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HANDOUTS

COMPARATIVE BUSINESS AND EUROPEAN LAW

-CLASS 17-

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This handout is written by students with no intention of replacing university materials.

It is a useful tool for studying the subject, but does not guarantee preparation as exhaustive and complete as the material recommended by the University.

LECTURE 1. INTRODUCTION TO "CBEL"

TRENDS IN INTERNATIONAL TRADE

The **WTR 2024** highlights the importance of international trade for economic growth and for the promotion of inclusivity. Over the last 3 decades, global per capita income has increased by 65%, highlighting the impact of trade on economic development.

Benefits include **economic metrics** and **social indicators** improvements as well as a facilitated access to **essential services** (e.g., education and health). Overall, trade improves the **quality of life** of several individuals across the globe.

➔ **Free trade increases wealth.**

On the other hand, *Concerns* include **inequality** and **adverse effects on globalization**.
- Approximately 700 million people still live in extreme poverty, highlighting the uneven distribution of trade benefits.
- It is essential to implement **inclusive policies** to ensure a **fair distribution** of benefits.

Despite these concerns, the WTR warns that restricting trade could further limit opportunities for inclusive growth, especially for vulnerable economies which face several **barriers** in integrating into the global market *(Barriers for vulnerable economies):*
- High **transaction costs**.
- **Custom tariffs.**
- Limited access to **international markets**.

In the context of emerging challenges related to **digitalization** and **sustainable trade**, international **cooperation** plays a crucial role. However, current geopolitical tensions threaten to undermine the progress made in the fight against poverty.

The WTR suggests that while the WTO regulations aim to support vulnerable economies, additional measures (e.g., development programs and trade assistance projects) are necessary.

Major Actors:
- **States** and **non-states:** Governments, agencies, and private parties doing business internationally, autonomously, or interacting with each other.
- **UN-UNCITRAL** (United Nations Commission on International Trade Law): A **core legal body** in international trade law. It **reforms global commercial law**.
- **IMF** (International Monetary Fund): Established at Bretton Woods. It provides **conditional loans** to maintain **global monetary stability**.
- **WTO** (World Trade Organization): Funded in 1995 from GATT and EU efforts.
  - Promotes **free trade**.
  - Provides a **forum** for trade **negotiations**.
  - Settles trade **disputes**.
  - Operates a **system of trade rules**.
- **OECD:** A coalition of developed economies that **gives recommendations** and **drafts policies** to improve economic and social **well-being**.
- **World Bank:** Supports international trade by providing loans.

International Trade Agreements:
- *GATT (General Agreement on Tariffs and Trade):* A multilateral agreement (1947) established to regulate international trade. *Goal:* Reduce tariffs and other trade barriers.
  - 1st round (1947): 23 countries.
  - **Uruguay round (1986):** 123 countries.
  - *Outcome:* It led to the creation of the **WTO** (1995).
- *RTAs (Regional Trade Agreements):*
  - **NAFTA (1994):** US, Canada, Mexico. Replaced by SMCA (2020).

- **SADC (2000):** Regional organization that promotes economic cooperation and development in Southern Africa.
- **Trans-Pacific Strategic Economic Partnership (2006):** Brunei, Chile, Singapore, New Zealand.

GLOBALIZATION

There is a correlation between **economic growth** and **trade openness**. However, trade liberalization alone does not necessarily guarantee growth, nor an equal distribution of wealth.

As a matter of facts, some countries grew thanks to the use of **protectionism** (for a limited period of time), especially to protect infant industries. on the other hands, there is evidence that **free circulation** of technology improves general growth.

- *Note:* Raising barriers for winners to help losers is a wrong approach.

Development of globalization: In recent years, especially after the **economic crisis**, the globalization model has been questioned. Multinationals are often criticized for contributing to inequality. Moreover, benefits like **advantage of scale** are diminishing, and we see **fragmentation** in global business rules.

Protectionism is raising. Host countries are **less welcoming**, particularly in the digital economy.

The **future** global business landscape will be characterized by three elements:

1. **Top tier** multinationals: A small group of large firms will integrate into host economies to reduce nationalistic concerns.
2. **Global digital and IP** multinationals: Tech, pharma, and franchise-based firms will remain global but fragile.
3. **Pocket** multinationals: The most intriguing element. Small businesses operating globally through e-commerce. Despite their size and limited R&D expenditure, they can target market niches and reduce costs. [*Example:* PayPal].

This new chapter *(A new kind of globalization)* is defined by **five interconnected themes** (challenges and opportunities):

- Growth in **emerging markets**.
- **Labor productivity** and **talent management**.
- **Global flow** of *goods, capital, information*.
- **Natural resources management.**
- **Protectionism** (increasing role of governments).

These trends have an impact on multinational firms:

- **Higher costs** and **reduced competition**.
- **Investor uncertainty** and **local economic fragmentation**.

➔ *Resulting changes:* As a result, **globalization** may evolve into **fragmented capitalism** – a system more locally focused and less efficient but potentially gaining more public support.

ISSUES IN INTERNATIONAL TRADE

UNIFORM *VS* SPECIFIC RULES

Creating a **"global law"** is difficult due to the existence of sovereign national legal systems. One solution could be creating a **"halfway house"**, i.e. the creation of **draft conventions** to be included in every legal system, so that the courts of every legal system can apply the same (uniform) law.

Uniform law in international trade is meant to be **binding** for everyone, eliminating the role of domestic law in international trade.

- *Def. international trade* = transaction occurring between parties that have their place of business in ≠ countries.

As of today, uniform law remains **aspirational** (not fully realized in practice).

Examples:
- *CISG (Convention of Vienna, 1980):* Pieces of legislation adopted by many countries, so that each country has its own domestic law which is exactly the same as that of the other countries that adopted it.
- (Non-international) *US UCC:* Adopted by every US state to create uniformity of law for **interstate transactions**. It is a uniformly adopted state law (≠ federal law).

Globalization has reshaped domestic legal frameworks through:
- **Legal transplantation** – i.e., the adoption and implementation of legal principles from one country into another. It fosters harmonization and consistency.
- **Uniform international laws** – i.e., standardized laws created to ensure uniformity across ≠ jurisdictions. Developed by UN agencies or independent bodies (e.g., UNIDROIT).

Rules *VS* Standards

Lawmakers cannot anticipate every possible situation, so laws are often **general in nature** and **incomplete**.

There are two main drafting techniques:
- **Rules:** Clear and specific. You either comply or not.
- **Standards:** Require **interpretation** based on **circumstances**.

The choice between *rules* and *standards* affects how laws are **applied and interpreted**.
- This distinction is common in many laws, including articles of the CISG.

Domestic sale of goods issues:
- **Quality** (goods meet required standards).
- **Quantity** (correct amount of goods).
- **Payment** (securing timely payment of goods).
- **Delivery** (ensuring goods are delivered on time and in good conditions).
- **Dispute resolution.**
- **Property** (transfer of ownership of the goods).
- **Risks** (managing risks – e.g., loss or damage – during transit).

Distance sale of goods issues: Broader set of complications.
- **Shipping** (managing the logistics of transporting goods over long distances).
- **Delivery/payment coordination** (goods shipped before payment or payment made before inspection).
- **Third-party intervention** → To deal with these issues, third parties are included.
    - Payments often go through **banks**.
        - *Focus on banks:* Banks are in long-lasting relationships. Buyer pays its bank → Buyer's bank pays Seller's bank (i.e., bank S is guaranteed by bank B) → Seller's bank pays the seller.
    - **Insurers** cover **transportation risks** and **goods quality** (additional costs).

International sales of goods: Buyer and seller are in ≠ countries. Additional issues.
- **Goods unloading** (managing the process of unloading goods in ≠ countries).
- **Customs** (manage customs regulations and duties).
- **Insurance** (having proper insurance coverage for international transit).
- **Inspection** (goods must meet agreed standards).
- **Currency** (currency exchange and fluctuation).
- **Banks** (facilitating payment through international banking systems).
- **Dispute** (disputes across ≠ legal systems).
- **Force majeure** (managing unforeseen events – e.g., natural disasters).
- **Applicable law** (determine which country's law applies to the transaction).

Examples (Seller is in Boston):

- *Scenario (A): **Domestic** commercial relationship (Boston-California).*
  - *Payment:* Managed by banks within the same country (possibly, the same).
  - *Currency and language:* Same.
  - *State law:* ≠ state laws, but the UCC applies as a source of uniform law.
  - *Legal culture:* Similar culture and common law tradition. There could be slight differences.
- *Scenario (B): **International** commercial relationship (Boston-Thailand).*
  - *Cultural differences:* ≠ business and social cultures.
  - *Legal systems:* ≠ legal systems → Issues like applicable law and forum of disputes.
  - *Legal risk:* Broader legal risks.
  - *Language:* Nuances in business English may lead to ≠ interpretations.
  - *Contract interpretation:* Use of pre-established clauses from the ICC Incoterms.
  - *Currency:* Potential issues with currency exchange.
  - *International payment:* Seller's bank may advance payment and require guarantees from the buyer's bank.
  - *Logistics:* Additional risks related to international shipping.
- *Scenario (C): **International** commercial relationship (Boston-China) (**non-market economy**).*
  - *Additional risks:* More complex.
  - *≠ shades of NME, including:*
    - Advanced developing countries (ADCs).
    - Newly industrializing countries (NICs, China).
    - NME but developing nations which find it necessary to do business with ME (e.g., Cuba).
    - Nations trying to become ME but having difficulties associated to a past of central planning and public involvement (e.g., Eastern Europe until recent times).
  - *Public entity purchases:* Potential privileges enforced by local courts if the buyer is a public or government entity.
  - *Countertrade:* Involves complexities and costs, either voluntary (modern barter) or involuntary.

Evolution of a client's business in international trade (issues that the seller must address):

Step 1: International sale → Initial phase where the seller successfully engages in international sales.

Step 2: Establishing local presence → As sales grow, the seller may decide to establish a **local presence** in a specific country. This can be done in two ways:

- **Agent** – i.e., a person who promotes the goods and facilitates contract stipulations.
- **Distributors** – i.e., a reseller who buys the goods and resells them.

OR Instead of relying on a third party, he can set up his own **local company**, which must comply with local laws and regulations.

