein Rechtsgeschäft, das der Hauptschuldner nach der Übernahme der Bürgschaft vornimmt, wird die Verpflichtung des Bürgen nicht erweitert.

(2) Der Bürge haftet für die dem Gläubiger von dem Hauptschuldner zu ersetzenden Kosten der Kündigung und der Rechtsverfolgung.

§ 768 Einreden des Bürgen

(1) Der Bürge kann die dem Hauptschuldner zustehenden Einreden geltend machen. Stirbt der Hauptschuldner, so kann sich der Bürge nicht darauf berufen, dass der Erbe für die Verbindlichkeit nur beschränkt haftet.

(2) Der Bürge verliert eine Einrede nicht dadurch, dass der Hauptschuldner auf sie verzichtet.

§ 769 Mitbürgschaft

Verbürgen sich mehrere für dieselbe Verbindlichkeit, so haften sie als Gesamtschuldner, auch wenn sie die Bürgschaft nicht gemeinschaftlich übernehmen.

§ 770 Einreden der Anfechtbarkeit und der Aufrechenbarkeit

(1) Der Bürge kann die Befriedigung des Gläubigers verweigern, solange dem Hauptschuldner das Recht zusteht, das seiner Verbindlichkeit zugrunde liegende Rechtsgeschäft anzufechten.

(2) Die gleiche Befugnis hat der Bürge, solange sich der Gläubiger durch Aufrechnung gegen eine fällige Forderung des Hauptschuldners befriedigen kann.

§ 771 Einrede der Vorausklage

Der Bürge kann die Befriedigung des Gläubigers verweigern, solange nicht der Gläubiger eine Zwangsvollstreckung gegen den Hauptschuldner ohne Erfolg versucht hat (Einrede der Vorausklage). Erhebt der Bürge die Einrede der Vorausklage, ist die Verjährung des Anspruchs des Gläubigers gegen den Bürgen gehemmt, bis der Gläubiger eine Zwangsvollstreckung gegen den Hauptschuldner ohne Erfolg versucht hat.

§ 772 Vollstreckungs- und Verwertungspflicht des Gläubigers

(1) Besteht die Bürgschaft für eine Geldforderung, so muss die Zwangsvollstreckung in die beweglichen Sachen des Hauptschuldners an seinem Wohnsitz und, wenn der Hauptschuldner an einem anderen Orte eine gewerbliche Niederlassung hat, auch an diesem Orte, in Ermangelung eines Wohnsitzes und einer gewerblichen Niederlassung an seinem Aufenthaltsort versucht werden.

(2) Steht dem Gläubiger ein Pfandrecht oder ein Zurückbehaltungsrecht an einer beweglichen Sache des Hauptschuldners zu, so muss er auch aus dieser Sache Befriedigung suchen. Steht dem Gläubiger ein solches Recht an der Sache auch für eine andere Forderung zu, so gilt dies nur, wenn beide Forderungen durch den Wert der Sache gedeckt werden.

§ 773 Ausschluss der Einrede der Vorausklage

(1) Die Einrede der Vorausklage ist ausgeschlossen:

1. wenn der Bürge auf die Einrede verzichtet, insbesondere wenn er sich als Hauptschuldner verbürgt hat,
2. wenn die Rechtsverfolgung gegen den Hauptschuldner infolge einer nach der Übernahme der Bürgschaft eingetretenen Änderung des Wohnsitzes, der gewerblichen Niederlassung oder des Aufenthaltsorts des Hauptschuldners wesentlich erschwert ist,
3. wenn über das Vermögen des Hauptschuldners das Insolvenzverfahren eröffnet ist,

4. wenn anzunehmen ist, dass die Zwangsvollstreckung in das Vermögen des Hauptschuldners nicht zur Befriedigung des Gläubigers führen wird.

(2) In den Fällen der Nummern 3, 4 ist die Einrede insoweit zulässig, als sich der Gläubiger aus einer beweglichen Sache des Hauptschuldners befriedigen kann, an der er ein Pfandrecht oder ein Zurückbehaltungsrecht hat; die Vorschrift des § 772 Abs. 2 Satz 2 findet Anwendung.

§ 774 Gesetzlicher Forderungsübergang

(1) Soweit der Bürge den Gläubiger befriedigt, geht die Forderung des Gläubigers gegen den Hauptschuldner auf ihn über. Der Übergang kann nicht zum Nachteil des Gläubigers geltend gemacht werden. Einwendungen des Hauptschuldners aus einem zwischen ihm und dem Bürgen bestehenden Rechtsverhältnis bleiben unberührt.

(2) Mitbürgen haften einander nur nach § 426.

§ 775 Anspruch des Bürgen auf Befreiung

(1) Hat sich der Bürge im Auftrag des Hauptschuldners verbürgt oder stehen ihm nach den Vorschriften über die Geschäftsführung ohne Auftrag wegen der Übernahme der Bürgschaft die Rechte eines Beauftragten gegen den Hauptschuldner zu, so kann er von diesem Befreiung von der Bürgschaft verlangen:

1. wenn sich die Vermögensverhältnisse des Hauptschuldners wesentlich verschlechtert haben,
2. wenn die Rechtsverfolgung gegen den Hauptschuldner infolge einer nach der Übernahme der Bürgschaft eingetretenen Änderung des Wohnsitzes, der gewerblichen Niederlassung oder des Aufenthaltsorts des Hauptschuldners wesentlich erschwert ist,
3. wenn der Hauptschuldner mit der Erfüllung seiner Verbindlichkeit im Verzug ist,
4. wenn der Gläubiger gegen den Bürgen ein vollstreckbares Urteil auf Erfüllung erwirkt hat. Ist die Hauptverbindlichkeit noch nicht fällig, so kann der Hauptschuldner dem Bürgen, statt ihn zu befreien, Sicherheit leisten.

§ 776 Aufgabe einer Sicherheit

Gibt der Gläubiger ein mit der Forderung verbundenes Vorzugsrecht, eine für sie bestehende Hypothek oder Schiffshypothek, ein für sie bestehendes Pfandrecht oder das Recht gegen einen Mitbürgen auf, so wird der Bürge insoweit frei, als er aus dem aufgegebenen Recht nach § 774 hätte

Ersatz erlangen können. Dies gilt auch dann, wenn das aufgegebenes Recht erst nach der Übernahme der Bürgschaft entstanden ist.

§ 777 Bürgschaft auf Zeit

(1) Hat sich der Bürge für eine bestehende Verbindlichkeit auf bestimmte Zeit verbürgt, so wird er nach dem Ablauf der bestimmten Zeit frei, wenn nicht der Gläubiger die Einziehung der Forderung unverzüglich nach Maßgabe des § 772 betreibt, das Verfahren ohne wesentliche Verzögerung fortsetzt und unverzüglich nach der Beendigung des Verfahrens dem Bürgen anzeigt, dass er ihn in Anspruch nehme. Steht dem Bürgen die Einrede der Vorausklage nicht zu, so wird er nach dem Ablauf der bestimmten Zeit frei, wenn nicht der Gläubiger ihm unverzüglich diese Anzeige macht.

(2) Erfolgt die Anzeige rechtzeitig, so beschränkt sich die Haftung des Bürgen im Falle des Absatzes 1 Satz 1 auf den Umfang, den die Hauptverbindlichkeit zur Zeit der Beendigung des Verfahrens hat, im Falle des Absatzes 1 Satz 2 auf den Umfang, den die Hauptverbindlichkeit bei dem Ablauf der bestimmten Zeit hat.

§ 778 Kreditauftrag

Wer einen anderen beauftragt, im eigenen Namen und auf eigene Rechnung einem Dritten ein Darlehen oder eine Finanzierungshilfe zu gewähren, haftet dem Beauftragten für die aus dem Darlehen oder der Finanzierungshilfe entstehende Verbindlichkeit des Dritten als Bürge.

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STRIKING A BALANCE IN COMPULSORY LICENSE LEGISLATION

*Kishore Khan**

INTRODUCTION

On March 3, 2008, India's patent office issued a license to Bayer to import and market Nexavar, a drug that is used to extend the lives of people with liver or kidney cancer.¹ Bayer sold limited quantities of Nexavar in India for a price of 280,248 rupees (approximately \$5,300 USD) per month.² However, because the average wage in India was so low compared to this price, the medicine was not available to the majority of the public. By one economist's projections, a low ranking government employee would have to work three and a half years to afford Nexavar for one month.³ As a result, less than two percent of India's patients that needed Nexavar had access to it over the next two years. Natco Pharma Ltd. ("Natco Pharma"), a generic drug manufacturer, approached Bayer to negotiate a license that would allow them to sell a generic version of the drug for 8,800 rupees (approximately \$170 USD) a month. However, Bayer refused to issue a voluntary license.

Three years after the Bayer's patent was active in India, Natco Pharma applied for a compulsory license, which alleged that the patent holder had not allowed the reasonable requirements of the public to be met or that the patented invention was not available to the public at a reasonable price.⁴ A compulsory license authorizes the applicant to create and market the patented invention despite the existence of a patent.⁵ Based on factors such as the exorbitant price charged and the incredibly low market supply maintained by Bayer, the Indian government determined that Bayer did not make the drug available in a capacity that would benefit the public and therefore awarded Natco Pharma a compulsory license, allowing them to manufacture and market

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¹ Natco Pharma Ltd., C.L.A No. 1 of 2011, available at http://www.ipindia.nic.in/ipoNew/compulsory_License_12032012.pdf (Application for Compulsory License Under Section 84(1) of the Patents Act, 1970 in Respect of Patent No. 215758);, *AHFS Consumer Medication Information: Sorafenib*, U.S. National Library of Medicine (October 1, 2010), available at <http://www.ncbi.nlm.nih.gov/pubmedhealth/PMH0000401/>.

² Natco Pharma Ltd *supra* note 1, at 15.

³ *Id.* at 25.

⁴ Patents Act, 1970, §84(1), No. 39. of 1970, INDIA CODE (1979) (amended 2005).

⁵ WTO Fact Sheet, *TRIPS and Pharmaceutical Patents* (Sept. 2006), available at www.wto.org/english/tratop_e/trips_e/tripsfactsheet_pharma_2006_e.pdf.

a generic version of Nexavar at price that many more people would be able to afford.⁶

India's issue of the compulsory license signifies a landmark in the effort to increase access to patent medicines for people around the world. The action marks India's first use of the World Trade Organization ("WTO") Trade Related Aspects of Intellectual Property Rights ("TRIPS") agreement provisions allowing a country to use the subject of a patent without the authorization of the right holder.⁷ Under TRIPS, countries must respect the exclusive rights conferred by patents except under certain circumstances, such as when it is necessary to protect public health, provided that the exceptions do not unreasonably conflict with a normal exploitation of the patent and do not unreasonably prejudice the legitimate interests of the patent owner.⁸

Patent holders often refuse to negotiate voluntary licenses because it is in their best interest to restrict the supply of the patented product and thus receive a greater profit from each sale. They may engage in forms of patent abuse such as unreasonably restraining trade, fixing prices, limiting production, allocating markets, and other anti-competitive measures.⁹ Patent holders advocate strict intellectual property laws and frequently express opposition to the creation of compulsory license frameworks in order to maintain the ability to commit such practices.¹⁰ In addition, patent holders may resort to litigation, political measures, and diplomatic channels to stifle the issue or use of a compulsory license.¹¹ TRIPS addresses these practices and indicates that countries may take appropriate measures to prevent the "use of intellectual property rights"

⁶ See Natco Pharma Ltd., *supra* note 1, at 54-62.

⁷ Madhur Singh, *Compulsory License Will Allow Natco To Sell Generic of Bayer's Nexavar in India*, 83 PAT. TRADEMARK & COPYRIGHT J. 691 (2012); WTO Agreement, General Agreement on Tariffs and Trade - Multilateral Trade Negotiations (The Uruguay Round): Agreement on Trade-Related Aspects of Intellectual Property Rights, Including Trade in Counterfeit Goods, 33 I.L.M. 81, 95 (1994) [hereinafter WTO Agreement].

⁸ WTO Agreement, *supra* note 7, at 87, 95.

⁹ Ellen 't Hoen, *Commission on Intellectual Property Rights, Innovation and Public Health, TRIPS, Pharmaceutical Patents and Access to Essential Medicines: Seattle, Doha and Beyond*, 47 (2003), available at <http://www.who.int/intellectualproperty/topics/ip/tHoen.pdf>.

¹⁰ Tamlin H. Bason, *Lawmakers Told That Compulsory Licenses are Impacting Global Pharmaceutical Sales*, 84 PAT. TRADEMARK & COPYRIGHT J. 8 (2012); see Robert C. Bird, *Developing Nations and the Compulsory License: Maximizing Access to Essential Medicines While Minimizing Investment Side Effects*, 37 J.L. MED. & ETHICS 209, 209 (2009).

¹¹ Bason, *supra* note 10; see Jerome H. Reichman, *Comment: Compulsory Licensing of Patented Pharmaceutical Inventions: Evaluating the Options*, 37 J.L. MED. & ETHICS 247, 248 (2009).

and “practices which unreasonably restrain trade or adversely affect the international transfer of technology.”¹²

As seen in cases such as the one between Bayer and Natco Pharma, patent holders often refuse to negotiate voluntary licenses in order to maintain the exclusive right to use an invention.¹³ This is especially profitable in developing countries, which have a narrow highly inelastic demand curve, allowing the patent holder to earn greater profits by maintaining high prices to serve the portion of demand that is highly inelastic. In some cases, the prices for patented medicines may even be higher in lower income countries than in higher income countries.¹⁴ One scholar refers to this as a systemic issue because, in countries with very high income inequality, the “market forces may produce incentives for patent holders to maximize profits by pricing their products to serve only the wealthiest sliver of the population.”¹⁵ This creates an ethical issue for countries when the intellectual property rights withheld are necessary to address public health issues. The country must choose between enforcing the patent, foregoing the need of the public, or allowing a third party to use the patent against the will of the patent holder, to fulfill the country’s public health needs.

This Note discusses the creation of the international legal framework within which intellectual property rights are enforced. An examination of the competing considerations in reaching the TRIPS agreement places the compulsory license in perspective of the interactions between developing and developed nations. Part II analyzes legislation passed by countries such as Canada, the European Union, India, and Thailand that implement obligations under the TRIPS agreement. It explores how different regimes approach the same issues with different legislative mechanisms. The Note continues by highlighting the legislative challenges and rationales behind various compulsory license requirements. Part III discusses the role of compulsory license legislation in providing access to patented medicines and advocates the need to expand such legislation with a baseline set of requirements to ensure the correct incentives are achieved. A baseline set of requirements will work to prevent abuses of compulsory license and will make the passing of

¹² See WTO Agreement, *supra* note 7; see also WTO Fact Sheet, *supra* note 5.

¹³ See Singh *supra* note 7.

¹⁴ Keith E. Maskus, *Parallel Imports in Pharmaceuticals: Implications for Competition and Prices in Developing Countries* (2001) at 7, 8, 33-34, available at http://www.wipo.int/about-ip/en/studies/pdf/ssa_maskus_pi.pdf.

¹⁵ Sean Flynn et. al, *An Economic Justification for Open Access to Essential Medicine Patents in Developing Countries*, 37 J.L. MED. & ETHICS 184, 185 (2009).

compulsory license legislation easier in countries where patent holders have greater representation. Also, a baseline set of restrictions brings legitimacy to the compulsory licenses issued through such regimes.

I. BACKGROUND

A. *World Trade Organization*

The international body that governs international trade is the WTO.¹⁶ The WTO negotiates agreements that help producers of goods and services, exporters, and importers conduct their business.¹⁷ Through the WTO, countries have agreed to reduce tariffs and lower trade barriers in order to enjoy a greater level of access to markets.¹⁸ As a part of joining the WTO, members agree to abide by the trade rules and comply with decisions issued by the WTO dispute resolution process.¹⁹ Countries that violate the rules may be disciplined by placing duties on the imports from that country.²⁰ Therefore, the WTO provides an enforcement mechanism by providing penalties that injure the violating country's trade abilities.²¹

B. *Trade Related Aspects of Intellectual Property Rights*

Trade Related Aspects of Intellectual Property Rights (TRIPS) is an agreement between WTO members that establishes a common scheme of intellectual property rights.²² At its foundation, TRIPS requires member nations to treat all other member nations equally with regards to intellectual property rights.²³ In reaching the agreement, developing countries and

¹⁶ See World Trade Organization, *Understanding the WTO*, 12 (5th ed. 2011), available at http://www.wto.org/english/thewto_e/whatis_e/tif_e/understanding_e.pdf.

¹⁷ *Id.*

¹⁸ *Id.* at 25.

¹⁹ *Id.* at 55.

²⁰ *Id.*

²¹ *Id.*

²² Levon Barsoumian, *India's Use It or Lose It: Time to Revisit Trips?*, 11 J. MARSHALL REV. INTELL. PROP. L. 797, 803 (2012).

²³ *Id.* (TRIPS is further modified by the Doha Declaration. The Doha Declaration was promulgated by the Ministerial Conference on November 14, 2001. One of the topics discussed at the Doha Ministerial Conference was public health. The Doha Declaration authorizes compulsory licensing in stronger terms than TRIPS, especially as the compulsory licensing pertains to public health).

developed countries negotiated terms that would advance the interest of their respective constituencies.

1. Developed Countries

Because a majority of innovation occurs in developed countries, a common problem for developed countries is having developing countries enforce intellectual property rights of patent holders from developed countries. The decline of American manufacturing coupled with growth of global technology-focused industries motivated United States officials to give intellectual property rights enhanced importance.²⁴

2. Developing Countries

It is often in a developing country's best interest to maintain weaker intellectual property laws, allowing the country to enjoy the benefits of innovation in other countries since little innovation occurs within the country. Therefore, during the negotiation of TRIPS, the developed countries needed to provide concessions to the developing countries in order to strengthen their enforcement of intellectual property rights.²⁵ TRIPS laid down minimum standards for protection and enforcement of intellectual property rights, which required countries to promote effective and adequate protection of intellectual property rights with a view towards reducing distortions and impediments to international trade.²⁶ On the other hand, since little innovation occurs in developing countries, these countries are slower to adopt newer technologies.

Developing countries rarely have access to the newest drugs. This is an unfortunate result of their limited market size and purchasing power; many private firms generally would not find the prospect of selling pharmaceuticals to least developed countries a particularly attractive business proposition.²⁷ Together, both groups of countries were able to strike a balance between promoting access to existing drugs and promoting research and development into new drugs. TRIPS recognized that protection and enforcement of intellectual property rights should be achieved in a manner that is conducive to

²⁴ See Bird, *supra* note 10.

²⁵ See Reichman, *supra* note 11, at 249.

²⁶ WTO Fact Sheet, *supra* note 5.

²⁷ United Nations Conference on Trade and Development, *Investment in Pharmaceutical Production in the Least Developed Countries*, 14 (2011), available at http://unctad.org/en/docs/diaepcb2011d5_en.pdf.

social and economic welfare.²⁸ In this respect, TRIPS allows for members to adopt measures necessary to protect public health and nutrition.²⁹ Accordingly, TRIPS allowed for compulsory licenses to be granted in limited circumstances.³⁰ In return, TRIPS provides developed countries stronger intellectual property rights in developing countries.³¹

3. TRIPS Flexibility

TRIPS recognizes that developing countries need access to newer lifesaving technologies and thus contains provisions that allow a country to issue a compulsory license where efforts to obtain a voluntary license from the patent holder have been unsuccessful and there is a demonstrated need to protect public health.³² A compulsory license allows the government or a third party authorized by the government to practice the patent without the authorization of the patent holder.³³ The developing country can then have a generic version of the medicine created to address the public health issue. In this regard, the developing nations received legal recognition of their right to social welfare in exchange for stronger intellectual property rights in the long run.³⁴

Compulsory licenses have been documented in treaties as early as 1883.³⁵ The Paris Convention Treaty recognized the right for a country to “take legislative measures providing for the grant of compulsory licenses to prevent the abuses which might result from the exercise of the exclusive rights conferred by the patent.”³⁶ TRIPS allows for countries to provide limited exceptions to the exclusive rights conferred by a patent provided that the exceptions do not conflict with a normal exploitation of the patent and do not unreasonably prejudice the legitimate interests of the patent owner.³⁷ Importantly, these provisions were not limited to only developing countries

²⁸ See WTO Agreement, *supra* note 7, at art. 7.

²⁹ *Id.*

³⁰ *Id.* at art. 31.

³¹ See Reichman, *supra* note 11, at 247.

³² See WTO Agreement, *supra* note 7, at art. 7; See also WTO Fact Sheet, *supra* note 5, at 4.

³³ See WTO Fact Sheet, *supra* note 5, at 4.

³⁴ See Reichman, *supra* note 11, at 247, 248.

³⁵ Paris Convention for the Protection of Industrial Property, 21 U.S.T. 1583, art. 5(A)(2).

³⁶ *Id.*

³⁷ See WTO Agreement, *supra* note 7, at art. 31.

but to any country that had a public emergency or needed to enact the provisions for non-commercial uses.³⁸

The compulsory licensing regulation represents a crucial measure for some of the poorest countries in the world, which can gain improved access to affordable medicines that are safe and effective.³⁹ A particular difficulty in the use of compulsory licenses arises when the country lacks the ability to manufacture generic medicines.⁴⁰ When the TRIPS agreement was originally adopted, it did not allow the developing countries to use compulsory licenses to import drugs.⁴¹ TRIPS states that products made under compulsory licensing must be “predominantly for the supply of the domestic market.”⁴² This meant that even if a country issued a compulsory license, the country could not gain access to the drug if it did not have the capacity to develop and manufacture generic drugs within the country. Therefore, the ability to issue a compulsory license would not have provided an incentive to patent holders to issue a voluntary license in these countries.

The WTO addressed this issue in the Doha Ministerial Declaration which instructed the WTO Council to find a solution to the inability of countries to make use of compulsory licenses due to insufficient manufacturing capacity.⁴³ In response to the Doha Ministerial Declaration, governments in developed and developing countries have passed legislation and implemented policies to accommodate the production and export of generic medicines to countries that can issue compulsory licenses but do not have the necessary infrastructure to produce medicines.⁴⁴

This decision was so important that the WTO adopted a separate declaration called the Declaration on the TRIPS Agreement and Public Health.⁴⁵ The WTO agreed that TRIPS does not and should not prevent

³⁸ *Id.*

³⁹ Press Release, European Commission, *Commission Welcomes Changes to EU Law to Allow Export of Patented Medicine to Countries in Need* (Apr. 28, 2006), <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/06/550&format=HTML&aged=0&language=EN&guiLanguage=en>.

⁴⁰ WTO Decision, *DOHA Ministerial 2001: Declaration on the Trips Agreement and Public Health*, 41 I.L.M. 755 (2002).

⁴¹ Daniel J. Gervais, *Intellectual Property, Trade & Development: The State of Play*, 74 *FORDHAM L. REV.* 505, 513 (2005).

⁴² *See* WTO Agreement, *supra* note 7, at art. 1.

⁴³ *See* Gervais, *supra* note 41, at 513.

⁴⁴ WTO General Council, *Implementation of Paragraph 6 of the Doha Declaration on the TRIPS Agreement and Public Health*, 43 I.L.M. 509 (2003); *See supra* note 40 (WTO Decision).

⁴⁵ *See* WTO Decision, *supra* note 40.

members from taking measures to protect public health.⁴⁶ The WTO underscored countries' ability to use the flexibilities built into TRIPS, including compulsory licensing and parallel importing.⁴⁷

4. Pharmaceutical Research Incentives

Pharmaceutical companies face enormous costs of research and development during the innovation of medicines. Only small percentage of the drugs created are introduced into the market. Pharmaceutical companies place large amounts of capital at risk with the expectation that they will be able to recoup their costs by selling their medicines at high prices. Because compulsory licenses alter the exclusive nature of a patent, the issue of a compulsory license threatens the ability of pharmaceutical company to profit from their investments. Without the profit from their research, pharmaceuticals may be less willing to invest in the creation of new medicines. It is for this reason that the TRIPS agreement allows for compulsory licenses where there is a public health need. It indicates that the compulsory license should only be used if the drug is not available to the people already. Therefore, compulsory licenses that are legitimately issued in accordance with TRIPS objectives should not significantly undermine incentives to innovate since the recipients would not have had access to the drug but for the compulsory license.

Pharmaceutical companies are critical of compulsory licenses because they may cause the abuses which that potentially impact their profitability. Compulsory licenses are typically issued for the purpose of providing access to medicine to a group of people that could not otherwise afford to purchase the medicine. Therefore, the generic medicines generated under such compulsory licenses are priced lower than if the patent holder were to sell the medicine. This is a monetary concern for pharmaceutical companies because the selling of generic medicines at lower rates than the brand medicines may undermine the pharmaceutical companies' target markets in which medicines are sold at a premium rates. In this way, manufacturers view compulsory licenses as a factor that may impact their profitability. However, it is important to note that developing countries are currently responsible for a very small portion of pharmaceutical companies' profits.⁴⁸

⁴⁶ *Id.*

⁴⁷ See note 16 at 4.

⁴⁸ Paige E. Goodwin, *Right Idea, Wrong Result - Canada's Access to Medicines Regime*, 34 AM. J.L. & MED. 567, 576 (2008).

5. Parallel Importation

Another concern for patent holders is the threat of a grey market created by parallel importation.⁴⁹ Parallel importation occurs when a product that is sold in one market is imported into another market to take advantage of the difference in pricing between the markets.⁵⁰ Drugs created under a compulsory license may make their way into markets that they were not originally intended to reach, creating a grey market. Under TRIPS, a patent holder cannot raise a dispute regarding parallel importation unless it can show that the country is engaging in discriminatory practices.⁵¹ In this way, a compulsory license may unintentionally enable misappropriation of medicines to the pharmaceutical company's primary markets. This in turn undermines the pharmaceutical company's profitability.

Pharmaceutical companies are often criticized for the large difference between the medicine price and their manufacturing costs. As mentioned above, pharmaceutical companies seek to recuperate the costs of research and development by selling their medicines at a premium rate. This is only possible if the price charged is higher than the actual cost to manufacture the medicine. Compulsory licenses create an even greater concern for pharmaceutical companies because the sale of medicines at much lower prices may prompt customers of primary markets to demand lower prices based on the price disparity between the drug prices in developed countries and drug prices in developing countries.⁵²

It is important to note that compulsory licenses are typically granted for the purpose of providing people access to medicines to which they would not have access otherwise. Therefore, although compulsory licenses are not designed to impact a patent holder's profitability, in practice patent holders have much to lose from the issue of a compulsory license. It is thus important that the laws created under TRIPS contain restrictions that protect the patent holder's interests to maintain the incentives to promote innovation. The Thai government recognized this issue when issuing compulsory licenses and claimed the generic medicines created by them are only directed towards the portion of the population that would not otherwise have access to the drugs.⁵³

⁴⁹ See WTO Fact Sheet, *supra* note 5, at 5.

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² See Reichman, *supra* note 11, at 251.

⁵³ The Ministry of Pub. Health and The Nat'l Health Sec. Office Thai., *Facts and Evidences on the 10 Burning Issues Related to the Government Use of Patents on Three Patented Essential*

II. COMPULSORY LICENSE RESTRICTIONS

Several countries have passed legislation to allow for compulsory licenses. For example, India amended its Patents Act to allow the government to authorize the sale or distribution of a patented article by a person other than patent holder where the Indian central government is satisfied that it is necessary or expedient in the public interest.⁵⁴ Thailand allows any person to apply to the Director-General for a license if it appears that the patented product has not been produced, that the patented product is not sold in any domestic market, that the patented product is sold at an unreasonably high price, or that the quantity of the patented product available does not meet the public demand without a legitimate reason.⁵⁵ This type of legislation allows the country to grant compulsory licenses to manufacture and sell products within the country.

As TRIPS was originally adopted, it did not allow the developing countries to import drugs to which compulsory licenses were granted,⁵⁶ meaning that even if a country did issue a compulsory license, it could not gain access to the drug if it did not have the capacity to develop and manufacture generic drugs within the country. In 2001, the WTO recognized that members with insufficient or no manufacturing capabilities in the pharmaceutical sector could face difficulties in making effective use of compulsory licenses.⁵⁷ As a result, the WTO General Council decided in the Doha Ministerial Declaration to waive the requirement that compulsory licenses only be used to supply the domestic market and allowed countries to export patented products to other countries.⁵⁸

In response to the Doha Ministerial Declaration, governments in both developed and developing countries passed legislation and implemented

Drugs in Thailand. Document to Support Strengthening of Social Wisdom on the Issue of Drug Patent (2007) at 17, available at <http://apps.who.int/medicinedocs/en/m/abstract/Js18718en/>.

⁵⁴ The Patents (Amendment) Ordinance, § 24 (D), 1994 No. 13 OF 1994, INDIA CODE (1994).

⁵⁵ Patent Act B.E. 2522, § 46 (1979) (Thai.) (amended 1999) [hereinafter Thailand Patent Act].

⁵⁶ See Gervais, *supra* note 41, at 513.

⁵⁷ See Goodwin, *supra* note 48, at 571.

⁵⁸ *Id.*

policies to accommodate the production and export of generic medicine to countries that have the ability to issue compulsory licenses but do not have the necessary infrastructure to produce medicines. Canada's Access to Medicines Regime ("CAMR") is one of the first pieces of legislation that creates a legal mechanism for generic manufacturers to export medicines under a compulsory license. India followed suit and passed a similar regulation, followed by Norway⁵⁹ and the European Union.⁶⁰

These compulsory licensing legislation schemes have requirements mandated by TRIPS that must be met by applicants in order for a compulsory license to be granted. In addition to these requirements, countries are free to determine the appropriate method of implementing the provisions of compulsory licenses within their own legal system and practice.⁶¹ Many countries' legislations contain additional requirements beyond what is specified in TRIPS for the issue of a compulsory license.

A. *Negotiation Requirement*

TRIPS requires that prior to the issue of a compulsory license, the applicant must have "made efforts to obtain authorization from the right holder on reasonable commercial terms and conditions and that such efforts have not been successful within a reasonable period of time."⁶² The purpose of this requirement is to ensure that the patent holder is notified about the intent of the applicant and has the opportunity to negotiate a voluntary license. Although the meaning of "reasonably commercial terms" and "reasonable period of time" have not been explicitly defined in TRIPS, the various implementing legislations have tried to define them. A voluntary license from the patent holder is preferable to a compulsory license issued by the government because it maintains the incentive for potential patent holders to continue to innovate and avoids government intervention with intellectual property rights. This is consistent with the TRIPS objective that "protection and enforcement of

⁵⁹ See WTO Fact Sheet, *supra* note 5, at 6 (As of 2006, Norway, Canada, India and the EU have made such laws, and Australia is in the process).

⁶⁰ See Patents Act, *supra* note 4, at §92A(1) ("Compulsory license shall be available for manufacture and export of patented pharmaceutical products to any country having insufficient or no manufacturing capacity in the pharmaceutical sector for the concerned product to address public health problems, provided compulsory license has been granted by such country or such country has, by notification or otherwise, allowed importation of the patented pharmaceutical products from India").

⁶¹ See WTO Agreement, *supra* note 7, at art. 1.

⁶² *Id.* at art. 31(b).

intellectual property rights should contribute to the promotion of technological innovation.⁶³ The negotiation requirement can be waived in the case of national emergencies or other circumstances of extreme urgency.⁶⁴ The rationale for this exception is obvious; when there is no time to negotiate, TRIPS will not prevent countries from adopting measures necessary to maintain public health.⁶⁵

1. India's Take on the Negotiation Requirement: Reasonable Public Need Requirement and the Reasonable Price Requirement

India does not have an explicit negotiation requirement.⁶⁶ India's version of this requirement, as set out in Indian Patents Act, compares the actual availability of the invention to the reasonable requirements of the public.⁶⁷ Under this type of scheme, compulsory licenses may be granted if the reasonable requirements of the public with respect to the patented invention are not satisfied or if the invention is not available to the public at a reasonable price within 3 years.⁶⁸ Patent holder delays in the distribution of the invention are considered grounds to challenge the patent and to obtain a compulsory license.⁶⁹ In addition, the decision to issue a compulsory license is based on other factors such as the nature of the invention and the amount of time that the patent has been available.⁷⁰ The Indian Patents Act further articulates what it means when the reasonable requirements of the public are deemed not satisfied.⁷¹ This determination is made based on factors such as the refusal to

⁶³ *Id.* at art. 7.

⁶⁴ *Id.* at art. 31(b).

⁶⁵ *Id.* at art. 8.2.

⁶⁶ See Patents Act, *supra* note 4, at §84(1).

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.* at §85.

⁷⁰ *Id.* ("Matters to be taken into account in granting compulsory licences. In determining whether or not to make an order in pursuance of an application filed under section 84, the Controller shall take into account, - (i) the nature of the invention, the time which has elapsed since the sealing of the patent and the measures already taken by the patentee or any licensee to make full use of the invention; (ii) the ability or the applicant, to work the invention to the public advantage; (iii) the capacity of the applicant to undertake the risk in providing capital and working the invention, if the application were granted, but shall not be required to take into account matters subsequent to the making of the application.

⁷¹ *Id.* at §90.

grant a license on reasonable terms, prejudicial development of trade, and failing to meet the demand for the product.⁷²

The reasonable public need requirement and the reasonable price requirement embody an important TRIPS objective, which is to ensure the mutual advantage of producers and users of technological knowledge in a manner conducive to social and economic welfare.⁷³ The burden of showing that the patent holder has not met the reasonable public need is necessary to prevent potential abuse when the patent holder makes its best efforts to make the invention available to the public. The reasonable price requirement is equally necessary because it takes into account the actual purchasing capability of the people of the country. The requirement reinforces the TRIPS principle that members may take measures to promote the public interest in sectors of vital importance to their socio-economic need and technological development.

2. Canada's Take on the Negotiation Requirement: Explicit Negotiation Requirement

CAMR takes a different approach to the negotiation requirement by requiring that the applicant seek a license to manufacture and sell the pharmaceutical product for export to the country on reasonable terms and conditions and to show that the efforts have not been successful. This tracks more closely to the language in TRIPS requirements.⁷⁴ However, the statute creates uncertainty in that reasonable terms and conditions are not concretely defined. CAMR provides a thirty day requirement for negotiations.⁷⁵ This provides a clear timeframe for companies to respond to a negotiation attempts. This negotiation requirement is also part of the European Parliament, Norway, and Thailand compulsory license regulation.⁷⁶

⁷² See Patents Act, *supra* note 4, at §90.

⁷³ See WTO Agreement, *supra* note 7, at art. 7 (Objectives - The protection and enforcement of intellectual property rights should contribute to the promotion of technological innovation and to the transfer and dissemination of technology, to the mutual advantage of producers and users of technological knowledge and in a manner conducive to social and economic welfare, and to a balance of rights and obligations).

⁷⁴ See *id.* at art. 31 (Such use may only be permitted if, prior to such use, the proposed user has made efforts to obtain authorization from the right holder on reasonable commercial terms and conditions and that such efforts have not been successful within a reasonable period of time).

⁷⁵ See Goodwin, *supra* note 48, at 578.

⁷⁶ Council Regulation 816/2006, art. 9, 2006 O.J. (L 157) 1 (EU); Regulations of 20 December 1996 No. 1162 §108 (amended 2004) (Nor.); See Patent Act, *supra* note 55, at §46, §47 ("the applicant for a license must show that he has made an effort to obtain a license from the

3. Comparison of Approaches to the Negotiation Requirement

The Indian approach to the negotiation requirement creates uncertainty for companies that may want to file for a patent in India because it places a duty on patent holders to work their patents so that the reasonable needs of the public are met. There is a burden on the patent holder to scale its operations so that its patent may remain viable. The Indian Patent Act gives the patent holder three years to work the patent before it may be challenged, whereas CAMR requires only that negotiation attempts take place within the last 30 days.