OR The seller can **license his technology to local manufacturers**, allowing them to produce goods using his technology. This carries the **risk** of technology theft.

Conclusions: Differences in legal systems and cultural approaches are generally more complex in international transactions compared to domestic ones.

Common issues in international transactions:

- **Choice of law** – i.e., determine which country's law will govern the transaction.
- **Choice of forum** – i.e., determine the location where any dispute will be litigated.
- **Mandatory arbitration** – i.e., a legal requirement that disputes between parties must be resolved through arbitration rather than litigation in national courts. Used to avoid inefficiencies of poor legal judicial systems and provide a more efficient resolution process.

SOME IDEAS ON COMPARATIVE LAW

LEGAL FAMILIES

- **Common law:**

  - Originates from English and American legal systems.
  - Makes up about 40% of legal systems globally.
  - Relies heavily on **court decisions and precedents** (**case law**).
- **Civil law:**
  - A) French legal origins. Includes countries like Italy. Makes up about 30% of legal systems.
  - B) Roman-Germanic legal origins. Makes up about 20% of legal systems.
  - Focuses more on **written statutes and codes** (≠ case law).
- **Smaller legal families** (Scandinavian LS, Socialist LS, Religious LS – e.g., Sharia law).

Main differences between *common* and *civil* law are seen in **private law**, which regulates relationships between private individuals or between a private person and the govt (acting in a commercial capacity).

STARE DECISIS

Meaning: "To stand by things decided".

Concept: The **doctrine of precedent**. It refers to the legal principle that courts should follow established legal principles from **previous cases** decided by the same court or courts of equal/higher rank.

Mechanisms:
- **Horizontal *stare decisis:*** A court follows its own past precedent.
- **Vertical *stare decisis:*** A court follows a precedent set from higher courts.

Rationale:
1. Ensures **uniformity, coherence, and predictability** in law application.
2. **Reduces costs** (because it discourages re-litigation of established precedents).
3. Helps prevent overloaded courts by streamlining the court system.

Application: Mainly used in **common law** legal systems. Civil law rely more on statutes and ordinances.

Specificity of US legal system: Every state in the US (except Louisiana – civil law) uses a common law system and follows *stare decisis*.

Stare decisis is **not permanent** (not absolute or unchangeable). **Statutes** can change case law and **higher courts** (e.g., Supreme Court) can reverse previous decisions (i.e., **reversal**) (*note:* it's rare).

LECTURE 2. INTERNATIONAL CONVENTION FOR THE SALE OF GOODS

RISK OF INTERNATIONAL SALES

- **Seller's concerns:** To be paid.
- **Buyer's concern:** To receive the right goods at the right time.

Currency issues: **Exchange and currency controls**.

- Countries with weak currencies may have controls that restrict how their money is exchanged for strong currencies (e.g., US dollar or Euro). Controls include *limits on exchange, fixed rates, approval requirements*.

Regulatory issues:

- **Product requirements** (adhering to safety rules and other regulatory requirements).
- Unexpected **restrictions** or **customs duties**.
- Determining **applicable law, forum, and enforcement**.

To reduce these risks we consider **documentary transactions** (i.e., using documents like *bills of lading* and *letters of credit* to secure payment and shipment) and **incoterms** (*international commercial terms* that define the responsibilities of buyers and sellers; they clarify who handles *costs, risks, logistics* at each step).

HISTORY OF THE CISG

Before the CISG, other attempts to unify international trade law failed.

- **1964, Hague Conventions** (2 conventions). Technically sound but did not achieve success.

After the Hague Conventions failed, the **UN** established the **UNCITRAL (1966)** to unify and harmonize international trade law.

The UNCITRAL developed the **CISG** (Convention of Vienna, 1980), a **body of norms** on the **international sale of good**. *Goals:* Reduce **legal obstacles** and **transaction costs**, enhance **predictability**, promote the **development of new legal concepts**.

Adoption of the CISG:

- **Entry into force:** Mandatory for the states that adopted it on January 1, **1988**.
- **Initial adoption:** Ratified by 10 states (including Italy and US).
- **Expansion:** 2021: 77 states; **2025: 97 states**.

EUROPE AND THE CISG

Ratification: Every European country has ratified the CISG except for **Ireland** and the **UK**.

Reasons for **non-ratification**: Many believe this reluctance comes from a **belief in the superiority of English common law**, which is widely respected and trusted in international commerce → English law offers *stability and predictability (i.e., stare decisis),* making it attractive for businesses. This preference is also **financially beneficial** → English law generates revenue: international contracts often require English lawyers, and disputes are resolve in English courts or arbitration panels.

AN OVERVIEW OF THE CISG

The CISG governs the **sale of goods** between parties of **≠ countries**, unless parties opt out of it.

It is a **self-executing treaty**. It becomes law upon **ratification** without needing sperate implementing legislation (**automatic law**), aiding *legal harmonization*.

- By making **reservations**, countries may choose not to follow certain parts of the treaty.
- In the **US** it is **federal law** and overwrites conflicting state laws (including *Art. 2 UCC* which otherwise governs the sale of goods).

Scope: The CISG governs **international sales of goods, not services**. Some goods and sales are excluded *(ART. 2).*

ART. 4 and *ART. 5* – **Governed aspects**:
- **Contract formation** (i.e., rules on how contracts are formed).
- **Rights and obligations** (of both the buyer and the seller).
- **Passage of risk** (i.e., when the risk of loss transfers from seller to buyer; it is ≠ from ownership).

DOES NOT govern:
- **Validity of contract** (issues like fraud, duress, mistake).
- **Passage of ownership.**
- **Liability for death or personal injuries** (product liability laws protect consumers from harm).

➔ Uncovered issues are governed by **local laws** according to **conflict of laws rules**.

SPHERE OF APPLICATION *(ART. 1-6)*

ART. 1 This Convention applies to contracts for the sale of goods between parties whose place of business are in different States.

➔ Three **application criteria** (a, b, c).

a) The transaction must involve the **sale of goods**. However, the terms "sale" and "goods" are not explicitly defined.

Exclusions for sales:
- Auctions *(ART. 2)*.
- Judicial sales.
- Barter, based on *ART. 53* which requires to *"pay the price"*.
- Maquiladora agreements *(ART. 3(1)* and *ART. 3(2))* are excluded when the buyer provides a substantial part of the materials for assembly (it is more a service contract).
- Franchise agreements are excluded because they primarily involve the transfer of IP.

Exclusions for goods:
- Securities, financial instruments, and money *(ART. 2)*.
- Ships, vessels, hovercraft, aircraft, electric *(ART. 2)*. *Note:* Parts of aircraft (e.g., engines) are ok.
- Crops and timber if not harvested are not considered goods. If harvested, ok.
- Software if the service aspect prevails over the good aspect.

ART. 2(A): This Convention does not apply to sales of goods bought for personal, family, or household use, unless the seller, at any time before or at the conclusion of the contract, neither knew nor ought to have known that the goods were bought for any such use.

➔ The convention applies **only to B2B** transactions.
- *Exception:* If the seller didn't know that the buyer was a consumer.

Rationale: This exclusion avoids conflicts with **domestic public policy law** that protects consumers, and which cannot be derogated by the will of the parties (while the Convention is based on the principle of *party autonomy*).

b) The transaction must be **international** – i.e., the parties have their place of business in ≠ countries.

Place of business refers to a **permanent establishment** where business is conducted **continuously** (≠ warehouse or agent's office). *Note:* CISG does not explicitly define it, but *ART. 10* provides guidance.

*ART. 10(A): If a party has more than one place of business, the place of business is that which has the **closest relationship** to the contract and its performance, having regard to the circumstances known to or contemplated by the parties at any time before or at the conclusion of the contract.*

➔ If a party has **more than one place of business**, the place of business is the one that has the **closest relationship** to the contract and its performance.

Example: A US client buys goods from a French seller who has factories in both France and the US. If the goods are made in France, the contract should state that France is the place of business with the closest connection to the contract. The relationship between the contract and France is stronger than with the US office.

If identifying the place of business is difficult (e.g., business conducted mainly through agents), the concept of **habitual residence** (**headquarter**) is used.

c) The transaction must involve **at least one Contracting State** (97 adopted the Convention).

ART. 1: This Convention applies to contracts for the sale of goods between parties whose place of business are in different States.
(1)(A): When the States are Contracting States.
(1)(B): When the rules of private international law lead to the application of the law of a Contracting State.

Not all international contracts are regulated by the CISG. Only those that have a **substantial relationship with a contracting state** → Two ways to satisfy the "substantial relation" requirement:

1. *ART. 1(1)(A):* Parties have their place of business in ≠ states and are both CISG Contracting States.
2. *ART. 1(1)(B):* If **domestic conflict of law rules** (i.e., the rules of private international law) lead to the application of the law of a Contracting State.

- *Note:* Conflict of law rules determine the applicable law when conflicting laws of ≠ countries are involved.

Examples:

- *Australia / US:* Both are CISG Contracting States → CISG automatically applies (unless excluded by *ART. 6*).
- *Australia / Egypt:* Egypt is not a CISG Contracting State, but Australia is. The CISG might still apply under *ART. 1(1)(B)* if Egypt's conflict of law rules choose Australian law (governed by CISG).
- *US / India: Exception!* US is a CISG Contracting State, India is not. CISG does not apply even if US law is chosen through conflict of law rules.
    - ***Reservation** (ART. 95)* allows states to declare that they won't be bound by *ART. 1(1)(B)*. The US did so because the UCC is considered superior and international choice of law rules are considered uncertain.

ART. 6 declares **party autonomy** → Possibility of **excluding the CISG**. This is possible even if both parties are Contracting States.

Important: In any case, even when the CISG is applicable, it is better to **designate a default domestic law** in the contract for issues not covered by the CISG.

CASE 1: *American Mint v. Gosoftware.*

Issue: Does CISG apply when the parties opt for State of Georgia (GA) law?

Facts:

- **Plaintiff** (i.e. starting a lawsuit): Goede GmbH and Mr. Goede (Germany, DE) owner of subsidiary American Mint (Pennsylvania, PA). **Buyer.**
- **Defendant:** Gosoftware (GA) – provider of credit card billing software to be used in DE. **Seller.**
- The software malfunctioned, causing Goede to incur heavy losses (over $700,000).

American Mint and its German parent company sued Gosoftware in a US federal court because they argued the case fell under international contract law (CISG). *Is the subject matter of this case under the jurisdiction of a US federal court?* Yes, **IF:**

A. The claim arises under the Constitution, federal laws, or treaties of the US.
B. The amount in controversy exceeds 75K USD and there is diversity among the parties.

Defendant (Gosoftware) argument: The complaint should be dismissed for **lack of subject matter jurisdiction**.

A. It is not a federal question: Gosoftware argues CISG does not apply.
    a. **Choice of law** (GA law applies, not CISG).
    b. **Lack of internationality** (Goede GmbH and Mr. Goede are not parties to the contract).
B. Amount in controversy is less than $75,000 (irrelevant for our purposes).

Court reasoning: The court rejected the defendant's argument because **CISG was not expressly excluded** (GA law includes CISG). *However,* **CISG does not apply** because the court found Goede GmbH and Mr. Goede's involvement unproven (i.e., the contract was between two US parties). No federal question can be submitted.

Conclusion: The court **lacked subject matter jurisdiction**.

CAN PARTIES OPT IN?

ART.6 emphasizes **contractual freedom** (in particular, exclusion of CISG), but does not address the possibility of opting-in.

- CISG does not contain an explicit provision allowing parties to opt-in.
- However, based on the **principle of party autonomy**, parties are generally allowed to do so.

LECTURE 3. INTERNATIONAL CONVENTION FOR THE SALE OF GOODS

INTERPRETATION

Common law (more objective): Interpretation is based solely on the contract's written content (***parol evidence* rule**).

Civil law (more subjective)**:** Interpretation considers the **circumstances**, especially parties' intentions.
- Contracts must be interpreted **assuming parties' good faith** [totally extraneous to common law].

Keep in mind:
- **Ambiguous terms** are interpreted against the drafter (i.e., who prepared it).
- The **merger clause** ensures that what is written in the contract is the entire agreement, excluding prior negotiations/agreements. *["This is the parties' entire agreement on this matter, superseding all previous negotiations or agreements"*]. However it still leaves room for extra-contractual elements (e.g., how parties perform).

CISG interpretation rules:
- Must reflect its **international character**.
- *Goal:* **Uniform interpretation** across countries.
- **Avoid domestic legal traditions** (e.g., don't just apply US or German law).

ART. 8 (about interpretation) is a **compromise between *common* and *civil* law** (although more *civil*).
- Where the parties have a **common understanding** of their *intent or meaning of a provision*, that common understanding will prevail.
- *Statements and conduct* of a party are interpreted according to its **intent** when the other party knew or should have known the intent.
- If not applicable, they are interpreted according to the **understanding of a reasonable person** (considering all relevant circumstances, including *negotiations, practices established between parties, usage and subsequent conduct of parties*).

ART. 9 (usages). Parties are bound by:
- Any **usage agreed upon and practices established** between themselves (*ART. 9(1)*, including local ones).
- **Implied accepted usages** that are:
  - Known or should have been known by the parties.
  - International in nature.
  - Widely known and observed in the relevant international trade.
- **Merger clause** is relevant.

CASE 2: *MCC v. Ceramica Nuova.*

Issue: Should "parol evidence" be considered in a contract governed by CISG?

Facts:
- MCC (USA) agrees to buy tiles from Ceramica Nuova (Italy).
- **MCC (plaintiff)** sues CN for non-delivery.
- **CN (defendant)** argues MCC didn't fully pay for earlier shipments.
- CN refers to binding **contract terms** printed on the back of the form, which:
  - Allow contract cancellation for non-payment.
  - Require written defect complaints within 10 days of receipt.
- MCC argues they never agreed to those back-page terms.
- MCC submits **affidavits** (including from CN employees) supporting this.
- District court enters summary judgment in **favor of CN**.

Court findings (11th circuit appeal):

- The **CISG applies** (Italy and US, CISG Contracting States). The fact that the contract was in Italian (language barrier) is not sufficient to argue MCC is not bound.
- CISG allows **oral agreements** and does not follow the ***parol evidence* rule** *(ART. 11)*. Parties can include a **merger clause** if they want only the written contract to govern.
- ***ART. 8(3)*** requires courts to consider **all relevant circumstances** including **negotiations and party intent**.
- Therefore, the **lower court was wrong to ignore MCC's affidavits**.
- Even if MCC may lose credibility later on, the **evidence must be reviewed**.

FORM

Art. 11: A contract of sale needs to be concluded in or evidenced by writing and is not subject to any other requirement as to form. It may be proved by any means, including witnesses.

➔ **Freedom of form.** Contracts can be concluded and proved by any means, not limited to written form.

Art. 12: Any provision of article 11, article 29, or Part II of this Convention that allows […] any form other than in writing does not apply where any party has his place of business in a Contracting State which has made a declaration under article 96 of this Convention.

Art. 96: A Contracting State whose legislation requires contracts of sale to be concluded in or evidenced by writing may […] make a declaration in accordance with article 12 that any provision of article 11, article 29, or Part II of this Convention, that allows […] any form other than in writing, does not apply where any party has his place of business in that State.

ART. 12 and ***ART. 96*** allow Contracting States to make a **reservation** (i.e., **opt-out**) and declare that the **local law** of a particular State will govern the **form** requirements (e.g., a contract must be in writing) for a sale contract if any party has its own place of business in that State.

- The reservation applies only if the domestic law of the *reserving State* requires the contract to be in writing.

FORMATION OF CONTRACT

US, UK: Formation involves *offer, acceptance, consideration.* However, **consideration** (i.e., benefit each party receives) is not present in *civil law* or CISG.

Offer (CISG): Under *ART. 14*, elements to be accepted:

- **Proposal** for concluding a contract.
- **Intention to be bound** in case of acceptance (exclusion of offers to the general public).
- **Sufficiently definite:** The offer must clearly describe the *goods, quantity, price*.
  - *ART. 14(2):* A proposal is definite if it indicates the goods and expressly or impliedly fixes or makes provision for determining the quantity and the price.
  - *Note:* **Case law restrictive.** Some courts have ruled that if essential details are missing, it might not count as a valid contract offer.
  - **Open quantity contracts** define quantity but not volume (e.g., electricity bills).

ART. 55 permits reference to the **price generally charged** at the time of the conclusion of the contract for such goods sold under comparable circumstances – i.e., it allows to refer to the **market price**.

Contract conclusion: A contract is **concluded** when an **acceptance** of an offer becomes **effective**.

Revocability: *ART. 16* → Offers are revocable unless stated otherwise.

- Common law: Always revocable.
- German law: Never revocable unless it states that.

ART. 16(2): An offer can indicate that it is **irrevocable** by stating a fixed time or other circumstances.

ART. 17: An offer, even if it is irrevocable, is **terminated** when a **rejection reaches the offeror**.

Example: If A makes an irrevocable offer to B (irrevocable through September 20), B rejects it on September 3, and changes his mind on September 4 to accept, A can avoid accepting, as the offer was terminated by B's rejection.

Acceptance: *ART. 18.*

- **Statement OR conduct** indicating **assent** is an acceptance.
- Silence or inactivity are not considered acceptance, but **silence and conduct can be**.
- Starting performance can be acceptance (***facta concludentia***). [*Example:* Buyer sends an offer to buy a product. Seller doesn't respond but sends the product].

EXAMPLE: ABC Inc. v. DEF

- ABC Inc. (US) agrees orally over the phone with DEF (Mexico) to purchase 500 dishwashers at $600 each.
- DEF ships the dishwashers. The invoice includes a clause requiring the buyer (ABC) to notify the seller (DEF) of defects within 30 days of delivery.
- ABC takes delivery and starts selling the dishwashers.
- *Issue:* 2 months after delivery, several dishwashers explode due to a production defect.
- DEF argues that the defect should have been notified within 30 days of delivery, as per the invoice clause.
- *Enforceability of invoice provision:* Yes, the provision is enforceable. By starting to sell the merchandise, ABC accepted the 30-day notification term (by *facta concludentia*).
- *Consideration under CISG → ART. 18(3):* Acceptance by conduct is valid **only if the procedure is allowed** by the *offer, usage, or prior course of dealing between the parties*.
- *CONCLUSION:* ABC's action of selling the dishwashers constitutes acceptance of the 30-day notification clause, making the provision enforceable. However, the court must consider whether this acceptance procedure aligns with *ART. 18(3).*

When is the contract formed?

Common law → *Mailbox rule:* A contract is formed, and the offeror cannot revoke the offer, once the acceptance is dispatched by the offeree (i.e., put in the mail).

ART. 18:

- Acceptance becomes **effective** when it **reaches the offeror** (similar to *civil law*).
- The **offeror cannot revoke** the offer after the acceptance is dispatched (similar to *common law*).
- Acceptance is not effective if it doesn't reach the offeror within the time fixed or, if no time fixed, within a reasonable time under the circumstances.

ART 16(1): The **offeree** can **withdraw** his acceptance until it reaches the offeror.

Battle of the forms → *Problem:* Buyer sends an order → Seller sends back an acknowledgment form and "acceptance" with slightly ≠ terms.

CISG approach similar to *common law* **mirror image approach** (≠ UCC) – *ART. 19:*

- If buyer and seller's forms differ on **material terms**, there is no offer and acceptance (but a rejected offer and a **counteroffer**).
- A reply to an offer that claims to be an acceptance but has ≠ terms that **do not materially alter the terms is an acceptance**. However, the offeror can object.

Material terms: price, payment, quality & quantity, place & time of delivery, extent of liability (i.e., who is responsible for damages or losses), dispute settlement.

However, contracts are often performed even with ≠ forms. *Example scenario:*

- Buyer sends an order with a 30-day notice provision for defects.
- Seller ships goods with a 10-day notice provision for defects.
- Buyer takes delivery and pays.

- *What are the terms?*

➔ *Three approaches:*

1. **Mirror image + last shot rules:** The seller's form controls.
2. Shipping implies acceptance of **buyer's terms**; ≠ terms in the acknowledgment are irrelevant.
3. **Knock-out rule:** The contract is formed based on agreement on basic elements, and diverging terms are knocked out. *ART. 19* is not applied. Common terms form the contract, while **material elements** are regulated by **applicable law** based on rules of **private international law**.