On the other hand, Canada's explicit negotiation requirement also has its drawbacks. The negotiation and application process is complex and may be delayed.⁷⁷ One critic notes that the generic medicine producers have described the negotiation process as lengthy, complex, and expensive.⁷⁸ Typically, patent licensing is not always a fast undertaking; often it can take over a year between a licensing program and the issue of the first license agreement.⁷⁹

It is necessary to go through the process of negotiation, because doing so preserves the patent holder's right to provide a voluntary license. An explicit negotiation requirement is also more consistent with the TRIPS objective calling for "the promotion of technological innovation" than the public need requirement and the reasonable price requirement. This is because innovators would be more likely to pursue research if they knew that compulsory licenses

patentee having proposed conditions and remuneration reasonably sufficient under the circumstances but unable to reach an agreement within a reasonable period.").

⁷⁷ Jillian C. Cohen-Kohler et al, *Canada's implementation of the Paragraph 6 Decision: is it sustainable public policy?*, 3 *Globalization and Health* 12 (2007) (One disincentive of applying for a compulsory license is the cost associated with making use of the legislation. Generic drug companies are required to negotiate a voluntary license with potentially multiple patent holders pursuant CAMR.); See Goodwin, *supra* note 48, at 571-72.

⁷⁸ George Tsai, *Canada's Access to Medicines Regime: Lessons for Compulsory Licensing Schemes Under the WTO Doha Declaration*, 49 *Va. J. Int'l L.* 1063, 1082 (2009); See Goodwin, *supra* note 48, at 571-72 (Generic drug companies described CAMR as a lengthy, complex and expensive process, with no time limit given to these requirements).

⁷⁹ ROBERT C. MEGANTZ, *HOW TO LICENSE TECHNOLOGY (INTELLECTUAL PROPERTY LIBRARY)* 572, (3 1996) (It is not uncommon for as much as a year to pass between the decision to implement a licensing program and the consummation of the first license agreement).

would not be issued without their having the opportunity to negotiate a voluntary license.

In addition, TRIPS defines the rights conferred by a patent as the ability to “prevent third parties not having [the patent holder’s] consent from the acts of: making, using, offering for sale, selling, or importing . . . [the] product”.⁸⁰ This indicates that TRIPS places an emphasis on gathering the patent holder’s consent before acting to invalidate the rights conferred to the patent holder. Thailand has a more aggressive approach in which the government begins to create the medicines fairly quickly in case where negotiations with pharmaceutical companies are derailed.⁸¹ However, the country is still open to negotiation with the patent holder after the issue of the compulsory license.⁸² This eliminates the problem of having pharmaceutical companies stall while making sure that the country’s public health needs are promptly addressed.

When there is a risk that pharmaceutical companies will negotiate in bad faith, countries should require the use of deadlines to more clearly delineate acceptable negotiation timelines. In addition, dispute resolution or arbitration should be required when negotiations are stalled or ineffective. If the content of the negotiation is made public, parties may be dissuaded from negotiating in bad faith, because their actions may negatively impact their reputation. In this regard, public negotiations may apply pressure on the parties to arrive at a compromise.

B. *Import Restrictions*

Most compulsory license legislation seeks to restrict use of the medicines once they are within the intended country. For example, in the Indian Patent Act, the grant of a compulsory license comes with the condition that the import of the patented article will not infringe upon the rights of the patentee.⁸³ CAMR requires applicants seeking to export to non-WTO countries to certify that the product will not be used for commercial purposes.⁸⁴ Compulsory licensing in the European Union prohibits the release for free circulation and re-export of products created under a compulsory license.⁸⁵

⁸⁰ See WTO Agreement, *supra* note 7, at art. 28.

⁸¹ See Facts and Evidences, *supra* note 53, at 5-7.

⁸² See *id.* at 8.

⁸³ See Patents Act, *supra* note 4, at §90.

⁸⁴ Patent Act, R.S.C. 1985, c. P-4, c. 21.04(3)(v) (Can.).

⁸⁵ See Council Regulation, *supra* note 76, at art. 13.

Here the first sale doctrine is implicated. According to the first sale doctrine, “an unconditional sale of a patented device exhausts the patentee’s right to control the purchaser’s use of the device thereafter.”⁸⁶ TRIPS states that the WTO does not determine disputes based on exhaustion.⁸⁷ The concern is that once the drug is within the intended country, the receiving country or entity may choose to divert the drugs to a commercial market and thereby make a profit at the expense of the patent holder’s profitability. The purpose of restrictions on the use of the drugs is to ensure that the operation of the compulsory license does not interfere with the normal exploitation of the patent and does not unreasonably prejudice the legitimate interests of the patent owner in accordance with the goals expressed in TRIPS.⁸⁸ These requirements are not mandated in the TRIPS agreement, but versions of the restrictions are codified in the requirements in the different countries’ legislations.

The implementation of the Doha Ministerial Declaration, however, does require eligible importing members to take reasonable measures within their means, proportionate to their administrative capacities and to the risk of trade diversions to prevent re-exportation.⁸⁹ If the receiving country does not provide legal means to prevent diversion of the product, the matter may be submitted to the TRIPS Council for review.⁹⁰ Therefore, these restrictions serve as a protection measure to the patentee in the absence of enforcement under the first sale doctrine. In addition to ensuring that the patentee’s interests in the drugs are not unduly harmed, these restrictions serve the purpose of ensuring that the drugs reach their intended recipient.

⁸⁶ JOHN GLADSTONE MILLS, III ET.AL., PAT. L. FUNDAMENTALS §20:40.50 (Updated 2012).

⁸⁷ See WTO Agreement, *supra* note 7, at art. 6 (Exceptions to Rights Conferred - Members may provide limited exceptions to the exclusive rights conferred by a patent, provided that such exceptions do not unreasonably conflict with a normal exploitation of the patent and do not unreasonably prejudice the legitimate interests of the patent owner, taking account of the legitimate interests of third parties).

⁸⁸ See WTO Agreement, *supra* note 7, at art. 30 (WTO Agreement) (Exceptions to Rights Conferred - Members may provide limited exceptions to the exclusive rights conferred by a patent, provided that such exceptions do not unreasonably conflict with a normal exploitation of the patent and do not unreasonably prejudice the legitimate interests of the patent owner, taking account of the legitimate interests of third parties).

⁸⁹ See WTO General Council, *supra* note 44, at art. 4.

⁹⁰ See WTO General Council, *supra* note 44, at art. 5.

C. *Quantity Limitations and Notifications*

Most compulsory license legislation places a limit on the quantity of medicines exported and used for their intended need, even though this is not mandated by TRIPS. The Indian Patent Act contains a condition that the import of articles under a compulsory license will not infringe upon the rights of the patentee.⁹¹ Similarly, CAMR applications require the declaration of the maximum quantity of the drug to be created and once the application is granted, those quantities are notified to the WTO and maintained on a website.⁹² These provisions serve as measures to deter overproduction of generic medicines. This is desirable because overproduction of generic medicines may create a grey market, consequently diluting the patent holder's profits. Most legislations require compulsory license applicants to keep all other members informed and guard against parallel applications that could result in the creation of more drugs than the public actually needs.⁹³ These provisions in the legislation are based on the sound principle of limiting the abuse of compulsory licenses.

D. *Drug Limitations*

Under CAMR, only products that are on a pre-approved drug list may be exported under a compulsory license.⁹⁴ The pre-approved drug list restriction, which is not mandated by TRIPS, has been criticized for its excessive narrowness and has been characterized as a disease-specific limitation on compulsory licensure.⁹⁵ One critic of the pre-approved drug list restriction claims that it is unnecessary, contrary to the spirit of TRIPS, questions Canada's good faith, and introduces the potential for delays by political lobbying.⁹⁶

The pre-approved drug list restriction plays a significant role in preventing the use of the system for commercial, non-humanitarian purposes.⁹⁷

⁹¹ See Patents Act, *supra* note 4, at §90.

⁹² See Patent Act, *supra* note 84, at c. 21.07.

⁹³ See WTO Fact Sheet, *supra* note 5, at 2-3.

⁹⁴ See Patent Act, *supra* note 84, at c. 21.02.

⁹⁵ See Goodwin, *supra* note 48, at 576.

⁹⁶ Richard Elliott, *Pledges and Pitfalls: Canada's Legislation on Compulsory Licensing for Export*, 1 INT'L. J. INTELLECTUAL PROP. MGMT. 94, 101-02 (2006).

⁹⁷ Government of Canada, *Report on the Statutory Review of Sections 21.01 to 21.19 of the Patent Act* 10, available at http://www.camr-rcam.gc.ca/review-reviser/camr_rcam_report_rapport-eng.pdf.

Without this kind of restriction, a compulsory license could be issued for nonessential drugs, thus denying the patent holder's right to exclusive use of the invention. One example of the abuse of compulsory licenses for the creation on nonessential medicines is the Egyptian government's issuance of a compulsory license for Viagra.⁹⁸ The Egyptian government's actions were "tainted by the appearance of impropriety and self dealing."⁹⁹ Since Viagra is a drug that is not considered essential to public health, the compulsory license was improper. A pre-approved drug list restriction limiting the use of compulsory licenses to essential medicines would have been a good measure to prevent abuse of the compulsory license system in Egypt.

With the rapid innovation occurring in the pharmaceutical industry, new lifesaving drugs are constantly patented. It is thus important that a pre-approved drug list can be modified in a relatively short period of time in order to accommodate the creation of lifesaving drugs. CAMR has a mechanism in place to amend the eligible medicines list.¹⁰⁰ To ensure that amendments are performed in an informed and transparent manner, the Canadian Government's Ministers of Industry and Health have an expert committee to advise them on what drugs should be eligible for export under the regime.¹⁰¹ If a particular drug or medical device is needed by a country but is not on the list of eligible products included in Canada's Patent Act, the importing country or a non-governmental organization can make a request for its addition. Because amendments are based on the recommendation of an expert committee, they are considered in an objective manner. Therefore, the ministers are unlikely to reject a drug for which there is a true need. In a country like Canada, it is likely that this body will be competent to determine appropriate medicines. This is a safeguard to ensure that CAMR is not used to interfere with the valid operation of patents.

This process of modifying the pre-approved drug list was used to add TriAvir in the creation of the first compulsory license by Canada. The list has been amended twice since the enactment of CAMR. During the process of the first attempt to amend the pre-approved drug list, pharmaceutical companies pressured a minister to withdraw some motions to amend the list.¹⁰² The request was denied and the House was able to amend the list.¹⁰³

⁹⁸ See Bird, *supra* note 10, at 211-12.

⁹⁹ See Reichman, *supra* note 11, at 254.

¹⁰⁰ See Patent Act, *supra* note 84, at c. 23.01.

¹⁰¹ Government of Canada, *supra* note 97, at 10.

¹⁰² Elliott, *supra* note 96, at 101-02.

¹⁰³ *Id.*

The successful amendment to the pre-approved drugs list shows that such a restriction, when not susceptible to political pressures, is an appropriate way to determine medicines that will be eligible for compulsory licenses. In addition, the restriction provides certainty to patent holders that compulsory licenses will not be issued against non-essential medicines because it allows for patent holders to raise objections in cases in which they feel that it would be inappropriate to add a drug to the list.

The European Union regulation that addresses compulsory license legislation calls for a similar restriction.¹⁰⁴ The regulation highlights the objective that medicines created under the regulation should reach only those who need them.¹⁰⁵ They impose clear conditions on the licensee to identify pharmaceutical products and the countries that need those products.¹⁰⁶ There is no specific restriction on the pharmaceutical products covered, although there is acknowledgement that the products are required to address public health problems in order to facilitate the Doha Ministerial Declaration.¹⁰⁷

There is a reasoned basis for the restrictions on the medicines available for compulsory licenses protects against the issue of compulsory licenses for nonessential medicines. In cases where there is a need for essential medicines, the restrictions are not difficult to overcome. A pre-approved drugs list type of restriction that is maintained by the government would be less suitable in countries such as Egypt where the bureaucratic agency may be susceptible to corruption or may not have the competency to determine medicines that will be essential to public health. In these cases, public health purposes may be better served by referencing an objective pre-approved drugs list that is maintained by an expert committee such as the World Health Organization Model Lists of Essential Medicines.¹⁰⁸

¹⁰⁴ See Council Regulation, *supra* note 76, at art. 13.

¹⁰⁵ See *id.* at art. 8.

¹⁰⁶ *Id.*

¹⁰⁷ Press Release, *European Union, Commission Welcomes Changes to EU Law to Allow Export of Patented Medicine to Countries in Need*, (Apr. 28, 2006), available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/06/550&format=HTML&aged=0&language=EN&guiLanguage=en>.

¹⁰⁸ World Health Organization, *WHO Model Lists of Essential Medicines*, available at <http://www.who.int/medicines/publications/essentialmedicines/en/>.

E. Time Limitations

TRIPS provides that the scope and duration of compulsory licenses be limited to the purpose for which it was authorized.¹⁰⁹ The purpose of the time restriction is to ensure that the compulsory license is used for the purpose for which it was authorized.¹¹⁰ In this regard, TRIPS recognizes the importance of limiting the amount of time that a patent holder's right to exclude others from the use of the patent is suspended.

Under CAMR, compulsory licenses are valid for a term of 2 years.¹¹¹ If any portion of the medicines is not exported by the end of the 2 years, the applicant may renew the authorization for an additional 2 years.¹¹² One critic claims that this limitation complicates coordination of long-term medical treatment for diseases like AIDS.¹¹³ She argues that, because people with AIDS will need medication for the remainder of their lives, the compulsory license should not have a categorical expiration.¹¹⁴

While it is true that AIDS requires a lifetime of treatment, the authorization need not be for an indefinite period of time. Two years provides an adequate horizon for planning purposes since there is no restriction on having multiple licenses or applications. There is no reason to believe that if the circumstances have not changed, the application for another license will be denied. Also, a time limitation allows for the determination of whether the circumstances which led to the approval of the authorization are still in existence, something that TRIPS authorizes the country to do anyway.¹¹⁵

Thailand's legislation takes a different approach in that the compulsory licenses may be terminated if and when the circumstances which led to the issue of the compulsory license cease to exist and are unlikely to recur.¹¹⁶ This is a more lenient rule that allows for a compulsory license to be issued for an indefinite period of time. One commentator argues that an open-ended

¹⁰⁹ WTO Agreement, *supra* note 7, at art. 31(c).

¹¹⁰ *Id.*

¹¹¹ Patent Act, *supra* note 84, at c. 21.09.

¹¹² *Id.* at c.21.12(4).

¹¹³ Goodwin, *supra* note 48, at 582.

¹¹⁴ *Id.*

¹¹⁵ See WTO Agreement, *supra* note 7, at art. 31(g) ("authorization for such use shall be liable, subject to adequate protection of the legitimate interests of the persons so authorized, to be terminated if and when the circumstances which led to it cease to exist and are unlikely to recur. The competent authority shall have the authority to review, upon motivated request, the continued existence of these circumstances.").

¹¹⁶ See Thailand Patent Act, *supra* note 55, at §50bis.

compulsory license is appropriate in light of the continuing medicinal needs of those with terminal diseases.¹¹⁷ While this view is correct in identifying that the needs for any given person may be continuous, this does not necessarily mean that the need for the compulsory license will be continuous. As a country continues to develop, the country may increase their medicine building capacity and thus the circumstance that created the need for the compulsory license may no longer be present. For these reasons, a time limitation on the duration of a compulsory license is desirable and should be implemented in compulsory license legislation.

Another scholar also calls for open compulsory licenses as a solution. However this is too broad.¹¹⁸ Compulsory licensees are not meant to be a permanent measure. Issuing a compulsory license for indefinite periods of time would be an abuse of the privilege to create compulsory licenses. In addition, such broad provisions create uncertainty for patent holders and potential patent holders who choose to continue research only if it remained a profitable endeavor. TRIPS calls for a scope and duration that is limited for the purpose that it is authorized.¹¹⁹ This cannot be properly construed as requiring compulsory licenses for indefinite periods of time. In addition, the time limitation periodically brings patent holders into voluntary license negotiations. This provides the patent holders the opportunity to change their negotiation stance and instead decide to issue a voluntary license in cases where a compulsory license was issued in the past.

F. Regulatory Approval Requirement

Another issue that countries seeking to export medicines under a compulsory license must consider is whether the drugs will need to undergo regulatory approval. This is a concern for generic manufacturers since production costs rise when medicines are subjected to regulatory approval.

Under CAMR, drugs exported under a compulsory license are subject to the provisions of Canada's regulatory legislation, the Food and Drugs Act.¹²⁰ The standard practice is to perform an abbreviated review based on the data submitted by the generic manufacturer showing that the product is equivalent

¹¹⁷ Goodwin, *supra* note 48, at 582.

¹¹⁸ Flynn, *supra* note 15, at 185.

¹¹⁹ TRIPS calls for a scope and duration that is limited for the purpose that it is authorized.

¹²⁰ Patent Act, *supra* note 83, at c. 21.04(3)(b).

to a brand-name product already approved.¹²¹ European Union regulation calls for procedures to be implemented that guarantee the scientific quality of the products and that the products follow the same authorization and supervision standards of medicinal products.¹²²

One commentator notes that the regulatory approval requirement creates an additional hurdle in the process of providing access to patented medications.¹²³ However, as seen in the first application for a compulsory license under CAMR, this requirement is not impossible to overcome. For example, the first application of a compulsory license issued under CAMR, a generic manufacturer sought to license a fixed dose combination of 3 HIV/AIDS drugs that were packaged and sold separately.¹²⁴ The combination of the medicines was more feasible in terms of production and distribution efforts and made the treatment more effective than creating individual doses of each medicine.¹²⁵ There was little existing data on the efficacy of fixed dose combination of the drugs.¹²⁶ However, the review of the drugs, in this case, took seven months to receive of the approval of the combination of three HIV/AIDS drugs.¹²⁷ This is not excessively long compared to the United States Food and Drug Administration's goals for drug approval, which are six to ten months, indicating that subjecting generic medicines that will be exported under a compulsory license to regulatory approval will not be unduly burdensome.¹²⁸

Drugs intended for export should be subject to regulatory standards to ensure that a minimum level of quality is sustained. This policy ensures that a proper level of care is taken during the manufacturing process. In addition, this

¹²¹ CANADIAN HIV/AIDS LEGAL NETWORK, *The Jean Chrétien Pledge to Africa Act and its Impact on Improving Access to HIV/AIDS Treatment in Developing Countries*, p. 4, available at <http://www.aidslaw.ca/publications/interfaces/downloadFile.php?ref=696>.