SELLER'S OBLIGATION AND BUYER'S REMEDIES

Rights and obligations of the parties – General provisions

*ART.25 **(fundamental breach):** A breach of contract committed by one of the parties is fundamental if it results in such **detriment to the other party as substantially to deprive him of what he is entitled to expect under the contract**, unless the party in breach did not foresee and a reasonable person of the same kind in the same circumstances would not have foreseen such a result.*

Subjective nature → Whether a breach is fundamental depends on the **circumstances**. The notion of fundamental breach is **fact-based** and must consider the specific circumstances of each case.

Objective idea of breach → There is a **non-coincidence** between what was due and what was delivered, regardless of fault.

Remedy for fundamental breach: **Avoidance**.

- The party not in breach can **avoid** (i.e., **terminate**) the contract without a judicial remedy.
- Avoidance is limited by the **foreseeability** of the detriment *(ART. 25)*.
  - The party in breach can prevent avoidance if the breach was unforeseeable.
  - So, the party not in breach can avoid the contract only when detriment was foreseeable.

Declaration of avoidance: Avoidance if effective from the moment the party in breach receives notice *(ART. 26)*. *Remember:* The contract is void without needing a court decision.

Detriment = Anything resulting from **nonperformance** that deprives a party of their expected benefit. [*Example:* A buyer cannot use a machine for a new product due to a defect. The inability to start the new product could be a detriment resulting in a fundamental breach].

- A detriment can result in a fundamental breach if it is so serious it allows the contract to be avoided.

SELLER'S OBLIGATION

- The seller must **deliver the goods** as required by the contract and the CISG *(ART. 31 FF.)*.
  - Must meet *quantity, quality, description, and packaging requirements (ART. 35)*.
- The seller must **provide any necessary documents** related to the goods *(ART. 34)*.
- The seller must **transfer ownership** (or property) of the goods.
  - *Counterintuitive aspect:* CISG obliges the seller to transfer ownership BUT the transfer is not governed by CISG – it is governed by **applicable domestic law**. Transfer can occur at the conclusion of the contract, upon delivery, or later.

Delivery (in-depth) → Three basic ways to deliver goods:

1. **Delivery contracts:** Seller must deliver and leave the goods at the disposal of the buyer at a certain location.
2. **Shipment contracts:** The seller must hand over the goods to the first carrier and make appropriate **carriage contracts** (i.e., carriage by third party).
   - There may be additional obligations related to shipment (e.g., *Incoterms*).
3. **No transportation contracts:** Delivery occurs where the goods are (i.e., seller's place of business or warehouse).

More precisely, ***ART. 31***: If no other place is specified:

1. **First carrier** (IF the contract includes an obligation to deliver the goods).

2. If not, and specific goods were **known to be** at a particular location, at that place.
3. If not, at the **seller's place of business** at the time the contract was made.

Goods (in-depth) → The seller must deliver goods that meet *quantity, quality, description, and packaging requirements* stated in the contract.

Goods are **not conforming** with the contract **unless they** *(ART. 35(2)):*

a. Are fit for **normal use** – i.e., for the purpose for which they would ordinarily be used.
   - *Note:* Fit in the buyer's country, if seller knew the destination.
   - *Example:* Office chairs must be comfortable, durable, and suitable for long hours of sitting.

b. Are fit for **particular purposes** expressly or impliedly made known to the seller at the conclusion of the contract. Often litigated, make sure it is clear in a contract.
   - *Example:* A bakery orders an oven to bake gluten-free bread at a specific temperature range. If the oven cannot achieve or maintain that range, it fails to meet the particular request.

c. Possess the **qualities** that the seller has presented to the buyer as a **sample or model**.
   - *Example:* A fashion boutique orders leather jackets based on a soft, high-quality sample. If the delivered jackets are stiff and low-quality, they do not possess the qualities of the sample.

d. Are **adequately packed** in a usual or adequate manner.
   - *Example:* A tech company orders delicate computer monitors. If the monitors are packed poorly and arrive damaged, the seller failed to pack the goods properly.

The seller must deliver the **goods free from third-parties rights or claims** – including IP. Moreover, if a contract specifies a country in which goods are to be resold or used, delivery must occur in that country. If not specified, delivery is at the buyer's place of business *(ART. 42).*

Note: The **seller is not liable if the lack of conformity** *(under ART. 35(2) a-d)* was known or the buyer could have known at the time of conclusion of the contract.

CASE 3: *Medical Marketing International v. Internazionale Medico Scientifica.*

Facts:

- **MMI Inc.** (US, **plaintiff**) had an exclusive deal with **IMS S.r.l.** (Italy, **defendant**).
  - 1993 contract: MMI Inc. was given exclusive right to sell a mammography unit by IMS S.r.l.
- In 1996, the **FDA confiscated the machines** for **not meeting US safety standards**.

Issue: Who was responsible for ensuring compliance with US regulations?

Arbitration and court proceedings:

- Arbitration: In 1996, damages were awarded to MMI Inc.
- MMI Inc. then went to the US District Court under the FAA to have the arbitration decision officially confirmed and enforced.
- *But* IMS argued that the **arbitrators went beyond their legal powers**. Specifically, they ignored or misapplied the CISG that applied to the case.

Analysis:

- **CISG applied** (international sale of goods).
- *ART. 35* → Goods must be fit for normal or specific use made known to the seller.
- IMS argued that the arbitrators misapplied the CISG which **does not require conformity with the buyer's local law**. They cited a 1995 German case, which held that the seller doesn't need to deliver goods conforming to the buyer's local law **unless**:
  a. They are the same in the seller's state.
  b. The buyer has informed the seller about the rules.
  c. The seller should know due to circumstance.

Outcome:

- Arbitrators found **IMS liable**, saying it **should have known** about US safety rules.

- US court **upheld the arbitration**, saying the decision did not violate international law or public policy.

Conclusion: Even under the CISG, a **seller may be liable for non-conformity if they knew or should have known** about the buyer's local rules.

Transfer of risk and buyer's examination

At a certain point in time, the risk borne by the seller transfers to the buyer.

ART. 38 and *ART. 39:*
- The buyer must **examine the goods** within a short period as practicable.
  - *Note:* The period depends on the type of goods (e.g., complex machinery *vs* apples).
- If the contract involves **carriage**, examination is **deferred** until the goods arrive at destination.
- The **buyer loses the right** to rely on a lack of conformity if he doesn't **notify the seller** about the defect **within a reasonable time** after discovery and in any case no more than 2 years from delivery of goods.
- *Note:* ≠ contractual provisions (more or less favorable to one party) are possible – e.g., *guarantees*.

Transfer of risk of **non-conformity**:
- The buyer has the risk of loss during transportation by carrier, unless stated otherwise *(ART. 67)*. In other words, the **risk passes** to the buyer when the **seller delivers the goods to the carrier**.
- If the **goods are not to be transported**, the risk passes when the buyer takes over the goods or, if late, when the goods are placed at his disposal.
- If the **goods are already in transit**, the risk passes when the contract is concluded.

Note: The transfer of risk **does not affect the passage of ownership**, which is not regulated by CISG.

BUYER'S REMEDIES FOR SELLER'S BREACH

(Remedy 1) ART. 46: **Specific performance** obligates the seller to fulfill his original obligations.
- More common in *civil law* (very rare in *common law*).
- Often, buyer prefers damages.

Example: Seller was supposed to deliver 10 apples but didn't. Specific performance would require him to deliver the 10 apples as originally agreed. *Problem:* If he wasn't able to supply the apples in first instance, it is improbable he will be able to do so in time for the buyer's need.

Two conditions for specific performance:
1. Buyer has not resorted to any inconsistent remedy (i.e., another remedy which conflicts with specific performance – e.g., avoidance).
2. Specific performance is also provided by the domestic law of the court *(ART. 28)*.

(Remedy 2) ART. 49: **Avoidance** of the contract.

Very important note: Both *specific performance* and *avoidance* are applicable in case of **fundamental breach** (which is more severe than simple nonconformity – *ART. 25*).

(Remedy 3) ART. 74 FF.: **Damages** (more in *common law*) consist of a **compensation** corresponding to a sum equal to the **loss**, including loss of profit.

- Damages also for simple nonconformity.
- Two caveats:
  1. **Foreseeability:** ONLY damages that were **foreseen** (or should have been) at the conclusion of the contract.
  2. **Mitigation:** The buyer must take reasonable measures to mitigate the loss.

Damages are available even if the contract was **avoided** (i.e., terminated due to fundamental breach) or the seller has **cured** the breach.

- Avoidance is not an exclusive remedy (i.e., *avoidance + damages* is possible).
- *"To cure a breach"* means the seller provided a remedy to the breach. *Example:* Seller eventually delivered the goods (but later than agreed) → Buyer is still entitled to receive damages for any losses suffered.

The buyer doesn't have to prove the seller's fault to claim damages.

(Remedy 4) ART. 50: A buyer may **reduce the price** for nonconformity.
- CISG does not clearly explain *by how much* or if it applies for *quality or only for quantity*.
- The seller must have the **possibility to cure** the nonconformity.

Some issues:
- The buyer must give **notice of nonconformity** (or fundamental breach), and the notice must be **specific enough**.
- **Non-delivery** isn't always fundamental breach.
    - The buyer must fix an **additional reasonable period** (i.e., a "period of grace") to the seller to fulfill the delivery *(ART. 47 + ART. 49)*.
    - The seller, even after delivery date, has a **right to cure before avoidance** is declared *(ART. 48)* at his own expense and if there are no unreasonable inconvenience to the buyer.

Note: Parties may **contract around these remedies**. [*Example:* Indicate that non-delivery on a certain date constitutes a fundamental breach].

KEY: ***Principle of conservation of the contract*** → The CISG aims to keep the contract alive as much as possible, emphasizing good faith and the preservation of contractual relationships.

LECTURE 4. SHIPPING GOODS, COMMERCIAL TERMS

BUYER'S OBLIGATION

Primary obligations: **pay the price** + **take delivery**.