¹²² Council Regulation, *supra* note 75, at art. 5(b).

¹²³ Goodwin, *supra* note 48, at 581.

¹²⁴ Canadian HIV/AIDS Legal Network, *supra* note 121, at 7.

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *See id.*

¹²⁸ United States Food and Drug Administration, *Frequently Asked Questions about the FDA Drug Approval Process*, <http://www.fda.gov/Drugs/ResourcesForYou/SpecialFeatures/ucm279676.htm> (last visited Jan. 2, 2013) ("Standard Review is applied to a drug that offers at most, only minor improvement over existing marketed therapies. The 2002 amendments to PDUFA set a 10 month goal for a standard review. Priority Review designation is given to drugs that offer major advances in treatment, or provide a treatment where none existed. The goal for completing a Priority Review is six months").

requirement works to protect the producer from liability from injuries that may occur from the use of substandard drugs. If medicines created for export under the TRIPS agreement are not subject to the same standards for use in the producing country, then substandard medicines may expose manufacturers to liability.

When AIDS patients fail treatment, the patients' only recourse is a more expensive second line treatment.¹²⁹ Therefore, it is more desirable to have a health review of drugs that is more comprehensive and more thorough than an abbreviated review that may result in greater expenditure in case that the treatment fails. One commentator provides a noteworthy solution to this issue, by allowing approval from any of the several credible approval agencies to suffice when issuing a compulsory license.¹³⁰

1. Political and Legal Obstacles

The limitations placed on compulsory license legislations are meant to prevent misuse of the compulsory licenses. The requirements in the different regimes are shaped by the level of representation of the patent holders in each country. Countries where the most innovation occurs have a higher level of representation by patent holders, while countries where a lower level of innovation occurs have a lower level of representation by patent holders. For this reason, countries with greater innovation observe a greater resistance to compulsory license legislation than countries with less innovation. In order for a country with greater innovation to pass compulsory license legislation, the restrictions will need to be tighter. Conversely, countries that have less innovation have greater public health needs and such governments are accountable to the people for meeting the country's health needs. For this reason, developing countries that implement compulsory license legislation will have more relaxed restrictions for the issue of compulsory licenses.

There should be a baseline level of requirements that all countries should adopt to curtail abuses at an optimal level without unduly burdening prospective generic medicine manufacturers. However, the differences in representation of patent holders make this difficult to achieve organically. Compulsory license legislation should continue to favor the patent holder to maintain the incentive to innovate while having enough flexibility to create the

¹²⁹ Richard Solash, *Long-Term HIV/AIDS Treatment Still Prohibitively Expensive For Many*, Radio Free Europe Radio Liberty (July 25, 2012) <http://www.rferl.org/content/longterm-hiv-aids-treatment-still-expensive-msf-second-third-line/24656735.html>.

¹³⁰ See Goodwin, *supra* note 48, at 581.

incentive for the patent holder to exploit the patent to benefit the public need. For example, the restrictions on an application for a compulsory license are much more clearly defined and more stringent in Canada than in India because of the greater representation of patent holders in Canada.

The role of the government in the compulsory licensing scheme is to issue a compulsory license when the public is not able to receive the medicines essential to public health while preventing abuses of patent holder rights. With restrictions as a safeguard to the issue of compulsory licenses, countries can achieve a balance that will ensure that their populations will continue to receive medicines essential to public health.

The European Union regulation that calls for the implementation of compulsory licenses advocates uniform implementation to avoid distortion of competition for operators in the single market.¹³¹ Uniform implementation may reduce complexity, incentivize cooperation, and maintain the incentive to innovate.

2. Political Pressures in Developed Countries

Pharmaceutical companies vehemently oppose compulsory license legislation and argue that stricter enforcement of intellectual property rights will benefit developing countries.¹³² Benefits cited for creating stricter intellectual property laws include increased investment by foreign companies in research and development, increased transfer of pharmaceutical technology, access to a variety of new drugs, and an increase in domestic research and development.¹³³ These arguments are not convincing because they do not provide a reason for foreign companies to increase their investments in a country on the basis that they have stricter intellectual property laws.¹³⁴ There would indication that foreign investments would increase once the developing countries strengthen their intellectual property laws.¹³⁵ Pharmaceutical companies could simply supply drugs to the country without any changes to their investments.¹³⁶ In addition, the lack of trained technicians and other infrastructure necessary for commercial pharmaceutical research are further

¹³¹ See Council Regulation, *supra* note 76, at art. 13.

¹³² Stefan Kirchanski, *Protection of U.S. Patent Rights in Developing Countries: U.S. Efforts to Enforce Pharmaceutical Patents in Thailand*, 16 LOY. L.A. INT'L & COMP. L.J. 569 (1994).

¹³³ *Id.* at 577.

¹³⁴ *Id.* at 578-79.

¹³⁵ *Id.*

¹³⁶ *Id.*

reasons why pharmaceutical companies may be hesitant to invest in research facilities in a developing country.¹³⁷ When Thailand increased its protection of intellectual property rights, the amount of medical research done in Thailand remained minimal.¹³⁸ In addition, the pharmaceutical companies actually moved factories abroad to countries with lower operating costs.¹³⁹

Patent holders put up a considerable resistance when it comes to protecting their intellectual property rights by political means. Pharmaceutical companies spend several million dollars lobbying Congress to push for a protectionist trade policy.¹⁴⁰ In 1998, the United States Trade Representative placed South Africa on the Office of the United States Trade Representative Special 301 Report Priority Watch list after South Africa passed an amendment to its Medicines Act that would permit the Minister of Health to suspend patent rights and issue compulsory licenses in cases where it was deemed necessary to offset a high price of patented drugs.¹⁴¹

Subsequently, the Pharmaceutical Research and Manufacturers of America brought suit against South Africa to have these new laws struck down, and asked the WTO to intervene and compel South Africa to honor its TRIPS agreement. In response to resounding global denunciation of their lawsuit, the Pharmaceutical Research and Manufacturers of America unconditionally dropped the three year old case.¹⁴²

3. Political Pressures in Developing Countries

When Thailand issued compulsory licenses for AIDS drugs, the United States responded to pressures from the pharmaceutical lobby by placing Thailand on the Office of the United States Trade Representative Special 301 Report Priority Watch list for deterioration in the protection and enforcement of intellectual property rights.¹⁴³ Despite hostility from the United States

¹³⁷ *Id.*

¹³⁸ See Ministry of Pub. Health, *supra* note 53, at 20.

¹³⁹ *Id.*

¹⁴⁰ Center for Responsive Politics, *Industry Profile, Pharmaceuticals/Health Products* (2011), available at <http://www.opensecrets.org/lobby/industries.php?id=H04&year=2011>.

¹⁴¹ Keith E. Maskus, *Parallel Imports in Pharmaceuticals: Implications for Competition and Prices in Developing Countries* (Apr. 2001) at 33, available at http://www.wipo.int/about-ip/en/studies/pdf/ssa_maskus_pi.pdf.

¹⁴² See Ann M Simmons, *Suit Against Cheap AIDS Drugs Ends in S. Africa*, L.A. Times, April 20, 2001, available at <http://articles.latimes.com/2001/apr/20/news/mn-53295>.

¹⁴³ Brook K. Baker, *Ending Drug Registration Apartheid: Taming Data Exclusivity and Patent/registration Linkage*, 34 Am. J.L. & Med. 303, 317 (2008); United States Trade

government, the Thai government has stood by their actions, maintaining that the actions are legitimate under the TRIPS agreement.¹⁴⁴ Despite the possibility that they may be subjected to illegal trade sanctions, they remain committed to maintaining their population's public health.¹⁴⁵

G. *Baseline Restrictions*

The compulsory licenses are created so that in cases where patent holders abuse their rights, countries can follow a process to provide adequate medicines to their country. The restrictions placed on compulsory licenses make the passing of compulsory license legislation easier because it shows that the issuing country is focused on providing lifesaving measures and are not on making a profit. Therefore, having properly defined restrictions will result in less political resistance from a reluctant patent holder lobby. Restrictions on importation show that a country has taken measures to avoid undermining patent systems in other countries.¹⁴⁶

If all the procedures are followed, there should a stronger presumption that the compulsory license is legitimate because they show that countries are not using the legislation to pursue commercial objectives. These regulations are designed to create a secure legal framework and to discourage litigation consistent with the European Union regulation.¹⁴⁷ In addition, they make the issue of compulsory licenses more defensible if a country brings a dispute to the WTO.

As described above, there are a variety of legislations implementing the legal operation of compulsory licenses. However, it may be beneficial for countries to establish a baseline set of restrictions above those required by TRIPS. A baseline set of restrictions will be better for developed countries because they will provide certainty for patent holders and prevent abuse. A baseline set of restrictions will be better for developing countries because it

Representative, 2007 *Special 301 Report* 26, available at http://www.ustr.gov/sites/default/files/asset_upload_file230_11122.pdf.

¹⁴⁴ See Facts and Evidences, *supra* note 53, at 4.

¹⁴⁵ *Id.*

¹⁴⁶ See WTO Fact Sheet, *supra* note 5, at 6.

¹⁴⁷ See Council Regulation, *supra* note 76, at art. 6.

will make their actions more transparent and defensible and the issue of compulsory licenses will be standardized for importing countries, making it easier for them to follow a single process. Finally, the negotiation requirement should be flexible in order to curb the practice of patent holders negotiating in bad faith. The inefficiencies created by the restrictions are an immediate burden to developing countries that need the medicines immediately, but ultimately they provide the foundation for a more productive negotiating environment.¹⁴⁸¹⁴⁹

Because generic manufacturers are familiar with the drug approval process for creating generic medicines, the CAMR application for a compulsory license to export medicine is not exceedingly complex. This is demonstrated by the fact that an application has been processed and approved by the Canadian Government already.

H. Application Complexity

Because generic manufacturers are familiar with the drug approval process for creating generic medicines, the CAMR application for a compulsory license to export medicine is not exceedingly complex. This is demonstrated by the fact that an application has been processed and approved by the Canadian Government already.

There is concern that the sophistication of the importing country will not be adequate to make use of this system.¹⁵⁰ Developing countries are lacking in their sophistication, and as a result may lack the resources to apply for CAMR.¹⁵¹ One commentator attributes the complexity of CAMR to the lack of direct input from developing countries.¹⁵² These concerns are not convincing because the complexity of a CAMR application does not create a burden for developing countries to use the system. CAMR allows a non-governmental organization (NGO) to enter into a sales agreement on behalf of the importing country. However, the importing country is still required to make the

¹⁴⁸ See Elliott, *supra* note 96, at 108; see Goodwin, *supra* note 48, at 582-83.

¹⁴⁹ See Megantz, *supra* note 79, at 72.

¹⁵⁰ See Goodwin, *supra* note 48, at 583 (Developing countries, the intended beneficiaries of CAMR, have cited major concerns with the law's complexity. Many developing countries lack the resources necessary to take advantage of CAMR and need more technological support to utilize it.); see Cohen-Kohler *supra* note 76.

¹⁵¹ *Id.*

¹⁵² See Cohen-Kohler, *supra* note 76, at 9.

notification to WTO or to exporting country governments.¹⁵³ In this manner, the intricacies of the CAMR application can be handled by a NGO.

TRIPS and properly designed compulsory licensing legislation creates an incentive for patent holders to maintain control over patent rights to exploit their patent to the greatest extent reasonable. Countries should strive to create a baseline set of requirements for patents to be issued. Such a change supports the competing interests of both developed and developing countries and their respective constituents' primary concerns.

Such changes will also help the compulsory licensing legislation scheme to achieve its primary goal as an incentive creator. For patent holders, the changes incentivize the use of their patents to maximize their profits while providing access to the drug for those who have no other opportunity to obtain the drug. For prospective generic manufacturers, such changes dissuade the application for compulsory licenses for drugs for which there is no public need or for drugs that will be used to undermine the patent holder's primary markets.

III. ROLE OF COMPULSORY LICENSE LEGISLATION IN PROVIDING ACCESS TO PATENTED MEDICINES

There are several documented examples where the use of compulsory licenses or just the threat of the use of compulsory licenses have influenced patent holder behavior. In 2001, the United States, faced with the Anthrax scare, threatened to issue a compulsory license for Ciprofloxacin.¹⁵⁴ Bayer quickly announced that it would offer Ciprofloxacin at a substantially lower price.¹⁵⁵ In 2007, Canada was the first country to grant a compulsory license under the Doha Declaration when it issued a compulsory license to Apotex to manufacture generic HIV medications for export to Rwanda.¹⁵⁶ Since then, no other applications for a compulsory license under CAMR have been filed.¹⁵⁷

¹⁵³ Government of Canada, *Role of Non-governmental Organizations*, available at <http://www.camr-rcam.gc.ca/countr-pays/ngo-ong/index-eng.php> (last modified Sep. 14, 2009).

¹⁵⁴ James P. Love, *Recent Examples of the Use of Compulsory Licenses on Patents*, Knowledge Ecology International (2007) at 2, available at <http://keionline.org/content/view/41/1>.

¹⁵⁵ Press Release, HHS Press Office, *HHS, Bayer Agree to Cipro Purchase* (Oct. 24, 2001), available at <http://www.cptech.org/ip/health/cl/cipro/dhhs10242001.html>.

¹⁵⁶ See Goodwin, *supra* note 48, at 574-75.

¹⁵⁷ Canadian Intellectual Property Office, *Use of Patents for International Humanitarian Purposes to Address Public Health Problems (Canada's Access to Medicines Regime)*, <http://www.cipo.ic.gc.ca/eic/site/cipointernet-internetopic.nsf/eng/wr00682.html> (last modified May 22, 2013).

India issued a compulsory license in 2012 for Nexavar, a drug that is used to extend the lives of people with liver or kidney cancer after less than two percent of the patients that needed Nexavar had access to it. Thailand addressed the supply and affordability of the AIDS drug, Efavirenz, in 2007 when it issued a compulsory license. The patent holder, Merck, charged twice the price of the generic drug and failed to maintain an adequate supply. After the issue of the patent price, Merck offered to reduce the price of the drug to about 20% above the Indian generic price.¹⁵⁸

The issue of compulsory licenses is a rare occurrence and when issued, they are widely publicized. The rare use of these compulsory license systems may be viewed as an indicator that the systems as they were designed are failing. One may argue that the use or lack of use of these legal mechanisms indicate that such legal mechanisms are not suitable because of the restrictions that they impose. However, the restrictions imposed on these systems do not necessarily deter the application of compulsory licenses. They deter the applications for compulsory licenses for illegitimate purposes.

A. *Restrictions are not Correlated to Issuance of Compulsory Licenses*

The frequency of issue of compulsory license legislation should not serve as an indicator of whether the compulsory license legislation is effective. Because the goal of the compulsory license legislation is to encourage pharmaceutical companies to negotiate voluntary licenses, the number of compulsory licenses does not indicate whether there is progress towards this goal. For example, Norway's and the European Union's compulsory license legislation schemes are less stringent than CAMR. The Norway and European Union laws do not have a pre-approved drug list like CAMR, but no compulsory licenses have been granted under those statutes.¹⁵⁹ India amended its patent legislation to allow for compulsory licenses in 2005, and it was only used once, and their standards are much more lenient.¹⁶⁰ India does not have a negotiation requirement, instead, a person may challenge the patent on the ground that the reasonable requirements of the public have not been met or that the patented invention is not available to the public at a reasonable

¹⁵⁸ Frederick M. Abbott & Jerome H. Reichman, *The Doha Round's Public Health Legacy: Strategies for the Production and Diffusion of Patented Medicines under the Amended TRIPS Provisions*, 10 J. INT'L ECON. L. 921, 953 (2007).

¹⁵⁹ See Singh, *supra* note 7.

¹⁶⁰ *Id.*

price.¹⁶¹ The role of restrictions is to prevent abuses, not to prevent the issue of valid compulsory licenses. Compulsory licenses are only meant to be a safeguard to be used if negotiations have failed. These examples support the contention that there is little correlation between the usage of compulsory license legislation and the limitations placed in the compulsory license legislation.

B. Lower Level of Compulsory Licenses Should be Expected

When faced with the prospect of a compulsory license, companies may agree to grant a voluntary license. Even if the system of issuing compulsory licenses were perfect, the system would rarely be used because the patent holder would rather get something for the use of the patent than the nominal royalty fee. Therefore compulsory licenses are only meant to be a safeguard in case negotiations are stifled by the refusal of a patent holder to negotiate a voluntary license.

Leading up to the issue of a compulsory license, the issue is contested and is as a result, highly publicized. However, the issue of a compulsory license sets a precedent for future voluntary license negotiations. Patent holders are placed on notice that a certain set of behaviors which place the public health at risk are likely to lose a portion of their patent rights. Patent holders in similar situations would consequently have a choice to either engage in the same behaviors, or adapt to make the best of their situation. This would also point to lower level of issuances of compulsory licenses.

C. Incentives Created by Compulsory Licenses are Difficult to Quantify

It is difficult to determine whether or not companies choose to issue voluntary licenses because of the incentive created by compulsory license legislation. It is in the pharmaceutical industry's best interest to keep the negotiation of voluntary licenses secret, especially if the decision was motivated by a potential compulsory license because the publicity of voluntary licenses will likely spur other potential genetic manufacturers to seek similar licenses.¹⁶² By keeping this type of information secret, the compulsory license legislation looks less effective because it appears as a piece of legislation that is never used, and therefore assumed to be useless. The underlying objective of

¹⁶¹ See Patents Act, *supra* note 4.

¹⁶² See Reichman, *supra* note 11, at 250.

compulsory licenses is to prevent the abuse of intellectual property rights by patent holders or to prevent the resort to practices that unreasonably restrain trade or adversely affect the international transfer of technology.¹⁶³ In this regard, the passing of legislation that allows for a compulsory license itself acts as a deterrent to patent abuse.