Price:
- Unless the contract grants credit, the sale is a **cash sale**.
- *Timing:* Payment is due when goods are at the buyer's disposal according to the contract, or against documents (such as *bill of lading*).
- *Place:* Payment is made where goods are handed over (if not specified, at the seller's place of business).

Delivery: The buyer has the **duty to take enabling steps** (i.e., **cooperate**) with the seller to facilitate delivery.

SELLER'S REMEDIES FOR BUYER'S BREACH

(Remedy 1) **Action for price:** The seller's right to **demand payment of the price** is similar to an action for specific performance. In other words, the seller wants the buyer to fulfill his part of the contract.
- *ART. 28* may apply: A court grants the remedy only if it would under its domestic law.

(Remedy 2) **Avoidance.** There are 2 separate grounds for a seller to declare avoidance:
1. If the buyer commits a **fundamental breach** *(ART. 64(1)(A))*.
2. If the buyer **does not pay** the price or **does not accept delivery** of the goods, and the additional time period granted by the seller has expired.

If the buyer doesn't pay, can the seller get back the goods after delivery by avoiding the contract?
- In *common law* it is generally difficult. **CISG seems to allow it.**
- BUT if **third parties** (e.g., creditors of buyer) have rights over the goods, it may be difficult because the CISG does not regulate **who owns** the goods *(ART. 4)* and does not require courts to order specific performance unless they would do so under their own laws *(ART. 28)*.

(Remedy 3) **Action for damages** *(ART. 74 FF.)* (similar to buyer, the seller is entitled to damages).
a. **If goods resold**, the seller can claim the difference between the contract price and the (lower) selling price.
b. **If not resold**, the seller can claim the difference between the contract price and the market price at the time of avoidance.

EXCUSED PERFORMANCE

ART. 79: A party is **not liable for failure to perform** if failure was due to an **impediment beyond his control** and **unforeseeable** at the time of the contract or **unavoidable**.

Elements needed to be proven:
- Impediment **beyond party's control** (approach closer to *civil law*).
- **Unforeseeability** (i.e., the impediment could not reasonably be expected).

Note:
i. The excuse is available only as long as the impediment continues (**temporary excuse**).
ii. The non-performing party must notify the other party of the impediment and its effects on performance.
iii. The excuse is **valid only for damages**, not for avoidance of the contract.

Courts are very cautious in granting excuses under *ART. 79*.

FOCUS: COVID-19 AND COMMERCIAL CONTRACTS

Special measures were introduced by the governments. Several **commercial contracts were disrupted**. It was crucial to analyze the *specific circumstances* to determine appropriate remedy.

Key considerations:

1. *Were COVID-19 and government orders **unpredictable events** affecting the execution of contractual obligations?*
2. *Could a party be excused for its breach (**excused performance**)?*
3. *Does the agreement include a **force majeure (FM) clause**? How was it drafted?*
4. *Does the agreement include a **hardship clause (HC)**? How was it drafted?*
5. *What is the governing law of the agreement?*
6. *Are there **uniform sources of law** that can help draft balanced **FM/HC** clauses?*

Force Majeure Clause (FM)

A FM clause is a contractual or legal provision that aims to **excuse a party's non-performance** when circumstances beyond their control prevent performance.

Its mechanism depends on the specific provision or contract draft. If not expressly provided in the contract, it is important to investigate the **applicable law** governing the agreement.

Sometimes a **draft** of such a clause is suggested by **uniform sources of law** (such as the *International Chamber of Commerce, **ICC***).

Hardship Clause (HC)

A HC is a contractual or legal provision that requires the **renegotiation of a contract** if unforeseeable circumstances render **performance excessively onerous** for a party. [Performance possible but too costly].

Usually, the provision also provides outcomes if renegotiation fails (e.g., contract termination or court intervention to revise or terminate the contract).

Sometimes a **draft** of such a clause is suggested by **uniform sources of law** (such as the **ICC**).

DIFFERENT APPROACHES BY DIFFERENT JURISDICTIONS

Common law countries (UK, Hong Kong, Singapore):

- It is a standard practice to include a FM clause in commercial agreements. The scope depends on how the clause is drafted and negotiated.
- In the **UK** the **doctrine of "frustration"** is relevant. A contract may be discharged if an **unforeseeable event** renders contractual obligation **impossible** or if it **radically changes** the basis upon which the contract was reached.
- **US** approach is **≠**. FM clauses are interpreted in a **narrow sense**. A breach is excused only if the event is explicitly mentioned in the clause. In absence of this clause, other doctrines can be applied:
    - **Impossibility** (performance is objectively impossible).
    - **Impracticability** (more flexible than *impossibility* but rarely applied).
    - **Frustration** (based on economic impossibility to perform).

Civil law countries (Germany, Switzerland, Italy) →

Laws of some European countries provide rules in case of **impossibility to perform** a contract due to circumstance not attributable to the debtor. However, conditions to invoke such provisions are ≠:

- Obligation is **technically and legally impossible** OR, even if possible, it would require **disproportionate expenses/efforts**.
- Sometimes, the consequence is the **unwinding of the contract** (Switzerland).
    - *Unwinding:* The process of cancelling the contract, putting both parties back in the position they were in before the contract was formed. It is a way to undo the contract and nullify its effects.
- In some cases, impossibility is **temporary** (Switzerland) or **only partial** (Italy).

ICC POST COVID-19 – FM clause

- It includes a **definition of FM** as an impediment beyond reasonable control, not reasonably foreseeable at the time of conclusion of the contract. This provides a lower threshold for invoking the clause compared to impossibility of performance.
- Certain events are **presumed to be qualified as FM** (war, currency and trade restrictions, plague, epidemic, natural disaster, etc.) (**presumption**).
- A party successfully invoking this clause is **relieved** from its **duty to perform** and from any liability in **damages**.
- The affected party has the **duty to mitigate** the impact of the impediment.

ICC POST COVID-19 – HC clause

- It allows a party to prove that continued performance has become **excessively onerous** due to an event beyond its reasonable control which could not have been expected at the conclusion of the contract.
- The clause suggests ≠ outcomes in case **renegotiation fails**:
    a. The **party invoking** hardship is entitled to **terminate** the contract on its initiative – and the other party can claim the unlawfulness of this decision.
    b. Both parties can request a **judge or arbitrator** to **adapt or terminate** the contract.
    c. Either party can request a **judge or arbitrator** to declare the **termination**.

SHIPPING GOODS, COMMERCIAL TERMS AND BILL OF LADING

ECONOMICS OF SHIPPING: When costs and risk of transportation are high and voyages are long, only small, durable, light, expensive merchandise is worth shipping.

Modern **international trade volumes** are possible due to **decreased transport costs** (*vs* pre-industrial revolution, expensive).

- Technological advancements.
- New ways through canals (Suez Canal, 1869 + Panama Canal, 1914).
- Revolutionary innovation: **containers**. Reduced shipping time by 84% and costs by 35%. By 2001, 90% of world trade was conducted using containers for non-bulk goods.
- Other elements influencing costs:
    - Type of goods [*Example:* Perishable items require special conditions, which increase costs].
    - Port facilities.
    - Modern advancements in transport have expanded shipping to include products with limited added value (no longer restricted to small, durable, light, expensive goods).

INCOTERMS 2020

ICC (Paris): A **non-governmental entity** that provides **written customs and usages** (not treaties or binding rules) to be incorporated in contracts.

Incoterms *(International commercial terms)* are a **set of rules** published by the ICC.

- *Purpose:* They state the **actions** that the seller must take **to deliver** goods and those that the buyer must take **to accommodate delivery**. They also define what **costs** each party bears and at what point of the process the **risk of loss passes** from the seller to the buyer.
- *Usage:* If not expressly incorporated in a contract, they may have effect as an **implicit term of the contract** in the form of international trade **usage**.
    - Courts often describe them as **widely observed usage for commercial terms**.
    - Therefore, they may be qualified under *ART. 9(2) CISG* as well-known and regularly followed by businesses involved in international sales contracts.
- *Hierarchy of sources in international trade law:* The **will of the parties** prevails over usages (i.e., Incoterms) BUT **usages prevail over conventions and dispositive laws** of any domestic legal system (i.e., national laws). [Will of the parties > Usages (Incoterms) > National laws].

Incoterms were revised in 2019 and entered into effect on **January 1, 2020**. *Revision* had the purpose of making the rules more **affordable, accessible, user-friendly, intuitive, and practical** → Incoterms 2020 include more graphics, a clearer and more detailed general introduction, explanatory notes for users.

*Quick overview – **Incoterms 2020:***

- **11 commercial terms** *(spectrum of responsibilities)* to describe (a) the **delivery obligations of the seller** and (b) the **reciprocal obligations of the buyer** to accommodate delivery.
- *Two extremes:* **EXW** (all obligations on the buyer) and **DDP** (all obligations on the seller). *Note:* Choosing EXW or DDP does not necessarily disadvantage one party. It is a combination of duties that best fit the shipment.
- The other terms fall along the *spectrum* allowing parties to choose the term that **best fits** their specific commercial transaction. *Two categories:*
    1. **Rules for sea and inland waterway transport:** FAS, FOB, CFR, CIF.
    2. **Rules for any mode or modes of transport:** EXW, FCA, CIP, CPT, DAP, DPU, DDP.

"F" terms	*"C" terms*	*"D" terms*
Seller delivers good to the carrier; buyer takes on risk from that point.	Seller pays transport (and sometimes insurance) but risk shifts to buyer once shipped.	Seller covers most or all costs and risks until delivery at the destination.
Shipment contracts: Transportation at buyer's risk, seller only arranges and may pay.		**Destination contracts:** Seller bears the risk and cost of transportation.

(1.1) FAS (Free Along Ship)

The seller fulfills his delivery obligations when goods are **placed alongside the vessel** nominated (i.e., chosen) by the buyer at the named port of shipment.

Seller's main obligations:

- Deliver goods **alongside** the ship arranged by the buyer.
- **Notify the buyer** that the goods have been delivered alongside the ship.
- Provide **commercial invoice**, **"usual proof"** that the goods have been delivered, and obtain any necessary **export license**.

The **risk of loss or damage** passes when the goods are alongside the ship, and the **buyer bears all costs** from that moment onwards.