As explained, a key difficulty in providing access to patented medicines is having the patent holders negotiate with countries to come to an agreement on pricing terms that are reasonable to both parties. Patent holders often refuse to negotiate because it makes business sense to sell the patented medicine at a higher price.¹⁶⁴ The possibility of a compulsory license creates an incentive for patent holders to negotiate voluntary licenses. Since a voluntary licensee is preferred to the issuance of a compulsory license, the frequency of the issuance of compulsory licenses should not be an indicator of whether the legislation is effective in creating the correct incentives. Therefore, the number of compulsory licenses issued pursuant to the compulsory license legislation should not indicate if the compulsory license legislation is effective or if its restrictions are overly burdensome. The laws may be effective despite their rare use because they create the correct incentives. The legislation places generic manufacturers in a better bargaining position when negotiating for a compulsory license. If there is no compulsory license legislation, and the patent holder decides not to provide a voluntary license, then the generic manufacturer cannot create the generic medicine without infringing upon the patent. However, if the country does have compulsory license legislation, the patent holder is free to walk away from negotiations, but that may mean giving up the ability to dictate the terms that the generic manufacturer will operate under if a compulsory license is granted. Thus, compulsory licensing allows generic medicine manufacturers to bargain with more authority and gives the patent holders incentive to issue a voluntary license.

D. Foreign Investment Concerns

Scholarship has suggested that compulsory licenses legislation may cause patent holders to avoid certain countries and seek more business friendly environments.¹⁶⁵ For example, if the threat of a compulsory license causes the patent holder to avoid registering the patent in a country, then the patent holder would avoid having a compulsory licensee issued for that product. However

¹⁶³ See WTO Agreement, *supra* note 7, at art. 8.2.

¹⁶⁴ See Flynn, *supra* note 15.

¹⁶⁵ See Reichman, *supra* note 11, at 256.

this reasoning is not convincing because if the patent holder does not file for a patent in a particular country, a generic medicines manufacturer will have the right to produce the medicine without infringing any patent rights. Consequently, there would be no patent infringement and generic manufacturers would be free to create the medicines in that country without infringing upon any patent.¹⁶⁶

E. Remuneration Incentives

Aside from losing the right to exclusively market the product, the patent holder stands to lose all of its bargaining power if a compulsory license is issued. Consequently, the patent holder will no longer have any control over remuneration for the use of its patent. TRIPS requires that adequate remuneration is provided for drugs sold under a compulsory license.¹⁶⁷ Although profit from the creation of generic drugs is very small when dealing with impoverished nations, it is likely that pharmaceutical companies could negotiate a higher royalty rate providing a voluntary license than if the government were to determine the level of compensation in a compulsory license.

F. Protection of Markets Incentive

When a patent holder directly contracts with a third party, the patent holder can negotiate the terms of the production and distribution and can require that manufacturers follow export processes that ensure that the drugs are delivered to their intended recipients and that shipments are audited to verify compliance. In this manner, the patent holder can ensure that the generic medicines do not enter or create grey markets. In addition, the patent holder may elect to contract territorial restrictions on the sale and movement of the drug. By imposing contractual restrictions on the locations where the drugs may be moved, the patent holder may be able to ensure that medicines created under the contract are not sold for commercial purposes. In this way, the patent holder can ensure that the generic medicines do not reach markets in which their drugs are selling for higher prices. In addition, patent holder can limit piracy of the drug by controlling the amount of the drug that is created and the duration of a contract.

¹⁶⁶ See Bird, *supra* note 10, at 209.

¹⁶⁷ See WTO Agreement, *supra* note 7, at art. 31(h).

G. *Option to Terminate Voluntary License*

As these examples show, there are several factors that relate to a patent holder's profitability that incentivize the patent holder to provide access to patented medicines and avoid the issue of a compulsory license. With a compulsory license, these aspects are left to the discretion of a third party and may be open to abuses. Perhaps the greatest incentive of voluntarily contracting is the patent holder's ability to terminate the contract if the pharmaceutical company finds that the contract is violated or if the contract is being used to undermine the patent holder's primary markets. If the voluntary license included damages, then the patent holder would also have a legal remedy for breach of the contract.

H. *Reputation Incentive*

In addition to providing patent holders a greater degree of control over the production and distribution of medicines, avoiding the issue of compulsory license can benefit the patent holder by building recognition of its brand. In this regard, the patent holder will be in a better position to compete with rival generic producers once the patent expires.¹⁶⁸ A company that provides the rights to make their medicine will be looked on favorably by their customers that pay premium prices for the drugs. In this way, avoiding a compulsory license by engaging in voluntary licensing allows a company to build goodwill and recognition from the positive effects of the drugs.

Pharmaceutical companies are aware of the advantages of this type of brand promotion and sometimes opt to provide their medicines free of charge. Merck, a well-known and reputable pharmaceutical company, pledged to provide Mectizan in the form of in-kind donations for as long as it is needed to

¹⁶⁸ United Nations Conference on Trade and Development, *Investment in Pharmaceutical Production in the Least Developed Countries, A Guide for Policy Makers and Investment Promotion Agencies* 1, 14 (2011), available at http://unctad.org/en/docs//diaepcb2011d5_en.pdf (The expiration of patents on some of the blockbuster drugs has meant that the large research and development (R&D)-based transnational corporations in the developed world, which had relied on the sales of these drugs for their profitability, have had to re-examine their business models and adjust accordingly. Many of them have undergone a significant reorganization of their operations. Some firms are forming alliances with major generic manufacturers, both in developed countries and the larger developing country markets. Other are acquiring smaller biotechnology firms with patent applications in the pipeline, while still others are expanding into related fields such as diagnostics and other areas).

end Onchocerciasis, more commonly known as river blindness, to some forty five million people in sub-Saharan Africa.¹⁶⁹ Through their donations, over eighty million people in eleven African countries were able to obtain treatment.¹⁷⁰ Similar types of donations have been made by SmithKline Beecham, Bayer, Novartis, and Pfizer.¹⁷¹

In addition to getting a better reputation with its consumer base, a patent holder can also enhance its image within its respective industry. For example, when AT&T licensed its proprietary UNIX operating system software, the company gained significant publicity and appreciation among computer specialists.¹⁷² Though the end consumers were not aware of the source of the software, the developers were aware of the source software and respected AT&T for its contribution.¹⁷³ Similarly, pharmaceutical companies can further enhance their respect in the medical industry by advancing the public health causes other than drug development.

The pharmaceutical companies may also gain a positive reputation in the country where the drug is made available to the public by opting to provide a voluntary license. Thus, the country may provide the patent holder preferential treatment in terms of taxes or other benefits. Licensing products is a way to promote a brand, and works especially well if the company's trademark follows the product.¹⁷⁴ The licensed products act as marketing efforts inure to the benefit of the licensor's reputation as long as the licensee maintains a level of quality in the product.¹⁷⁵ In this way, a patent holder can promote its brand in broader geographic areas. Therefore, a patent holder can build its brand and in turn, people may prefer to purchase drugs from the patent holder instead of

¹⁶⁹ Center for Global Development, *Controlling Onchocerciasis (River Blindness) in Sub-Saharan Africa*, at 1, available at http://www.cgdev.org/doc/millions/MS_case_7.pdf.

¹⁷⁰ *Id.*

¹⁷¹ See World Intellectual Property Organization, *Drug Development Through Public Private Partnerships* (2008), available at http://www.wipo.int/edocs/mdocs/tk/en/wipo_ip_iss3_ge_07/wipo_ip_iss3_ge_07_www_114639.pdf; Pfizer, *International Trachoma Initiative*, available at http://www.pfizer.com/responsibility/global_health/international_trachoma_initiative.jsp.

¹⁷² JAY DRATLER ET AL., LICENSING OF INTELLECTUAL PROPERTY (Law Journal Seminars Press 2006) at 27.

¹⁷³ *Id.*

¹⁷⁴ See Megantz, *supra* note 78 ("Licensing the product is a way to spread word of the product, this will work especially well if their trademark follows the product. The licensee's products act as marketing efforts inure to the benefit of the licensor's reputation as long as the licensee maintains a level of quality").

¹⁷⁵ *Id.*

a competitor.¹⁷⁶ The favorable reputation may continue to pay off as the country matures into a developed nation with greater spending power.

A particular issue for pharmaceutical companies is the great number of expiring patents.¹⁷⁷ Pharmaceutical companies can ease the loss in profits from expiring patents by providing the generic medicines before competitors can reach the market. A recent trend is the rise in public private partnerships.¹⁷⁸ A public-private partnership is an “arrangement between one or more public sector entities and one or more private sector entities created in order to achieve a public health objective or to produce a health-related product or service for the public good.”¹⁷⁹ These types of efforts will also inure reputational benefits to the brand of the patent holder in the developing country. In addition, the cost of providing drugs may be reduced since the public portion of the partnership may subsidize a part of the cost.

Once a country arrives at a point in which it is ready to issue a compulsory license, pharmaceutical companies may resort to litigation thwart the country’s efforts.¹⁸⁰ This typically results in negative publicity for the patent holder as seen in case the Pharmaceutical Research and Manufacturers of America brought against South Africa.¹⁸¹ There, the litigation brought disfavor to pharmaceutical industries and the public response was so great that the suit was dropped unconditionally.¹⁸² By negotiating with prospective

¹⁷⁶ United Nations Conference on Trade and Development, *supra* note 27, at 10 (some generic medicine manufacturers charge a premium based on the reliability of their brand name).

¹⁷⁷ United Nations Conference on Trade and Development, *UNCTAD Report says Least Developed Countries in Position to Improve Access to Medicines Through Local Production*, (May 9, 2011), http://unctad.org/en/pages/newsdetails.aspx?OriginalVersionID=174&Sitemap_x0020_Taxonomy=Intellectual%20Property (Events shaping the global pharmaceutical industry provide an unprecedented opportunity for the least developed countries (LDCs) to attract investment in the pharmaceutical sector, “large research and development-based pharmaceutical transnational corporations (TNCs) in developed countries are facing the expiration of patents over a series of blockbuster drugs and have a dearth of new medicines in the pipeline to replace these medications. Under pressure to meet shareholder expectations, these TNCs are partnering more and more with profitable generic manufacturers in developing countries as part of a survival strategy... As a result, generic manufacturers in large developing countries are increasingly producing for developed-country markets while entertaining the possibility of manufacturing generic medicines in countries where they can still legally produce a wide range of medicines off-patent.”).

¹⁷⁸ See World Intellectual Property Organization, *supra* note 169.

¹⁷⁹ World Intellectual Property Organization, *supra* note 169.

¹⁸⁰ See Bird, *supra* note 10, at 210.

¹⁸¹ See Simmons, *supra* note 142.

¹⁸² See *id.*

generic manufactures to voluntary licenses, companies have a chance to avoid negative publicity.

I. *Differential Pricing*

In countries where only a portion of the population can afford an invention at the premium price, patent holders should make efforts to provide the invention at a lower cost to the remaining part of the public. Patent holders typically avoid price discrimination in such countries because it is considerably more profitable to do so.¹⁸³ However, with compulsory license legislation in place, the patent holders risk a compulsory license if they ignore a substantial portion of the country's population. Patent holders can avoid the issue of a compulsory licensing through tiered pricing.¹⁸⁴ Under a tiered pricing scheme, patent holders adapt drug prices to the purchasing power of consumers in different geographical or socioeconomic segments.¹⁸⁵

Pharmaceutical companies are typically concerned "that differential pricing could erode profit margins in lucrative high and middle-income markets."¹⁸⁶ However, when faced with the prospect of a compulsory license, pharmaceutical companies have an incentive to accept the slightly lower profits in low- and middle-income countries.¹⁸⁷ Pharmaceutical companies face pressures to act in socially responsible ways and may suffer reputational harm for failing provide access to patented medicines.¹⁸⁸

¹⁸³ See Reichman, *supra* note 11, at 252.

¹⁸⁴ PRASHANT YADAV, *Differential Pricing for Pharmaceuticals: Review of Current Knowledge, New Findings and Ideas For Action* (2010) at 18, available at <http://www.dfid.gov.uk/Documents/publications1/prd/diff-ricing-pharma.pdf> ("Differential pricing with lower prices in low and middle-income countries is a good strategy to thwart such a threat and risk having strong price pressures on an important product.").

¹⁸⁵ *Id.* at 9.

¹⁸⁶ *Id.* at 5.

¹⁸⁷ *Id.* at 18.

¹⁸⁸ *Id.* at 17 ("Failure to respond to issues pertaining to access to medicines can quickly lead to reputational harm. Differential pricing allows pharmaceutical companies to signal that their pricing policies are socially responsible and consistent with their obligations to society and not merely geared towards maximizing their profit. New initiatives such as the Access to Medicine Index monitor highlight the efforts of pharmaceutical companies to increase access to medicines in developing countries. The ATM Index defines equitable pricing as a mechanism that is intended to lower financial barriers to pharmaceutical access. Equitable pricing and affordability are key aspects of how pharmaceutical companies are rated on this index. Differential pricing would lead to better ranking on indicators such as this which measure a pharmaceutical company's fulfillment of its societal obligations.") (citation omitted).

As these examples show, retaining the rights to control the production of patented medicines can have positive effects on profitability and reputation. Therefore the creation of a compulsory licensing legislation creates incentives for pharmaceutical companies to negotiate with developing countries. The threat of a compulsory license acts as a deterrent to patent abuses, and forces patent holders to work with developing countries to meet their population's needs.

CONCLUSION

This Note advocates expanding compulsory license legislation including a set of baseline set of requirements as a key step towards increasing access to patented medicines. The legislative and policy decisions in creating the requirements in CAMR are a positive step towards obtaining patient access to patented medicines in developing countries where patent holders stand to profit by keeping their drug prices unaffordable to the majority of those who need them. CAMR, which contains a negotiation requirement and limitations such as restrictions on the types, quantities, and importation of drugs is a good model of compulsory license legislation that provides protection from potential abuses. Such compulsory license legislation provides incentive for both pharmaceutical companies and developing nations to return to the table and negotiate a voluntary license. Because the underlying goal of compulsory license legislation is to encourage the creation of voluntary licenses, the activity level of the compulsory license legislation should not be considered a proper indicator of whether the process has made progress towards the legislation's underlying goals.

With the threat of compulsory licenses, pharmaceuticals may conclude that it is favorable to provide voluntary licenses or medicines to developing countries at little to no cost because compulsory licenses nullify important rights of the patent holder, when a compulsory license is issued, a patent holder loses the ability to negotiate terms such as adequate remuneration, production processes, export processes, whether the medicine will be sold for a profit, or who can claim recognition for providing the drugs. The very threat of compulsory licenses provides incentive for pharmaceutical companies to negotiate with the governments to provide favorable terms for both sides.

The rationales leading to TRIPS support benefits for both the developing countries and the developed countries who agree to its conditions. Therefore, developing countries should strive to develop compulsory license legislation with the needed limitations order to improve access to patented medicines. Programs like CAMR provide both sides with incentives to negotiate. The use of negotiation deadlines and dispute resolution measures should be employed when it is clear that negotiations are stalled or ineffective. In addition negotiations should be made public to discourage bad faith negotiation.

Pharmaceutical companies will need to determine whether the risk of compulsory licenses will justify negotiating a voluntary license with more favorable terms that will protect their property interests, avoid patent abuse,

maintain control their inventions, and benefit their reputations. Since it is unlikely that pharmaceuticals will obtain much in the form of royalty payments, it would be in their best interests to reconsider whether a licensing agreement or even a structured transfer of the drugs would be more feasible. A voluntary license may become an attractive option if the ability to refuse to negotiate is off the table. In addition, negotiating such licenses provides the opportunity to build goodwill and improve brand recognition. Goodwill can be built both in the companies' premium markets and in the markets where the generic medicines are provided. Maintaining favorable impressions with their consumer bases, market governments, and medical communities will eventually benefit patent holders.

Article 1 of TRIPS states that “[m]embers shall be free to determine the appropriate method of implementing the provisions of this Agreement within their own legal system and practice.”¹⁸⁹ While each country is free to implement the provisions on its own, countries should create baseline restrictions on the issue of compulsory licenses to balance incentives towards innovation and public health.

¹⁸⁹ See WTO Agreement, *supra* note 7, at art. 1.

SANCTIONS DISCLAIMERS IN LETTERS OF CREDIT

*Damien Smith**

INTRODUCTION

I. Background

A. *Letters of Credit*

Letters of credit arise from the terms of payment or guaranty of a contract. One of the parties to the underlying contract (the applicant) requests that a bank (the issuer) issue a letter of credit in favor of the other party to the contract (the beneficiary).¹ The following three relationships construct the letter of credit transaction: (1) the underlying contract between the applicant and the beneficiary, (2) the agreement between the applicant and the issuer containing the issuer's promise to issue the letter of credit and the applicant's promise to reimburse the issuer, and (3), existing in the letter of credit itself, the relationship between the issuer and the beneficiary in which the issuer promises to honor the beneficiary's demand for payment if it complies with the terms of the letter of credit.²

Traditionally, a letter of credit arose from an international sale of goods, as a commercial letter of credit, designed to ensure payment.³ A seller of goods might be reluctant to depend on a promise to pay made by a distant buyer, but a promise to pay issued by a banking institution with dependable credit is more enticing.⁴ Banks are willing to enter this undertaking for the fee provided by the applicant.⁵ It is only profitable for banks as a high-volume service and in dealing with applicants whose credit the bank can trust.

The use of letters of credit has expanded beyond the buyer-seller relationship to assure the beneficiary of the applicant's performance in other contract situations. A performance-guaranty letter of credit is known as a standby letter of credit and is designed to protect the beneficiary if the

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¹ Colorado Nat. Bank of Denver v. Bd. of Comm'rs of Routt Cnty., 634 P.2d 32, 36 (Colo. 1981).

² *Id.*

³ *Id.*

⁴ 1 Williston on Contracts § 2:23 (4th ed.)

⁵ *Id.*

applicant does not fulfill the bargain.⁶ The attractiveness of the letter of credit in providing certainty of payment has led to its use in securitizing performance in a variety of contexts.⁷ Letter of credit use has grown dramatically since the 1970s.⁸ It is important to note, however, that a standby letter of credit is not a traditional guaranty or surety and that letter of credit law and the independence principle⁹ apply.¹⁰ This puts the beneficiary to a standby letter of credit in a stronger position than a traditional guaranty because the letter of credit is documentary, that is, the beneficiary can demand payment by simply presenting documents stating that the applicant has, for example, breached the contract, but is not required to provide independent proof of that fact.¹¹

The third relationship, the letter of credit itself, does not require consideration.¹² It may be characterized as a contract, but it is not subject to principles of contract law; it is a promise without consideration (from the promisee), generally referred to as an undertaking.¹³ Instead, letter of credit law is *sui generis*, using its own jurisprudence with distinct principles.¹⁴ It generally reflects the norms of the international community of letter of credit practitioners,¹⁵ developing as practice rules issued by the International Chamber of Commerce.¹⁶ Banks voluntarily make the letters of credit subject to the practice rules by the terms of the letter of credit.¹⁷ The letter of credit is governed by the incorporated set of practice rules except where superseded by local law.¹⁸ In all U.S. states, Revised Article 5 of the Uniform Commercial

⁶ Colorado Nat. Bank of Denver v. Bd. of Comm's of Routt Cnty., 634 P.2d 32, 36 (Colo. 1981).

⁷ See generally, Cassondra E. Joseph, *Letters of Credit: The Developing Concepts and Financing Functions*, 94 BANKING L.J. 816 (1977).

⁸ 2A DANIEL R. MURRAY & CARTER H. KLEIN, *UCC with Illinois Code Comments Art 5 Intro*, in *Illinois Practice Series* (2012 ed.).

⁹ 1 Williston on Contracts § 2:23 (4th ed.).

¹⁰ *Id.*

¹¹ *Id.*

¹² Corporate Counsel's Guide to Letters of Credit § 1:2 (Updated Nov. 2011).

¹³ San Diego Gas & Elec. Co. v. Bank Leumi, 42 Cal. App. 4th 928, 933 (1996) (citing 3 WHITE AND SUMMERS, UNIFORM COMMERCIAL CODE (4th ed. 1995)).

¹⁴ JAMES E. BYRNE, INTERNATIONAL LETTER OF CREDIT LAW AND PRACTICE § 2:11 (West 2013).

¹⁵ This Community is mostly comprised by the banks who deal with the letters of credit in a larger volume than the applicants or beneficiaries and the lawyers who specialize in the field.

¹⁶ See generally, Janet Koven Levit, *Bottom-up Lawmaking Through a Pluralist Lens: The ICC Banking Commission and the Transnational Regulation of Letters of Credit*, 57 EMORY L.J. 1147, 1178-79 (2008).

¹⁷ *Id.* at 1173.

¹⁸ Banks issuing letters of credit "have always been subject to the application of relevant local law." International Chamber of Commerce on Banking Technique and Practice, *Guidance Paper on the use of Sanctions Clauses for Trade Related Products* (e.g., *Letters of Credit, Documentary Collections and Guaranties*) Subject to ICC Rules, ICC Publication No. 470/1129rev, 4.2 (March 26, 2010) [hereinafter *ICC Guidance Paper*].

Code governs letters of credit.¹⁹ U.C.C. Section 5-116(c) states that any practice rule governing the letter of credit by incorporation supersedes the U.C.C.²⁰ The United Nations Commission on International Trade Law's Independent Guarantees and Stand-by Letters of Credit Convention (the U.N. Convention) has a restricted scope due to its limited number of signatories, but will also recognize a choice of law agreed to by the parties in the letter of credit.²¹

Letter of credit law is practice-driven because of the need to protect the viability of the instrument. There is a need to protect the viability of the instrument because it provides a unique benefit. A letter of credit can facilitate a transaction where the counterparties do not know each other, but can rely on the credit of a bank and the bank's ability to assess a counterparty's creditworthiness.²² The central bargain of the letter of credit is the beneficiary's ability to hold the money pending resolution of a contractual dispute.²³ Ideally, where there is a contractual dispute between the applicant and the beneficiary, it will be settled after the bank has paid the beneficiary and the applicant has reimbursed the bank. This feature of the letter of credit facilitates the transaction where the beneficiary would not otherwise be enticed to contract with the applicant whose credit is unknown to the beneficiary.²⁴ Applicants may try to skip these steps, suing to enjoin the bank from paying the beneficiary, and thereby denying the beneficiary the benefit it had bargained for. The benefit of the letter of credit is reduced if courts are overly willing to grant such injunctions.

This central benefit is preserved by the independence principle, an axiom of letter of credit practice that holds the bank to its obligation on the letter of credit independent of any terms or conditions of the underlying contract between the applicant and the beneficiary.²⁵ Letters of credit are documentary credits; the bank's obligation is to honor a timely presentation of documents that comply with the terms and conditions of the letter of credit.²⁶ Protecting the core benefit to the beneficiary by upholding the independence principle and the strict obligation of the bank to honor is critical to preserving the viability of the letter of credit.

¹⁹ See U.C.C. Article 5 Table of Adoption.

²⁰ U.C.C. § 5-116(c).

²¹ THE UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW, INDEPENDENT GUARANTEES AND STAND-BY LETTERS OF CREDIT CONVENTION, ¶ 52.

²² Corporate Counsel's Guide to Letters of Credit § 1:2 (Updated Nov. 2011).

²³ *Id.*

²⁴ *Id.*

²⁵ 6B Hawklund UCC Series § 5-114:2.

²⁶ See, e.g., U.C.C. § 5-102(a)(10).

B. *U.S. Sanctions Law*²⁷

The power of the United States to impose sanctions on trade arises from the executive power to respond to national emergencies. The power to respond to national emergencies may be properly delegated to the executive by the legislature.²⁸ There are also times where executive power has been improperly delegated.²⁹ At other times, the President assumes extraordinary powers to meet extraordinary emergencies. For example, President Washington was the only sitting president to lead a military campaign, acting under the Militia Act of 1792 to quell the Whisky Insurrection.³⁰ President Lincoln issued an April 15, 1861 executive proclamation that Congress not come into session until July 4th of that year.³¹ He then ordered a blockade of confederate ports and new ships to be added to the federal navy.³² Lincoln also suspended writs of habeas corpus and unilaterally commissioned the acceptance of army volunteers.³³ Upon re-convening, Congress approved Lincoln's extraordinary actions as legitimate responses to emergency.³⁴ As discussed below, President Roosevelt acted under pretense of law to respond to a national banking emergency.³⁵ As it did for President Lincoln, Congress acceded to these acts.³⁶ These are cases where the President takes the prerogative to respond to a national emergency, leaving it to Congress and the courts to judge the constitutionality after the fact.

President Roosevelt's actions were accepted by Congress, but the indefinite legal grounding of the actions led Congress to investigate and then limit executive power to declare a national emergency and then act under color

²⁷ This comment is limited to U.S. financial sanctions, but international trade finance is also impacted by controls on actual goods. In U.S. law, the Export Administration Act of 1969 (EAA) authorizes the control of exported materials by the Export Administration Regulations (EAR), issued by the Bureau of Industry and Security (BIS) in the Department of Commerce. IAN F. FERGUSON, CONGRESSIONAL RESEARCH SERVICE, *THE EXPORT ADMINISTRATION ACT: EVOLUTION, PROVISIONS, AND DEBATE* (2010).

²⁸ See, e.g., *United States v. Yoshida Int'l, Inc.*, 526 F.2d 560, 572–73 (C.C.P.A. 1975) (Finding that Section 5b powers of TWEA properly delegate sanctions power to the President).

²⁹ See, e.g., *A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935).

³⁰ Frederick Bernays Wiener, *The Militia Clause of the Constitution*, 54 HARV. L. REV. 181, 187–88 (1940).

³¹ Jill Elaine Hasday, *Civil War As Paradigm: Reestablishing the Rule of Law at the End of the Cold War*, 5 WTR KAN. J.L. & PUB. POL'Y, 129, 130 (1996).

³² *Id.*

³³ *Id.*

³⁴ *Id.*

³⁵ Presidential Proclamation 2039, 48 Stat. 1689 (1933).

³⁶ 48 Stat. 1 (1933).

of that declaration.³⁷ Executive power to declare an emergency and order economic sanctions is now firmly established within constitutional jurisprudence.³⁸ The only remaining question on the legality of U.S. sanctions is extra-territorial jurisdiction.³⁹ U.S. courts have been willing to deny the U.S. Government extra-territorial enforcement in some cases,⁴⁰ an issue that will remain relevant as the United States will continue aggressive economic sanctions in its foreign policy and look to build on its perceived successes with OFAC sanctions in particular.

1. Legislative History

a. Trading with the Enemy Act (TWEA) of 1917

Section 5(b) of the TWEA gave the President power to regulate foreign exchange transactions, the export or hoarding of gold or silver coin or bullion or currency and transfers of credit in any form between the United States and any foreign country, exempting transactions to be executed wholly within the United States.⁴¹ Congress granted the powers for the successful prosecution of World War I.⁴² It did not include a provision permitting use of the act during periods of national emergency nor was its use restricted by its terms to the duration of the First World War or any specific term after the end of the war.⁴³

The executive expanded TWEA Section 5(b) powers beyond what was explicitly granted.⁴⁴ During a 1933 congressional recess, President Roosevelt cited Section 5(b) to declare a national emergency and a national banking holiday, despite the apparent limitations of Section 5(b) powers to wartime use and from regulating wholly domestic transactions.⁴⁵ Congress's first act upon reconvening was to ratify the emergency declaration.⁴⁶ President Roosevelt declared a "limited national emergency" in 1939 and then an "unlimited

³⁷ See HAROLD C. RELYEA, CONGRESSIONAL RESEARCH SERVICE, NATIONAL EMERGENCY POWERS 1, 10–12 (Updated August 30, 2007).

³⁸ *Dames & Moore v. Regan*, 453 U.S. 654 (1981) (upholding the President's power to act under the International Emergency Economic Powers Act).

³⁹ See Levine, Paretsky, & Taylor, *Increasing 'Extraterritorial' Application of U.S. Trade Control Laws to Non-U.S. Businesses*, THE NATIONAL LAW REVIEW (2012).

⁴⁰ *E.g.*, *United States v. Lloyds TSB Bank PLC*, 639 F. Supp. 2d 314, 325 (S.D.N.Y. 2009) (holding that provisions of the Money Laundering Control Act did not extend to a British bank's branch in Switzerland).

⁴¹ Trading With the Enemy Act, Pub. L. No. 65-91, ch. 106, 40 Stat. 411 (1917) (codified as amended in 12 U.S.C.A. §95a and scattered sections of 50 App. U.S.C.A.).

⁴² See *Regan v. Wald*, 468 U.S. 222, 226 n. 2 (1984).

⁴³ Trading With the Enemy Act.

⁴⁴ H.R. REP. NO. 95-459, at 7 (1977).

⁴⁵ Presidential Proclamation 2039, 48 Stat. 1689 (1933).

⁴⁶ Pub. L. No. 73-1, 48 Stat. 1 (1933).

national emergency” in 1941, prior to declaration of war.⁴⁷ President Truman terminated both in 1952.⁴⁸ President Nixon declared national emergencies in response to the 1970 postal strike threat and the 1971 balance of payments crisis.⁴⁹

b. National Emergencies Act of 1976 (NEA)

The NEA was Congress’s response to the expansive use of Presidential emergency powers under Section 5(b) of TWEA and the lack of a statutory provision for terminating declared emergencies.⁵⁰ The NEA resulted from the Senate Special Committee on the Termination of the National Emergency, which was formed to investigate the continuation of the 1950 national emergency declared by President Truman relating to actions in Korea.⁵¹ The Committee found four active national emergencies: the 1933 bank holiday, the Korea emergency, and the emergencies declared by President Nixon in 1970 and 1971.⁵² It then drafted the National Emergencies Act, which provided for the termination of these emergencies specifically and required a new bill providing for a defined process for Presidential invocation of emergency powers with accountability to Congress and termination mechanisms.⁵³

c. International Emergency Economic Powers Act (IEEPA)

The IEEPA was drafted to resolve the exemption of TWEA Section 5(b) powers from the NEA, and define Presidential emergency powers procedures.⁵⁴ It is the statutory basis for the financial sanctions administered by OFAC.⁵⁵ The IEEPA is Title II of Public Law 95-223.⁵⁶ Title I restricted the use of TWEA Section 5(b) powers to wartime, but allowed for the continuation of existing emergencies if necessary.⁵⁷ Title II authorizes the President to declare national emergencies as defined therein.⁵⁸ It grants the President powers comparable to TWEA Section 5(b) powers with provisions

⁴⁷ Presidential Proclamation 2532, 54 Stat. 2563 (1939); Presidential Proclamation 2487, 55 Stat. 1647 (1941).

⁴⁸ RELYEA, *supra* note 56, at 8.

⁴⁹ Presidential Proclamation 3972, 84 Stat. 2222 (1970); Presidential Proclamation 4074, 85 Stat. 926 (1971).

⁵⁰ RELYEA, *supra* note 56, at 9–12.

⁵¹ *Id.* at 9.

⁵² *Id.*

⁵³ *Id.* at 9–12.

⁵⁴ S. REP. No. 95-466, at 2 (1977).

⁵⁵ 50 U.S.C.A. § 1704 (West 2013).

⁵⁶ 50 U.S.C.A. §§ 1701-06 (West 2013).

⁵⁷ S. REP. No. 95-466, at 4 (1977).

⁵⁸ 50 U.S.C.A. § 1701 (West 2013).

for reporting, accountability, and mechanisms for termination by Congress.⁵⁹ Since 1976, IEEPA powers have been used extensively.⁶⁰

2. U.S. Sanctions Framework

United States financial sanctions are political decisions and the potential for sudden changes is inherent and constant. To assist with compliance, OFAC publishes guidance opinions on new regulations⁶¹ and offers a hot-line for immediate advice on live transactions⁶². OFAC regulations target individuals, listed on the SDN⁶³ and any transactions involving sanctioned countries, as well as some nebulous global networks like narcotics trafficking⁶⁴.

OFAC regulations are codified in Title 31 of the Code of Federal Regulations (CFR).⁶⁵ The sanction regime targeting Iran, for example, is codified in parts 535 and 560 of the CFR, the regime targeting Syria in part 542, Belarus in part 548, and so on.⁶⁶ Business with sanctioned countries is allowed only through general or specific licenses issued by OFAC.⁶⁷

C. *Sanctions Disclaimers*

Banks insert clauses in letters of credit in different forms. From simply notifying the beneficiary that the bank must abide by applicable sanctions, to broader clauses giving the bank discretion to dishonor a presentation if payment would violate the bank's internal policies concerning sanctions compliance, i.e., giving the bank discretion to withhold payment if it suspects it may be subject to sanctions.⁶⁸ Banks want discretion to dishonor because of the rate of change and complexity of sanctions regimes.⁶⁹ Letter of credit lawyers advise clients to be careful about whom they transact with and to

⁵⁹ 50 U.S.C.A. §§ 1701-04 (West 2013).

⁶⁰ Declared national emergencies and their status as of 2007 are cataloged in RELYEA, *supra* note 56, at 13–16 (Table 1).

⁶¹ See, e.g., Sudanese Sanctions Regulations, 31 C.F.R. Part 538 (2011).

⁶² U.S. Department of Treasury, <http://www.treasury.gov/about/organizational-structure/offices/Pages/Office-of-Foreign-Assets-Control.aspx>.

⁶³ OFFICE OF FOREIGN ASSETS CONTROL, Specially Designated Nationals and Blocked Person List (2012), available at <http://www.treasury.gov/resource-center/sanctions/SDN-List/Pages/default.aspx>.

⁶⁴ Narcotics Trafficking Sanctions Regulation, 31 C.F.R. § 536 (2008).

⁶⁵ Office of Foreign Assets Control, Department of the Treasury, 31 C.F.R. §§ 500–598 (2014).

⁶⁶ *Id.*

⁶⁷ Treasury, *supra* note 81.

⁶⁸ Geraldine Butac, Diane Galloway, and Robert Parson, *Client Alert: Sanctions Clauses - Safeguarding payment under Letters of Credit*, REED SMITH (Jan. 11, 2012), <http://www.reedsmith.com/en-US/Sanctions-Clauses---Safeguarding-payment-under-Letters-of-Credit-01-11-2012/>.

⁶⁹ Cannon et al., *supra* note 19.

avoid the unclear legal impact a sanctions disclaimer clause may have on the irrevocable and independent nature of the letter of credit.⁷⁰ Besides implementing better compliance systems and due diligence, banks have other options, for example, the issuer bank may ask the applicant to issue guarantees to the banks to indemnify the bank against sanctions enforcement.⁷¹

The following are examples of discretionary sanctions disclaimers found in letters of credit cited by the International Chamber of Commerce:

1.

[Bank] complies with the international sanction laws and regulations issued by the United States of America, the European Union and the United Nations (as well as local laws and regulations applicable to the issuing branch) and in furtherance of those laws and regulations, [Bank] has adopted policies which in some cases go beyond the requirements of applicable laws and regulations. Therefore [Bank] undertakes no obligation to make any payment under, or otherwise to implement, this letter of credit (including but not limited to processing documents or advising the letter of credit), if there is involvement by any person (natural, corporate or governmental) listed in the USA, EU, UN or local sanctions lists, or any involvement by or nexus with Cuba, Sudan, Iran or Myanmar, or any of their governmental agencies.⁷²

2.

Trade and economic sanctions ('sanctions') imposed by governments, government agencies or departments, regulators, central banks and/or transnational organisations (including the United Nations and European Union) impact upon transactions involving countries, or persons resident within countries currently including Balkans, Belarus, Côte d'Ivoire (Ivory Coast), Lebanon, Liberia, Rwanda, Sierra Leone, Somalia, Syria, the Democratic Republic of Congo, Uzbekistan, Afghanistan, Iran, Iraq, Myanmar (Burma), North Korea, Cuba, Zimbabwe and Sudan. Issuing bank and all of its

⁷⁰ *Id*; Butac et al., *supra* note 87.

⁷¹ *Economic Sanctions: Their Practical Impact on International Trade*, KENNEDY'S, (May 15, 2012), <http://www.kennedys-law.com/article/economicsanctionsinternationaltrade/>.