(1.2) FOB (Free On Board)

The seller fulfills his delivery obligations when goods are **on board the vessel** nominated by the buyer at the named port of shipment OR ensures the goods are already delivered on board.

Seller's main obligations:

- Deliver goods **on board** the ship arranged by the buyer.
- **Notify the buyer** that goods have been delivered on board the ship.
- Provide **commercial invoice**, **"usual proof"** that the goods have been delivered, and obtain any **export license**.

The **risk of loss or damage** passes when goods are on board the vessel, and the **buyer bears all costs** from that moment onwards.

(1.3) CFR (Cost and FReight)

Similar to CIF terms, except the seller has no obligation to either arrange or pay for insurance coverage of the goods during transportation.

Seller's main obligations:
- Deliver goods **on board** the ship arranged by the seller.
- **Arrange transportation** and **pay freight costs** to the **destination port**. *BUT REMEMBER:* The seller completes his delivery obligations once the goods are on board the vessel at the **port of shipment**.
- Provide **commercial invoice**, **"usual proof"** that the goods have been delivered, and obtain any necessary **export license**.
- **Notify the buyer** to enable him to take the goods.

The **risk of loss or damage** passes when goods are on board (i.e., port of shipment) the vessel. The **seller bears the costs** to bring the goods to the **named port of destination**.

(1.4) CIF (Cost, Insurance and Freight)

The seller fulfills his delivery obligations when goods are **on board the vessel** OR ensures the goods are already delivered on board.

Seller's main obligations:
- Deliver goods **on board** the ship arranged by the seller.
- **Arrange transportation**, **pay freight costs** AND **insurance** to the **destination port**. *BUT REMEMBER:* The seller completes his delivery obligations once the goods are on board the vessel at the **port of shipment**.
- **Notify the buyer** to enable him to take the goods.
- Provide **commercial invoice**, **"usual proof"** that the goods have been delivered, and obtain any necessary **export license**.

The **risk of loss or damage** passes when goods are on board (i.e., port of shipment) the vessel. The **seller bears freight costs and insurance** to bring the goods to the **named port of destination**.

CFR and CIF

The seller must provide a **transport document** that allows the buyer to **claim the goods from the carrier** and to **sell the goods in transit** by transferring the document to a subsequent buyer or by notifying the carrier.

How it works (traditional manner):
- The seller obtains a negotiable **bill of lading** from the carrier and offers it to the buyer through a series of banks.
- **Banks** allow the buyer to obtain possession of the document (and control of the goods) only after the buyer has paid for the goods.
- Thus, **the buyer *pays against documents*, while the goods are at sea**, meaning the payment is made before any post-shipment inspection of the goods is possible.

(2.1) EXW (EX Works)

The seller fulfills his delivery obligations when he places goods at the disposal of the buyer **at the seller's premises or at another named place**.

The seller *doesn't* need to load goods or clear goods for export, has no obligation to arrange transportation nor to pay insurance.

Seller's main obligations:
- Make goods **available** at the buyer's disposal.
- **Notify the buyer** to take delivery of the goods.
- Provide **commercial invoice**, but no obligation to obtain a document of title or export license.

The **risk of loss or damage** passes when goods are placed at the disposal of the buyer.

(2.2) FCA (Free CArrier)

The seller fulfills his delivery obligations by delivering the goods to the carrier or another person *nominated **by the buyer*** at the seller's premises or directly into the custody of the carrier (*nominated by the buyer*).

Seller's main obligations:

- Deliver goods at the **seller's premises** or into the **custody of a carrier** nominated by the buyer.
- **Notify the buyer** that the goods have been delivered.
- Provide **commercial invoice**, **"usual proof"** that the goods have been delivered, and any necessary **export license**.

The **risk of loss or damage** passes upon deliver to the carrier.

(2.3) CIP (Carriage and Insurance Paid to)

The seller fulfills his delivery obligations by delivering the goods to the carrier or to another person *nominated **by the seller*** at an agreed place (if any such place is agreed between the parties).

Seller's main obligations:

- Deliver goods **to the carrier** (or another person).
- **Arrange and pay** both **transportation and insurance** to a named *destination place* but completes delivery obligations upon deliver to the **first carrier at *place of shipment***.
- **Notify the buyer** that the goods have been delivered.
- Provide **commercial invoice**, **"usual proof"** that the goods have been delivered, and any necessary **export license**.

The **risk of loss of or damage** passes upon delivery to the first carrier at the place of shipment.

(2.4) CPT (Carriage Paid To)

Similar to CIP, except the seller has **no obligation** to arrange or pay for **insurance coverage** of the goods during transportation.

Seller's main obligations:

- Deliver goods **to the carrier** (or another person).
- **Arrange and pay** the **freight charges** to a named *destination place* but completes delivery obligations upon delivery to the **first carrier at *place of shipment***.
- **Notify the buyer** that the goods have been delivered.
- Provide **commercial invoice**, **"usual proof"** that the goods have been delivered, and any necessary **export license**.

The **risk of loss of or damage** passes upon delivery to the first carrier at the place of shipment.

CIP and CPT → **No bill of lading requirement.** Unlike CIF and CFR terms, CIP and CPT don't require payment against documents or restrict inspection rights before payment, unless the parties expressly agree to do so. These two Incoterms definitions contain no other payment or post-shipment inspection provisions.

(2.5) DAP (Delivered At Place)

The seller fulfills his delivery obligations when goods are placed at the disposal of the buyer on the arriving means of transport, ready for unloading at the named **place of destination**.

- No obligation for BOL.

Seller's main obligations:

- Deliver goods **at the named place**.
- **Arrange transportation** and **pay freight costs**.
- **Notify the buyer** that the goods have been delivered.

- Provide **commercial invoice**, **"usual proof"** that the goods have been delivered, and any necessary **export license**.

The seller bears the **risk of loss or damage** involved in bringing the goods to the named place of destination. The risk passes once the goods are ready for unloading (at the place of destination).

(2.6) DPU (Delivered at Place Unloaded)

The seller fulfills his delivery obligations when goods, once **unloaded** from the arriving means of transport, are placed at the **disposal of the buyer** at a named ***terminal***.

- ***Terminal*** includes ALL forms of terminals (quay, warehouse, container yard or road).

Note: Similar to DAP but here the seller is also responsible for unloading the goods.

Seller's main obligations:

- Deliver goods at the **named terminal**.
- **Arrange and pay** both **transportation and unloading** of goods.
- **Notify the buyer** that the goods have been delivered.
- Provide **commercial invoice**, **"usual proof"** that the goods have been delivered, and any necessary **export license**.

The **risk of loss or damage** passes when the goods are unloaded from the arriving means of transport and are placed at the disposal of the buyer at the named terminal.

(2.7) DDP (Delivered Duty Paid)

It represents the **maximum obligation for the seller** → The seller fulfills his delivery obligations when goods are placed at the disposal of the buyer at the agreed place of destination, cleared for import, and ready for unloading.

Seller's main obligations:

- **Unload goods** from the arriving means of transport.
- Obtain **import license** + pay all **import duties** and **terminal changes**.
- Complete all **customs formalities** at its risk and expense.
- **Notify the buyer** that the goods have been delivered.
- Provide **documents** enabling the **buyer to take delivery**.

The **seller bears all risks** involved in bringing goods **to the place of destination**.

CASE 4: *Dingxi v. Becwood (2010)*

Facts:

- Dingxi (seller, China) sold organic inulin to Beckwood (buyer, US).
- The contract was unclear on **delivery location**, mentioning Londonderry, New Hampshire, and Tianjin, *but* Dingxi's invoices said **FOB Tianjin**.
- Dingxi shipped to Tianjin using open trucks (≠ Becwood's instructions), then shipped to the US.
- Becwood rejected the shipment and didn't pay.
- Dingxi sued Becwood for breach of contract.

Analysis

- **Dingxi, plaintiff:** Risk passed at Tianjin (FOB), so Becwood must pay.
- **Becwood, defendant:** Risk passed only upon delivery in New Hampshire (no clear agreement on FOB), and goods arrived damaged.

Court's finding

- Passage of risk and FOB were not relevant in this case because there was no genuine issue of material fact regarding the damaged inulin, as it wasn't damaged:

    - Tests confirmed the inulin was fine.
    - Issued BOL showed the goods were shipped in good condition.
    - Becwood resold the product after buying it as salvage.
- The court ruled **in favor of Dingxi**. Beckwood had no valid reason to withhold payment.

Takeaway: **Passage of risk is fundamental.** If the inulin had been damaged, it would have been fundamental to establish whether FOB applied or not. If it was damaged before loading on the ship, all risks would have been borne *by the seller*.

LECTURE 5. BILL OF LADING

BILL OF LADING (BOL)

A BOL is a **"document of title"** – either in paper or electronic – that **entitles the holder to obtain goods from the carrier**.

➔ It **protects both parties**. *Safe and cheap:* It reduces the risk of delivering goods without being paid for the seller AND the risk for the buyer that someone else obtains the goods.

The **buyer *pays against the documents***, rather than after delivery and inspection of the goods (i.e., payment is made before delivery and inspection).

Crucial importance for sellers in international transactions: If the buyer rejects the goods after international shipment, the seller is left with goods at a foreign location and with no payment from the buyer. Without the BOL system, the seller's options would be limited to assuming the expense and hassle of a return shipment or a distress sale at the foreign port.

Two types of BOL:

1. **Non-negotiable (or straight) BOL:** It is issued to the consignee, and only he can obtain the goods. Someone else, even if in possession of the BOL, has no rights to the goods.
2. **Negotiable (or order) BOL:** Whoever is in possession of an indorsed BOL has the right to receive the goods. The order BOL can circulate (indorsement also in blank is valid; whoever has the BOL).
    - For a payment against documents transaction, only an *order BOL* is appropriate because it will permit the buyer to obtain goods only if he has physical possession of the BOL properly indorsed over to it.