⁷² *ICC Guidance Paper*, *supra* note 37, at 3.3.

related bodies corporate subject to and affected by, sanctions, with which it will comply. Please contact issuing bank for clarification before presenting documents to issuing bank for negotiation or undertaking any dealings regarding this credit involving countries or persons affected by sanctions. Issuing bank is not and will not be liable for any loss or damage whatsoever associated directly or indirectly with the application of sanctions to a transaction or financial service involving issuing bank. Issuing bank is not required to perform any obligation under this credit which it determines in its discretion will, or would be likely to, contravene or breach any sanction. This clause applies notwithstanding any inconsistency with the current edition of the International Chamber of Commerce Uniform Customs and Practice for Documentary Credits.⁷³

D. Cases

Case law on U.S. economic sanctions is usually either adjudicatory (brought by the administering agency to enforce their regulations) or challenges by private parties to the constitutionality of the agency's authority.⁷⁴ However, this comment will address hypothetical cases between private parties to a letter of credit disputing their rights with respect to U.S. economic sanctions. The first two sets of the following cases were caused by major geo-political events casting a sudden pall over the rights of American suppliers to Middle Eastern governments, and the third concerns sanctions disclaimers in shipping insurance contracts. These cases are helpful, but, as of this writing, no cases have been reported on the enforceability of sanctions disclaimers in letters of credit.

1. The Iranian Revolution

In the turmoil of the Shah's fall, American sellers faced the risk of opportunistic drawing on counter security instruments by hostile Iranian

⁷³ *Id.* at 3.4.

⁷⁴ *See, e.g.*, *Regan v. Wald*, 468 U.S. 222 (1984); *United States v. Amirnazmi*, 645 F.3d 564 (3d Cir. 2011); *Zarmach Oil Servs., Inc. v. U.S. Dep't of the Treasury Office of Foreign Assets Control*, 750 F. Supp. 2d 150 (D.C. Cir. 2010); *Freedom to Travel Campaign v. Newcomb*, 82 F.3d 1431 (9th Cir. 1996); *Clancy v. Office of Foreign Assets Control of the U.S. Dep't of the Treasury*, No. 05-C-580, 2007 WL 1051767 (E.D. Wis. Mar. 31, 2007).

entities. In the typical transaction, Iranian-government purchasers required American sellers to provide security against non-performance with the following two instruments: first, a bank guaranty from an Iranian bank that the Iranian-government purchaser could draw on by presenting proof of non-performance, and second, a standby letter of credit from an American bank to the Iranian bank draw-able on demand by documentary proof that the Iranian bank had paid the Iranian-government purchaser under the guaranty.⁷⁵ After the revolution, the American beneficiaries feared the new Iranian government would have little regard for future business prospects with American sellers and would opportunistically draw on the letters of credit.⁷⁶ They argued such drawings would be fraudulent, notice of which precludes a bank's obligation to pay on a letter of credit.⁷⁷ Many successfully sued for "notice injunctions", which required the American bank, which had issued the standby letter of credit, to notify the American seller when the Iranian bank presented documentary proof of payment to the Iranian-government purchaser under the guaranty.⁷⁸ This gave the seller opportunity to provide the bank with proof of fraud.⁷⁹ Other sellers sought outright injunctions on payment and lost.⁸⁰ The failed outright injunction cases were brought prior to Iranian assets being frozen by the United States. The sellers could not enjoin payment, where there was no illegality, simply because they anticipated fraudulent drawing.⁸¹

These cases show that the obligation to honor a complying presentation cannot be disregarded because of mere anticipation of fraud or illegality. It is similarly questionable if a bank can dishonor a presentation because it anticipates potential illegality under sanctions law.

2. The First Iraq War

In the Iraq cases, U.S. courts upheld the banks' obligation to pay beneficiaries on complying presentation, regardless of whether the bank is reimbursed.⁸² The crucial function of a letter of credit is the seller's ability to

⁷⁵ George Weisz & Jonathon I. Blackman, *Standby Letters of Credit After Iran: Remedies of the Account Party*, 1982 U. ILL. L. REV. 355, 360-61(1982).

⁷⁶ *Id.* at 356.

⁷⁷ See Part II(A)(1).

⁷⁸ *Harris Int'l Telecomms. v. Bank Melli Iran*, 79 Civ. 802 (S.D.N.Y. Feb. 22, 1979); *Stromberg-Carlson Corp. v. Bank Melli Iran*, 467 F. Supp. 530, 533 (S.D.N.Y. 1979).

⁷⁹ Weisz & Blackman, *supra* note 94, at 362-63.

⁸⁰ *KMW Int'l v. Chase Manhattan Bank*, 606 F.2d 10, 10-11 (2d Cir. 1979); *United Techs. Corp. v. Citibank*, 469 F. Supp. 473 (S.D.N.Y. 1979); *American Bell Int'l, Inc. v. Islamic Republic of Iran*, 474 F. Supp. 420 (S.D.N.Y. 1979).

⁸¹ Herbert A. Getz, *Enjoining the International Standby Letter of Credit: the Iranian Letter of Credit Cases*, 21 HARV. INT'L L.J. 189, 222-23 (1980).

⁸² *Bergerco Canada v. United States Treasury Department, Office of Foreign Assets Control*, 129 F.3d 189 (D.C. Cir. 1997) (reversing *Bergerco Canada v. Iraqi State Company for Food Stuff*

shift the risk of non-payment to the bank.⁸³ These Iraq cases held that the bank could not escape its obligation to pay and shift the risk back to the seller for the sole justification that the bank will not be reimbursed.⁸⁴

The Iraq cases also held that where a bank was obligated to pay, but payment would normally come from an account that was opened with the bank by a now-sanctioned Iraqi entity for payment on a letter of credit in favor of the American seller, but was now frozen, the seller could recover from the bank's non-frozen assets.⁸⁵ This may require suing OFAC for a license to sue for a judgment on the frozen assets.⁸⁶

3. The Insurance Cases

There have been a couple of reported cases on the effect of discretionary sanctions clauses in transactions outside of the letter of credit context, in maritime insurance policies. Review of these cases will help distinguish the treatment of discretionary clauses under letter of credit law from ordinary contract law. In these cases, the insurer's right to refuse indemnity or to cancel the policy outright under a sanctions disclaimer clause was upheld as a valid clause under ordinary contract law.⁸⁷ While courts have recognized marine insurer's rights to cancel under discretionary sanctions clauses, the expansive E.U. and U.S. sanctions regimes have led some to caution against over-reliance on these clauses and to advise insurers to instead decline questionable business.⁸⁸

Trading, 924 F. Supp. 252 (D.D.C. 1996)); *Consarc Corp. v. United States Treasury Department, Office of Foreign Assets Control*, 71 F.3d 909 (D.C. Cir. 1995); *Consarc Corp. v. Iraqi Ministry*, 27 F.3d 695 (D.C. Cir. 1994); *Centrifugal Casting Machine Co. v. American Bank & Trust Co.*, 966 F.2d 1348 (10th Cir. 1992); *Semetex Corp. v. UBAF Arab American Bank*, 51 F.3d 3 (2d Cir. 1995) (affirming *Semetex Corp. v. UBAF Arab American Bank*, 853 F. Supp. 759 (S.D.N.Y. 1994)); *Engel Industries, Inc. v. First American Bank*, 798 F. Supp. 9 (D.D.C. 1992); *Engel Industries, Inc. v. First American Bank*, 803 F. Supp. 426 (D.D.C. 1992).

⁸³ See Part I(A).

⁸⁴ Massimo Galli, *Sue or Lose: An Agenda for American Corporations and Companies Seeking Compensation from Iraq*, 1993 COLUM. BUS. L. REV. 241, 264 (1993); Seligman, *supra* note 17, at 151.

⁸⁵ Seligman, *supra* note 17, at 151 (citing *Tagle v. Regan*, 643 F.2d 1058, 1064 (5th Cir. 1981)).

⁸⁶ See *Tagle*, 643 F.2d at 1064.

⁸⁷ *Arash Shipping Enterprises Co. Ltd. v. Groupama Transport*, [2011] EWCA Civ 620 (25/05/2011); *Islamic Republic of Iran Shipping Lines v. Steamship Mutual Underwriting Association (Bermuda) Limited*, [2010] EWHC 2661 (Comm) (October 26, 2010).

⁸⁸ Liz McMahon, *International Union of Marine Insurance Conference 2012: Over-reliance on sanctions clauses dangerous for insurer*, LLOYD'S LIST, (Sept. 19, 2012), <http://www.lloydslist.com/ll/sector/Insurance/article407698.ece>.

II. ANALYSIS

Letter of credit law recognizes some exceptions (known as excuses or defenses to honor) to the bank's obligation to pay on a complying presentation. This part will analyze whether the discretionary sanctions disclaimers fit in an existing exception or justify recognizing a new exception.

E. *Defenses to Honor*

1. Fraud

A bank's obligation to pay may be excused for fraudulent presentation or where fraud in the underlying transaction has destroyed the beneficiary's right to payment. Under the U.C.C. Revised Article 5, banks are held to a good faith standard to honor; their obligation is not excused unless they are able to show forgery of required documents or a material fraud.⁸⁹ Payment may be excused for fraud in the transaction where the beneficiary has presented documents complying with the letter of credit, but does not have a reasonable basis for demanding payment on the underlying contract.⁹⁰ The UCP600 does not state a standard for fraud.⁹¹ Because it can be a contentious issue, getting consensus on a fraud standard may be an impracticality for the ICC, and so the question is left to local law.⁹² The ISP98 expressly declines to state a standard for a fraud defense, leaving the issue to local law.⁹³

The Iranian revolution cases granted limited relief to applicants for anticipated fraud, in the form of notice injunctions, requiring the issuing bank to notify the applicant of presentation, allowing applicants to provide evidence of fraudulent demand before payment was made.⁹⁴ Political turmoil and animosity towards the United States in Iran and the difficulty of assessing the authenticity of a demand convinced the court in a leading case of the likelihood of a fraudulent presentation which, in combination with the irreparable harm from an inability to recover in Iranian courts, warranted the notice injunction.⁹⁵ Though not all the Iranian revolution cases dealt directly with economic sanctions, the danger of fraudulent drawing was based on the

⁸⁹ U.C.C. § 5-109(a) (Official Comment 2).

⁹⁰ *See, e.g.,* Itek Corp. v. First Nat'l Bank of Boston, 730 F.2d 19, 28 (1st Cir. 1984).

⁹¹ Levit, *supra* note 35, at 1178-79

⁹² *Id.*

⁹³ International Chamber of Commerce, *International Standby Practices (ISP98)*, Rule 1.05(c), ICC Publication No. 590, (Jan. 1, 1999) [hereinafter ISP98].

⁹⁴ *Harris Int'l Telecomms. v. Bank Melli Iran*, 79 Civ. 802 (S.D.N.Y. Feb. 22, 1979); *Stromberg-Carlson Corp. v. Bank Melli Iran*, 467 F. Supp. 530 (S.D.N.Y. 1979).

⁹⁵ Getz, *supra* note 99, at 215 (citing *Harris Int'l Telecomms.*, 79 Civ. 802.)

breakdown of political relations between the United States and Iran leading to a break in economic relations and anticipation of economic sanctions.⁹⁶

Could a bank's obligation to honor be excused on the basis of a discretionary sanctions clause because it believes there is a sufficient likelihood of a fraudulent drawing because of the likelihood that existing or predicted sanctions will prohibit payment? To distinguish this hypothetical from the Iranian cases, it is first important to note that relief was granted to applicants whose recovery on the underlying contract was endangered, not the banks whose reimbursement was endangered. Protecting the applicant from fraud by excusing the bank's obligation to honor has a different effect on the viability of the letter of credit than protecting the bank itself by excusing the bank's obligation. Under the U.C.C., a bank is bound to dishonor where a presentation is fraudulent,⁹⁷ but a bank should not undermine its duty to examine documents for compliance on their face, and should refrain from policing conduct in the underlying transaction⁹⁸.

In other Iranian revolution cases, the courts refused to grant permanent injunctions based on possible fraudulent demands.⁹⁹ In general, the courts were unwilling to excuse the bank's obligation to honor simply because there were extraordinary circumstances, but did preserve the normal defenses against fraud.

2. Force Majeure

The UCP600 provides for *force majeure* exceptions to the bank's obligation.¹⁰⁰ However, illegality of payment, such as where prohibited by sanction, is not a *force majeure* event. *Force majeure* events refer to interruptions of business by "Acts of God, riots, civil commotions, insurrections, wars, acts of terrorism, or by any strikes or lockouts or any other causes beyond [the bank's] control".¹⁰¹ This excludes possible prohibition of payment by law. UCP600 Article 36 excuses the bank's liability for the consequences of these events, so that if presentation was thwarted by a *force*

⁹⁶ See Exec. Order No. 12170, 44 Fed. Reg. 65729, (Nov. 14, 1979).

⁹⁷ U.C.C. § 5-109(a).

⁹⁸ "There is absolutely no duty on the part of a letter of credit bank to investigate [claims of fraud]...[the bank's duty] may be the opposite, namely to focus on the documents alone and to disregard any allegations related to the underlying transaction." 6B Hawklnd UCC Series § 5-109:11 [Rev] (Updated December 2013) (citing International Chamber of Commerce, *The Uniform Customs and Practices for Documentary Credits (UCP600)*, ICC Publication No. 600, Articles 4, 5 (July 1, 2007) [hereinafter UCP600]).

⁹⁹ Getz, *supra* note 99, at 221–23.

¹⁰⁰ UCP600, Article 36.

¹⁰¹ *Id.*

majeure event, and the letter of credit expired during the *force majeure* event, the bank is not obligated to pay upon resumption of business.¹⁰²

The ISP98 does not use the *force majeure* language, but provides that if, on the last day for presentation, the bank is closed “for any reason,” the last day for presentation is automatically extended to thirty calendar days after the bank re-opens for business.¹⁰³

Sanctions are beyond the bank’s control, but do not interrupt business as to prevent presentation. They are outside the meaning of *force majeure*. A bank can control its sanctions compliance programs and improve its understanding of when law expressly prohibits payment. Sanctions disclaimers excusing dishonor where the transfer is expressly prohibited serve to put the beneficiary on notice of the risk, but have no legal effect on the obligations under the letter of credit. Where payment is illegal under a sanction, it is illegal whether the terms of letter credit recognized this possibility or not.

3. Supervening Illegality

Banks are legally obligated to dishonor where prohibited by sanction whether or not the letter of credit language recognizes the possibility.¹⁰⁴ Nondiscretionary sanctions clauses serve as notice to the beneficiary and do not affect any legal rights. True supervening illegality should be a bank’s only defense to honor under a letter of credit on the grounds of sanctions compliance. The third revision of the ICC’s draft opinion on the enforceability of sanctions clauses did not take this stronger approach.¹⁰⁵ It instead focused on the importance of knowing your customer and knowing the relevant sanctions law.¹⁰⁶ Somewhat stronger language was used in a prior draft. It is not clear why that language was dropped, but the decision is a subject of criticism.¹⁰⁷

¹⁰² *Id.*

¹⁰³ ISP98, Rule 3.14(a).

¹⁰⁴ Banks issuing letters of credit “have always been subject to the application of relevant local law.” *ICC Guidance Paper*, *supra* note 37, at 4.2.

¹⁰⁵ *See Id.*

¹⁰⁶ *Id.*

¹⁰⁷ *See* Kim Sindberg, *Sanctions According to the ICC*, KIM SINDBERG’S BLOG (last visited March 7, 2014), http://besttradesolution.com/index.php?page_id=58 (arguing that a bank should only refuse to honor based on sanctions in fact prohibiting payment and be required to provide sufficient proof of to that effect).

F. *Treatment of Discretionary Sanctions Clauses as Nondocumentary Conditions*

A bank's obligation in issuing a letter of credit is to honor a timely presentation of complying documents.¹⁰⁸ The letter of credit sets out the documentary conditions (the documents that must be presented in compliance with the letter of credit) of the bank's payment to the beneficiary.¹⁰⁹ In a commercial letter of credit, a "document" may be a bill of lading or other proof of the seller's performance.¹¹⁰ In the broader context of standby letters of credit, a document may be a statement representing some fact such as performance or default.¹¹¹ Documentary conditions define letters of credit.¹¹² When the payment obligation does not rely on documentary conditions or relies on nondocumentary conditions, the instrument may not be a letter of credit.¹¹³

Nondocumentary conditions usually require the bank to determine actual contractual performance by the seller, by looking outside the documents, before honoring the demand.¹¹⁴ U.C.C. Revised Article 5 adopted the position of *Wichita Eagle & Beacon Publishing Co. v. Pacific Nat. Bank* on the effect of nondocumentary conditions.¹¹⁵ In that case, the instrument was ruled a guaranty, despite its title, because the intent of the parties, as manifested in the terms of their agreement, strayed too far from the purpose of a letter of credit.¹¹⁶ Documentary versus nondocumentary is the critical distinction between a guaranty and a standby letter of credit.¹¹⁷ While a standby letter of credit is substantively similar to a guaranty in that it securitizes contractual performance, its difference in form makes for a different legal relationship between the applicant and beneficiary than between the guarantor and guaranteed.¹¹⁸ The beneficiary to a standby letter of credit is in a stronger position than under a traditional guaranty. A standby letter of credit applies the

¹⁰⁸ U.C.C. § 5-102(10).

¹⁰⁹ BYRNE, *supra* note 33, at § 1:6.

¹¹⁰ See Custom and Usage of Banks in Honoring Letters of Credit, 62 BANKING L.J. 17 (1945).

¹¹¹ U.C.C. § 5-102(a)(6). Additionally, a document may be in written or other form permitted by the letter of credit, but not oral, and must be examinable for compliance with the terms and conditions of the letter of credit. *Id.*

¹¹² BYRNE, *supra* note 33, at § 1:6.

¹¹³ This is stated in different ways. For example, "calling a pumpkin a 'letter of credit' will not make it one" (*Transparent Products Corp. v. Paysaver Credit Union*, 864 F.2d 60, 62 (7th Cir. 1988)), and, "the label on a document is not conclusive" (U.C.C. § 5-102 (Official Comment 6)).

¹¹⁴ See, e.g., U.C.C. § 5-102 (Official Comment 6) (giving the determination of a party's failure to perform on a construction contract as an example of a nondocumentary condition).

¹¹⁵ 493 F.2d 1285, 1286 (9th Cir. 1974) (adopted in U.C.C. § 5-102 (Official Comment 6)).

¹¹⁶ *Id.*

¹¹⁷ Gerald T. McLaughlin, *Standby Letters of Credit and Guaranties: An Exercise in Cartography*, 34 WM. & MARY L. REV. 1139, 1139-40 (1993).

¹¹⁸ *Bank of N. Carolina, N.A. v. The Rock Island Bank*, 570 F.2d 202, 206 n.7 (7th Cir. 1978).

independence principle to the beneficiary's advantage, whereas a guaranty would require the securitized party to provide actual proof of default in order to collect.¹¹⁹

Where the instrument meets the U.C.C. Revised Article 5 definition for a letter of credit, the issuer is directed to disregard nondocumentary conditions as though they were not stated.¹²⁰ Revised Article 5 established a rule for treatment of nondocumentary conditions by distinguishing fundamental and non-fundamental conditions.¹²¹ However, an instrument would not be a letter of credit if a nondocumentary condition were fundamental to the undertaking.¹²² The practice rules also require banks to disregard nondocumentary conditions in determining whether to honor a presentation. UCP600 requires a bank to examine a presentation solely by the presented documents, to determine if they appear to comply with the letter of credit "on their face."¹²³ Banks are also required to disregard a condition in a letter of credit that does not specify the document to be presented.¹²⁴ ISP98 requires that nondocumentary conditions be disregarded no matter what effect the condition would have on the bank's obligation.¹²⁵

The important element for analysis is the effect of the nondocumentary condition on the bank's examination of a presentation. Nondocumentary conditions requiring the determination of intrinsic facts, which are readily ascertainable in the ordinary course of the bank's operation, are enforceable where the condition does not require the examiner to go beyond his ministerial duties.¹²⁶ Where the bank employee examining the presentation would have to look beyond the presented documents and investigate extrinsic facts, the nondocumentary condition calls into question the bank's obligation and undermines the basic purpose of the letter of credit. If it is fundamental to the parties' intention, it is unfair to not enforce it, but should not be enforced in a letter of credit.¹²⁷ The question then is whether the offending condition can be safely excluded, and the instrument otherwise enforced as a letter of credit, or

¹¹⁹ McLaughlin, *supra* note 136, at 1139–40.

¹²⁰ U.C.C. § 5-108(g).

¹²¹ Richard F. Dole, Jr., *The Essence of a Letter of Credit Under Revised U.C.C. Article 5: Permissible and Impermissible Nondocumentary Conditions Affecting Honor*, 35 Hous. L. Rev. 1079, 1081 (1998). Establishing a rule on nondocumentary conditions was an important goal in revising Article 5. See The Task Force on the Study of U.C.C. Article 5, *An Examination of U.C.C. Article 5 (Letters of Credit)*, 45 BUS. LAW 1521, 1549–51 (1990).

¹²² U.C.C. § 5-102 (Official Comment 6); U.C.C. § 5-108 (Official Comment 9) (stating that nondocumentary conditions have "no place in this regime" since they undermine the basic purpose of the letter of credit which is forwarded by the independence and promptness of a bank's determination on its obligation to pay).

¹²³ UCP600, Article 14(a).

¹²⁴ UCP600, Article 14(h).

¹²⁵ ISP98, Rule 4.11(a).

¹²⁶ Dole, Jr., *supra* note 140, at 1093, 1105.

¹²⁷ *Id.* at 1094.

the condition is so central to the undertaking that the instrument must be removed from letter of credit jurisprudence.¹²⁸ Is the nondocumentary condition fundamental and non-fundamental?

Labeling an instrument a letter of credit is not conclusive.¹²⁹ The question is whether the nondocumentary condition undermines the manifested intent of the parties. If the manifested intent is that the seller receive the benefit of payment on complying presentation without the issuer policing the seller's performance on the underlying contact, the instrument should be treated as a letter of credit. If, however, the manifested intent is that payment is conditioned on actual performance, the instrument should be treated as a surety. The goal is to preserve the parties' intent, and avoid depriving a party of benefits that they bargained for and relied upon.¹³⁰

The U.C.C. and the practice rules try to preserve the manifest intent to enter a letter of credit by narrowly restricting what nondocumentary conditions may be considered in examination. Revised U.C.C. Article 5 Section 108(g), though strongly against nondocumentary conditions, allows innocuous determination of intrinsic facts, such as consulting a clock or calendar, or the relevant law or practice.¹³¹ This is also true in the ISP98, which allows nondocumentary conditions only if they can be determined from the "issuer's own records or within the issuer's normal operations."¹³² This rule prevents an examining bank from disregarding terms regarding the place, time, and mode of presentation on the grounds that the terms do not specify documents to be presented.¹³³ Time, place, and method of presentation are important terms of a letter of credit, but requiring a beneficiary to include in a presentation a document verifying the time, place, and method of that presentation would place an unnecessary administrative burden on the beneficiary, and would be redundant due to the ease with which the examiner can verify these terms. The UCP600 rule for examination does not address these innocuous determinations, but where the UCP is silent, U.C.C. Article 5 Section 108(g) applies in American courts.¹³⁴

Sanctions disclaimers claiming right to dishonor where it would violate the internal policies of the bank or where the bank believes honor would risk a

¹²⁸ *Id.* at 1095–96.

¹²⁹ U.C.C. § 5-102 (Official Comment 6).

¹³⁰ Dole, Jr., *supra* note 140, at 1111.

¹³¹ U.C.C. § 5-108 (Official Comment 9).

¹³² ISP98, Rule 4.11(b). ISP98, Rule 4.11(c) further defines these permissible determinations of intrinsic facts as the "when, where and how" of documentary presentation and communications affecting the standby, and determining amounts transferred in and out of the bank's accounts or as provided by a published index.

¹³³ U.C.C. § 5-108 (Official Comment 9).

¹³⁴ 15 West's Legal Forms, Commercial Transactions § 8:87 (3d ed.).

sanctions violation could be treated as nondocumentary conditions.¹³⁵ Admittedly, these discretionary sanctions disclaimers are not the kind of nondocumentary conditions contemplated by the U.C.C. and the practice rules, ones that applicants have requested to ensure the beneficiary's performance on the contract.¹³⁶ However, they should be treated as such for having equivalent effects on the bank's obligation. Nondocumentary conditions require examination of factual matters instead of a narrow review of the presented documents.¹³⁷ Non-discretionary sanctions clauses notifying the beneficiary that the letter of credit may be subject to relevant sanctions are unproblematic nondocumentary conditions since banks can consult the relevant laws to determine if payment is prohibited by supervening illegality without performing an external investigation.¹³⁸ Maintaining an updated compliance system and performing "know your customer" checks are part of a bank's normal business operations and would be protected under the practice rules. Local law prohibiting payment will supersede the terms and conditions of the letter of credit and the practice rules to which it is subject.

A discretionary sanctions clause may be treated as (1) an innocuous nondocumentary condition that should be enforced; (2) a nondocumentary condition that should be discarded; or (3) a nondocumentary condition so fundamental to the agreement that it cannot be discarded and the instrument's letter of credit status must be destroyed in order to enforce the condition.

First, a discretionary sanctions clause is not innocuous; it undercuts the purpose of the letter of credit by calling the issuer's obligation into question.¹³⁹ Its effect takes it beyond the narrow range of permissible nondocumentary determinations of time, place, and manner of presentation contemplated by the U.C.C. and the practice rules.¹⁴⁰ Those determinations are allowed because they are incidental to examining a presentation for compliance.¹⁴¹ A discretionary sanctions clause does not concern whether the beneficiary's presentation was complying; it is the examining bank granting to itself the leeway to navigate complex and risky sanctions regimes, and frustrating the purpose of the letter of credit in the process by undermining certainty of payment.

¹³⁵ This was suggested by James G. Barnes in *Letter from James G. Barnes to Dan Taylor and IFSA Regarding Mention in LC Text of Sanctions as a Defense Against Honor*, printed in 2009 ANNUAL REVIEW OF INTERNATIONAL BANKING LAW & PRACTICE 374.

¹³⁶ See, e.g., U.C.C. § 5-108 (Official Comment 9).

¹³⁷ The Task Force on the Study of U.C.C. Article 5, *supra* note 140, at 1549.

¹³⁸ U.C.C. § 5-108 (Official Comment 9).

¹³⁹ ICC Guidance Paper, *supra* note 37, at 4.1; Cannon et al., *supra* note 19; Butac et al., *supra* note 87.

¹⁴⁰ U.C.C. § 5-108 (Official Comment 9).

¹⁴¹ *Id.*

The second and third options are alternatives to each other. The discretionary sanctions clause can either be extinguished and the instrument enforced as a letter of credit, or the clause cannot be extinguished and the instrument must be enforced as something other than a letter of credit. The intent of the parties should determine this question. Ruling that the clause must “remove the undertaking from the scope of Article 5 entirely”¹⁴² may frustrate the intent of the parties by making contract or surety defenses to honor available to the bank that the beneficiary did not expect to have to face¹⁴³. If the parties intended to enter a letter of credit transaction, part of their reasonable expectations is that contract and surety defenses are not available to the bank. Making them available would grant the bank a windfall and deprive the beneficiary of its expected right to payment on demand.¹⁴⁴

Courts should be prejudiced against finding a purported letter of credit not one in fact since this might frustrate of the beneficiary’s expectation for prompt payment.¹⁴⁵ It is a step that should only be taken where the nondocumentary condition is so central to the party’s intentions that to discard it would be an injustice to one of the parties outweighing injury to the other parties’ in enforcing it.¹⁴⁶ The injustice would normally be to an applicant who reasonably expected that payment was conditioned on contractual performance, and that the bank issuing the instrument would police the beneficiary’s performance and only pay on satisfaction of performance.¹⁴⁷

Discretionary sanctions clauses are a different case. The letter of credit arises from bargaining over payment. The beneficiary’s reasonable expectations of the conditions for payment also arise from this bargaining. It is unlikely that the intention or reasonable expectation of parties labeling an instrument a letter of credit (with terms for payment on demand) was that the instrument would not be subject to letter of credit law, but instead subject to

¹⁴² *Id.*

¹⁴³ LARRY LAWRENCE, LAWRENCE’S ANDERSON ON THE UNIFORM COMMERCIAL CODE, § 5-102:3 (3d ed.) (Updated June 2012).

¹⁴⁴ In ruling the instrument a letter of credit—as it was labeled—and not a conditional payment guarantee as argued by the bank, the court in *Teleport Comms. Group, Inc. v. Barclay Fin. Group, Ltd.*, 176 F.3d 412, 416 (7th Cir. 1999), reasoned that the issuing bank and its customer were trying to entice the beneficiary into an unfavorable bargain by representing the instrument as a letter of credit, with the usual benefits to the beneficiary, but retaining ability to back out of payment because of the beneficiary’s possibly fraudulent performance on the underlying contract. There is a second problem, that ruling the instrument a guaranty may create an *ultra vires* problem, as national banks cannot guaranty payment or securitize debt solely for the other party’s benefit under U.S. law. (10 Am. Jur. 2d Banks and Financial Institutions § 505).

¹⁴⁵ The Task Force on the Study of U.C.C. Article 5, *supra* note 140, at 1549–50.

¹⁴⁶ Dole, Jr., *supra* note 140, at 1112.

¹⁴⁷ *Id.* (Discussing *Wichita Eagle & Beacon Publishing Co. v. Pacific Nat. Bank*, 493 F.2d 1285, 1286 (9th Cir. 1974)).

contract or surety law, and allowing payment to be subject to the bank's determination of the risk of sanctions violation.¹⁴⁸

This suggests the best path is to extinguish the discretionary sanctions clause. This would reduce the discretionary nature of the clause to the innocuous and redundant nondiscretionary nature of notice clauses which merely forewarn the beneficiary that payment will not be made when prohibited by law.

The language of a discretionary sanctions clause may not be clear enough to override a beneficiary's reasonable expectation of prompt payment on demand. This raises an issue of ambiguous drafting, and letter of credit law is similar to general contract law in this respect. Ambiguous or vague language in a letter of credit will be construed against the drafter in order to preserve the viability of the letter of credit as far as is reasonable.¹⁴⁹ This protects the reasonable expectation of the beneficiary from an issuing bank's attempt to claim benefits it did not bargain for. It also forces banks to improve their sanctions compliance procedures and due diligence in knowing their counterparties. Economic sanctions are an entrenched reality, and the banks are better positioned to evaluate the risks that sanctions create in international trade finance. The banks cannot have it both ways by representing to a beneficiary that payment is conditioned only on a complying demand, but reserving right to dishonor where it is unsure of its legal liabilities.¹⁵⁰

CONCLUSION

A defense to honor based on a discretionary sanctions clause does not fit within the excuses recognized in letter of credit law and granting a novel exception would undermine the fundamental nature of the undertaking. A letter of credit is a promise, but not quite a contract as it sometimes operates counter-intuitively to normal contract practice. Strict adherence to its unique set of governing law is crucial to preserving the core benefit it is designed to provide, that is, the right of the seller (or any of among the myriad types of beneficiaries to standby letters of credits) to hold the money pending resolution of a contractual dispute. This benefit is only preserved as long as the

¹⁴⁸ In *Witchita Eagle*, the court determined that the parties intended payment to be conditioned on actual breach of underlying construction contract. 493 F.2d at 1286.

¹⁴⁹ 6B Hawklnd UCC Series § 5-104:3, 4.

¹⁵⁰ "It is incumbent upon practitioners...to be careful in their choice of counter parties or service suppliers...it is also their responsibility to ensure that they do nothing that brings into question...the certainty of payment or the intent to honour obligations, always understanding that the letter of credit or guarantee and the UCP, ISP or URDG have always been subject to the application of relevant local law...[and] that sanctions may be in force in other countries with which they are dealing and should take these issues into account in accordance with their company's own risk policies." *ICC Guidance Paper, supra* note 37, at 4.2, 4.4.

bank is obligated to pay the beneficiary upon presentation of complying documents. Transacting parties should be wary of sanctions disclaimers because they cast a shadow on the bank's commitment to its obligations. Courts should not enforce discretionary sanctions disclaimers as terms of letter of credits because they undermine the independent and documentary nature of the obligation.

A bank's obligation to pay may be excused in some cases for fraudulent presentation or fraud in the underlying transaction. The Iranian revolution cases granted limited relief for fraud in relation to economic sanctions, where demand would likely be based on fraud in the transaction. Some applicants won notice injunctions, which required the bank to notify the applicant of presentation and granted applicants an opportunity to provide evidence of fraudulent demand. The courts refused to grant permanent injunctions based on the mere danger of possible fraudulent demands. Where the U.C.C. Article 5 and the practice rules excuse honor for fraud, the bank is bound only to good faith standards to dishonor where fraud is brought to its attention and not to conduct an external investigation of possible fraud in the demand or underlying contract. The bank is required to refrain from such an investigation.

The U.C.C. and the practice rules will excuse a bank's liability under *force majeure*. These exceptions are limited, however, to circumstances beyond the bank's control. OFAC regulations are beyond the bank's control, and the bank's obligation is excused where expressly prohibited by law. However, illegality of payment is not a *force majeure* event. *Force majeure* events are full interruptions, not disruptions, of business. If the letter of credit expired during the *force majeure* event, the bank is not obligated to pay upon resumption of business.

Sanctions disclaimers excusing dishonor where the transfer is expressly prohibited serve to put the beneficiary on notice of the risk, but have no legal effect. Banks are legally obligated to dishonor where prohibited by sanction whether or not the letter of credit language recognizes the possibility. A bank's internal determination of compliance risk is within the bank's control and not a *force majeure* event.

Discretionary sanctions disclaimers should be treated as nondocumentary conditions. They affect the issuing or confirming bank's obligation by requiring the bank (by terms inserted by the bank) to consider its own policies on the risk of non-compliance. It requires the bank to pay only if it does not violate its own policies. Nondocumentary conditions usually appear in documentary credits for the benefit of an applicant who wants payment to the beneficiary to be conditioned on proof of beneficiary's contractual performance, not conditioned on complying documentary presentation by beneficiary. Though the sanctions disclaimer is not a nondocumentary condition of the nature contemplated by the U.C.C. or the practice rules, they should be treated as such because they have the same effect on the bank's obligation.

Alternatively, if a court does enforce a discretionary sanctions disclaimer clause, it should not be as a term of a letter of credit, but on a determination

that the undertaking at issue is in fact not a letter of credit.¹⁵¹ The Official Comment to U.C.C. Article 5-108 “Issuer’s Rights and Obligations” states that where a nondocumentary condition affects the fundamental nature of the issuing bank’s obligation, the clause may take the instrument outside the scope of Article 5 entirely.¹⁵²

The U.C.C. and the practice rules require banks to disregard nondocumentary conditions in determining if a presentation is complying. The rule against nondocumentary conditions in documentary credits prevents buyers from contracting away what a seller bargains for in requesting a documentary credit. In this case, however, the bank is trying to mitigate risks of complex sanctions regimes, by conditioning payment on its own judgment of sanctions risk. Banks face stiff penalties for non-compliance and compliance is difficult. However unfortunate a position in which it places a bank trying to comply with sanctions while also honoring their obligations, allowing banks this discretion would frustrate the purpose of the letter of credit. “Courts should not allow the ‘sacred cow of equity to trample the tender vines of letter of credit law.’”¹⁵³

Payment should not be excused because a bank believes it might violate law, instead the bank should be required to demonstrate that payment is in fact prohibited and claim defense to honor for supervening illegality. Sanctions disclaimers excusing dishonor without reference to express legal prohibition should not be enforced where the parties intend payment by documentary credit. Otherwise, the instrument is not what they say it is.

¹⁵¹ It would be an interesting case where a court ruled that a purported letter of credit containing a discretionary sanctions clause was another type of instrument because a nondocumentary condition other than the sanctions clause was fundamental to the agreement.

¹⁵² U.C.C. § 5-108 (Official Comment 9).

¹⁵³ U.C.C. § 5-109 (Official Comment 5) (quoting from Harfield, *Code, Customs and Conscience in Letter-of-Credit Law*, 4 U.C.C.L.J. 7, 11 (1972)).