NEGOTIABLE BOL:

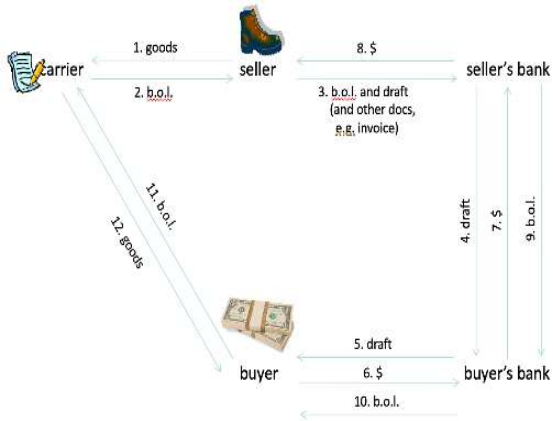
- When a bank undertakes to collect funds *from the buyer for the seller*, it receives from the seller a **"document of title"** (the **BOL**) **issued by the carrier**.
- The bank holds the BOL and gains **control over the carrier's delivery** of the goods. *Note:* The **buyer cannot take possession** of the goods from the carrier without the possession of a negotiable BOL.
- The bank receives the BOL from the seller only on the *condition of payment*. So, the **bank releases the BOL** to the buyer only **after receiving payment** (from the buyer).
- Once the buyer obtains the BOL, he can claim the goods from the carrier. *Note:* The buyer never sees nor inspect goods before buying them (he *pays against the documents*).

Draft (of Bill of Exchange)

Once the seller has a **negotiable BOL** from the carrier, he prepares and forwards along with the BOL a **"draft"** – i.e., a **legal instrument for "withdrawing" from the buyer the amount owed to the seller under the sales contract** → The **seller orders the buyer to pay**, to "honor" the draft.

How it works:

1. **Seller prepares the draft** and the **negotiable BOL**.
2. **Seller endorses both documents to his bank**, which forwards them to the **buyer's bank**.
3. The buyer can **only get the BOL** (and thus the goods) if he **"honor"** (i.e., pay) **the draft**.
4. The role of the bank depends on whether there is a ***letter of credit***:
    a. *With a L/C:* The **buyer's bank is obligated to pay** the seller if the documents match the terms of the L/C. This gives the seller strong payment security.
    b. *Without a L/C:* The buyer's bank acts **only as a collector** (i.e., just passes payment from buyer to seller). In some



cases, the bank may **discount the draft**, paying the seller in advance taking the risk of getting paid by the buyer later.

BOL: Risks to each party

Risk for the seller: **non-payment, draft dishonored**.

➔ The buyer dishonors the draft (i.e., refuses to pay). While the seller retains ownership of the goods and has the right to sue, the goods are often located at a foreign port, making recovery expensive. This may result in the need for a **distress sale at the foreign port** *(L/C addresses this problem).*

Risks for the buyer:

- **Issues with goods** (lost, stolen, damaged, nonconforming).
- **BOL stolen** and presented by someone else (if blank order, negotiable BOL) OR **forged BOL** (false BOL created by a third party with no authority from the carrier).

LECTURE 6. FINANCING TRADE LETTER OF CREDIT

PROBLEM IN INTERNATIONAL SALES

In an **international sale of goods**, the exporter (seller) and the importer (buyer) may not have previously dealt with one another. From this, some issues may arise (mainly related to trust between one another).

Seller's perspective → The seller doesn't know:
- If the buyer is creditworthy or trustworthy (i.e., if he'll fulfill obligations/payment).
- If the information received on these subjects from the buyer's associates is reliable.
- If exchange controls will obstacle payment by the buyer.
- How great the exchange risk is if payment in buyer's currency is allowed.
- The timing of payment and what delays may be involved.

Buyer's perspective → The buyer doesn't know:
- If the seller can be trusted to ship the goods if the buyer prepays.
- If the goods will be of the quantity and quality agreed.
- If the goods will be shipped by a reliable carrier and properly insured.
- If the goods might be damaged in transit.
- If the seller will furnish the buyer with sufficient ownership documentation covering the goods to allow him to claim those goods from the customs officials.
- If the seller will provide the documentation needed to satisfy export control regulations, import customs and valuation regulations.
- What delays may be involved in receiving unbound possession and use of goods at the buyer's location.

In addition to other risks, international trade is subject to a **significant financial risk**:
- The buyer is often located far away, in a ≠ jurisdiction, making it difficult for the seller or his bank to assess the **buyer's creditworthiness** (lack of accessible "credit history").
- Payment agreements in a specified currency may result in **financial uncertainty** due to currency **exchange rate fluctuations** (exchange risk).
- **Exchange control risks.**

L/C addresses the **buyer credit risk**. It aims at ensuring payment.

CONTRACTS INVOLVED IN A L/C TRANSACTION

In an **international sale of goods transaction** 3 primary contracts are involved.

(1) The **sale of goods contract** between buyer and seller.
- Parties to the contract are **the seller and the buyer**, but NOT the banks or the carrier.
- According to this contract:
  - The seller is responsible to deliver the agreed **quantity and quality** of goods.
  - The buyer is responsible for **taking the goods** and paying the agreed **price**.
- In international sales of goods, the contract governing law is commonly the **CISG**.

(2) The **BOL** – A contract between seller and carrier as well as a receipt issued by the carrier to the seller.
- Parties to the contract are **the seller (or buyer** – either one**) and a carrier**.
- According to the BOL contract:
  - The seller (or buyer) is responsible for **payment** of the **freight charge**.
  - The carrier is responsible for carrying the goods to either the **"consignee"** in a non-negotiable (*straight*) BOL ***OR*** the **person in possession** (holder) of the negotiable (*order*) BOL.
- *Note:* The **negotiable BOL** should be used in the documentary sale, so that the buyer is able to obtain delivery of goods only if he has physical possession of the BOL properly indorsed to it.

(3) The **L/C** which represents a **promise by the buyer's bank to pay the seller** under the condition that the **seller provides evidence of shipping**.

- Parties to the contract are usually **buyer, buyer's bank** (issuing bank), **seller**, **seller's bank** (advising or confirming bank).

How it works:

- **Buyer (applicant) requires his bank to issue a L/C to the seller (beneficiary)**, allowing him to receive payment upon presentation of evidence of the shipping.
- The **seller's bank advises the seller** of the availability and details of the L/C.
- Sometimes the contract requires the **confirmation** of the L/C by the seller's bank. In this case, the buyer's bank would requires the **seller's bank to obligate itself to pay the price to the seller** (additional layer of security).

L/C (details)

Therefore, a L/C is the **promise by a bank** (usually, the buyer's bank) **that it will pay the seller** when the latter will present **evidence that the goods have been shipped**.

➔ The *key document* that furnishes evidence of shipping is the **BOL**.

The L/C serves 3 ≠ functions:

1. Provides **evidence** that the goods have been **delivered to the carrier**.
2. Shows that goods are **destined for the buyer** and not some third parties.
3. Assures that the **bank pays the goods on behalf of the buyer** before the buyer physically receives them (as *buyer pays against the document*, before receiving the BOL).

L/C steps

Step 1: The process starts with the **sale of goods contract**. For maximum protection, the seller should seek payment through a **confirmed, irrevocable L/C** to avoid the risk of nonpayment by the buyer.

As a condition to payment under the L/C, banks often require the following documents:

- Negotiable BOL.
- Draft or bill of exchange.
- Commercial invoice (which indicates the terms of the purchase).
- Policy of marine insurance.
- Certificate of inspection (i.e., the inspecting firm confirms the number and type of goods shipped).
- Export license or health inspection certificate when necessary.
- Certificate of origin for tariffs/custom duties.

Step 2: If the buyer agrees to a L/C payment term, the buyer will contract with his bank to issue a L/C in favor of the seller.

a. If the sales contract requires a **confirmed L/C**, the buyer must also arrange for **payment promise by a local bank in the seller's area**. By indicating *"we confirm this credit"*, the **seller's bank** (i.e., confirming bank) makes a **direct and independent promise to the seller** that it will pay the price, after the presentation of the required documents.
b. If the sales contract ***does not* require a confirmation L/C**, the buyer's bank can forward the L/C through an **advising bank** located near the seller. Such **bank is not obligated to the seller** but acts as an intermediary to inform the seller of the issuance of the L/C.

Step 3: Once the L/C is issued and confirmed, the seller will **pack the goods**, issue a **commercial invoice** and procure an **insurance certificate** covering the goods during transit. Then, the seller sends the goods to a **carrier**.

Step 4: After having given the goods to the carrier, the **carrier issues the negotiable BOL** as a combination of a *receipt* and a *contract*.

Step 5: The **seller hands the BOL to his bank** which (as a *confirming bank*) is obligated to **pay the seller** the agreed price. The **seller** also prepares a **draft** (*bill of exchange*) to present to the bank; the draft resembles a **check** written by the seller and typically directed to the buyer's bank, specifying the amount of the contract price.

Step 6: The **seller's bank inspects the documents** (as it cannot inspect the goods, which are already in the possession of the carrier) to determine whether they comply exactly with the requirements of the L/C. If this is the case, the **seller's bank pays the seller**.

Step 7: The **seller's bank** indorses the *draft (or bill of exchange) and the BOL* and **forwards both documents to the buyer's bank**.

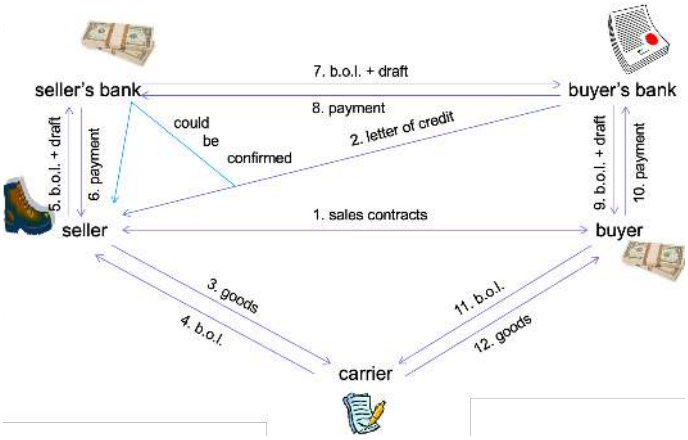
Step 8: As the issuer of the L/C, the **buyer's bank is obligated to "honor"** the draft (or bill of exchange) and thus to **reimburse the seller's bank** if all documents from the seller conform to the requirements of the L/C.

Step 9: The **buyer's bank contacts the buyer and requests payment** by presenting the documents handed by the seller's bank (including draft or bill of exchange). The **buyer must pay *against the documents*** (and not the goods themselves). Hence, it is necessary to specify the terms of the documents in the original contract for the sale of goods and repeat those specifications precisely in the L/C.

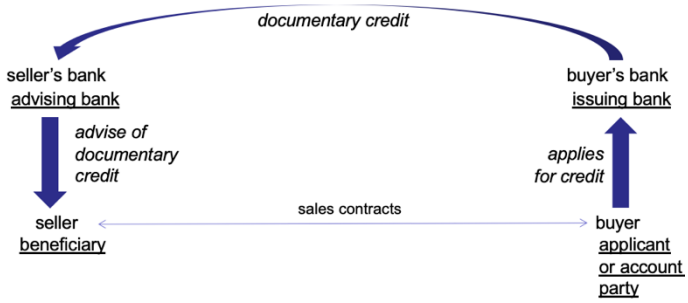
Step 10: Once he has paid his bank, the buyer will obtain possession of the BOL and only then he will have the power to obtain the goods from carrier.

Step 11 and 12: The **buyer hands the BOL** to the carrier *AND* **obtains the goods**.

L/C:



L/C (a ≠ look)



It is clear this mechanism **minimizes risks for both parties** in international transactions.

Seller's point of view: If the seller ships conforming goods, he has **independent promises of payment** from both the **buyer and the 2 banks**. He would be exposed to risk only if the seller's bank fails, the buyer's bank fails, and the buyer is either unable or unwilling to pay (i.e., a series of events very unlikely to happen).

Buyer's point of view: The buyer has a **document from the carrier entitling it to deliver the goods**, an **insurance certificate**, and perhaps an **inspection certificate** guaranteeing the goods conform the sales contract. In other words, he should receive what he bargained for.

When can the bank refuse to honor a L/C?

In a L/C, the **bank's obligations** are **independent** from the obligations of the buyer and the seller.

This is called a **documentary transaction**: The bank (obviously) never actually sees the goods (and would not be able to examine them), it only sees the documents. It must honor the letter only if the documents

are compliant with the L/C. Therefore, it examines the documents rigorously and **might refuse payment also for relatively small discrepancies**.

CASE 5: *Courtaulds North America v. North Carolina Nat'l Bank (1975)*

Facts:

- **Buyer (applicant):** Adastra buys yarn from **Seller (beneficiary):** Courtaulds.
- Adastra asks buyer's bank (Carolina Bank) to issue a L/C in favor of Courtaulds.
- **Buyer's bank** issues a **L/C**, promising to pay Courtaulds if documents match.
- **Buyer's bank refuses** to honor the draft, claiming a **discrepancy** between the L/C and the invoices. The L/C required to state *"100% acrylic yarn"* and the invoices stated *"imported acrylic yarn"*.
- District court initially held the buyer's bank liable, saying that the invoices and packaging lists (stating *"100% acrylic"*) should be read together.
- Appeal court reversed in favor of the buyer's bank, saying the submitted documents didn't strictly confirm the L/C.

Analysis:

- Banks only check **documents** (not actual goods).
- Any **small mismatch**, even one word, means the bank can **refuse payment** (this was the *issue*).
- This allows the bank to protect itself from potential liability if the goods don't match the contract.

Takeaways:

- **Banks** must follow the **exact terms of the L/C**, no interpretation.
- The **seller** must be **precise** in all documents.
- **L/C are independent from the sales contract.** Banks don't get involved in the actual trade, just the paperwork.

Conformity of documents is probably the **most litigated** issue concerning L/C.

- In roughly 50% of the cases there are some discrepancies.
- In 90% of cases, **applicants (buyers) waive the discrepancies**. If they don't do so, the issue might be taken before a court which usually adopts a **formalistic approach** (as in *CASE 5*).

The governing legal rules of L/C

The most significant rules are found in the **UCP** (Uniform Customs and Practices for Documentary Credits) which is a **set of contract terms prepared by the ICC**. [Most recent version: 2007 revision].

➔ Most international L/C **explicitly follow the UCP** rules.

However, the **UCP *doesn't* provide for a comprehensive regulatory system** for L/C (not complete, doesn't cover every legal issue). So, when there's a gap, **domestic law fills in** (***gap-filler*** is the applicable domestic law).

Example (US): The UCC **expressly validates the incorporation of the UCP** in a L/C but also makes clear that the UCP only applies as far as it doesn't conflict with the UCC (i.e., US law). In short, UCP is the main guide, but local law (i.e., UCC) fills the gaps.

Gap-filling

As noted, **domestic law is the gap filler of the UCP.**

The most evident *Example* of this "gap-filling need" is that **UCP has no rules that address fraud**.

Example: In a US context, UCC *Article 5* (and *not the UCP*) will provide the legal rules to resolve issues related to allegations of fraud in L/C transactions.

Fraud exception (Revised UCC 5-109) – Bank latitude to pay

What happens if the banks pay to the seller even in case of his fraudulent behavior (e.g., willful delivery of goods of lower quality)?

Tension between **competing principles**:

- **Principle of independence** of the L/C from the underlying transaction (which is essential to make L/C reliable).
- **Fraud exception:** Of course, banks are not supposed to pay in case of fraud. So, in case of fraud, the principle of independence does not apply anymore.

However, there are **limitations to the "fraud exception"**, so that a bank, under some circumstances, will pay the seller, even in case of his fraudulent behavior.

- If the bank pays in **good faith** and without notice of fraud or defects, it is entitled to **reimbursement**, even if the seller has engaged in fraudulent behavior.
- Even if the bank is notified of fraud or defects, it may still pay if it believes the payment is made in **good faith** (i.e., if fraud is not clearly proven). Banks are paid to handle documents, not to act as judges, especially without due process (and they don't want to be seen as unreliable).

Fraud exception (Revised UCC 5-109) – Court injunction

The **account party (buyer)** has the **right to seek a court order against payment** (i.e., block payment) if it can prove fraud or forgery in a required document under the L/C or fraud by the beneficiary in the underlying transaction.

If the buyer obtains an **injunction**, the **issuing bank will be forced to refuse to pay**. This happens rarely.

There are **limits** to the right to an injunction, based on fraud exception (UCC 5-109):

- The fraud must be **"material"** (the meaning of *"material"* is decided on a case-by-case basis).
- The buyer must produce **sufficient evidence**, not merely allegations.
- The buyer must satisfy all **procedural requirements** for injunctive or other relief.
- The fraud must be made by the beneficiary, not other third parties (e.g., the carrier).
- English and Canadian courts (based on US precedents) have adopted this approach, but they also require **scienter** (i.e., the intent or knowledge of wrongdoing by the offender) by the beneficiary which is an element of *common law fraud*.

LECTURE 7. SALES AGENTS AND DISTRIBUTORSHIP AGREEMENTS

ISSUE

We have seen the basic elements of an international sale of goods: CISG, BOL, L/C. Now, we consider an **issue** related to **international trade**: the **use of agents or distributors**.

➔ To be effective in a foreign market, especially for consumer goods, any business entity needs some connection with the foreign country. One of the most flexible possibilities is to have an **agent or distributor**.

COMMERCIAL DISTRIBUTION

The term **commercial distribution** means the activities related to the **transfer of goods and services** from the **producer** to the **end-user** against a monetary consideration.

Distribution can be:
- **Direct** – Where the transfer from the manufacturer to the end-user is direct, without any commercial mediation by third parties.
- **Indirect** – Where the manufacturer focuses every effort and care in the realization of the good but gives up control on the stages of commercialization.

The creation of a **distribution network** is necessary for any company doing business at an international level.

In **Italian law,** unlike many *common law* countries, there isn't one codified distribution agreement. The term distribution is used to refer to **3 ≠ commercial agreements**:
1. Agency agreement.
2. Exclusive distribution agreement.
3. Franchising.

- Their principal aim is the placement of the product on the market.

Agency agreements	*Exclusive distribution agreements*
Regulation differences	
1. Agents are **intermediaries** appointed by the principal to promote the conclusion of contracts of sale between the principal itself and the customers and are remunerated on a commission basis. 2. In most countries, agency agreements are subject to **specific rules**. 3. The **principal concludes the agreement personally and directly** with the customer.	1. The distributor is a **buyer-reseller** responsible for the distribution in a given territory. 2. Most countries' legal systems **do not provide for specific rules** for these agreements. Only the Belgian legislation expressly regulates them. 3. The **distributor concludes the purchase agreement personally** with the customers, so that the consideration is the difference between the price paid to the principal and that applied to end-users.
Differences on an economic level	
1. They give the **principal** a **more effective control over customers**. 2. The **risk of customer default** remains with the **principal** (unless otherwise agreed upon the *"del credere"* clauses).	1. The **distributor** is like a **barrier between the principal and the final purchases** (which he considers as his own costumers). 2. The **distributor** assumes the **risk of failure to reseller** the purchased goods and **failure of payment** by the clients.

AGENCY AGREEMENTS

Pursuant to ***Directive UE 86/653***, **commercial agent** means a self-employed intermediary who has **continuing authority** to:

- **Negotiate** the sale or the purchase of goods on behalf of another person (principal) ← **agent without representation**.
- **Negotiate *and* conclude** such transaction on behalf and in the name of the principal ← **agent with representation**.

Note: This Directive was issued to set a standard for Member States's legislation. Outside the EU, legal provisions can be very ≠ (peculiarities of any State are a critical issue whenever an agency agreement is to be signed).

Appointment of the agent

The **scope of the mandate** must be set. This means defining the **tasks and powers** of the agent. In practice this means:

a. Indicating the **products** to be promoted through the mandate.
b. Defining the **territory** where the agent will carry out his mandate.
c. Deciding whether the mandate is subject to an **exclusivity clause** and identifying its **possible limitations/exceptions**.

a. Identification of the products

The main issue is that the definition of **contractual product** may **vary over time**.

Usually, the agency agreement refers to all products made or sold by the principal subject to a technical appendix in which the products of the agreement and the technical specificities are described.

Moreover, the agency agreement must include a clause which regulates **possible changes of products**. [*Example:* During the contractual relationships some products are substituted by others or new products are placed on the market].

b. Territorial delimitation

It is fundamental to identify the **territorial zone** within which the agent carries out his mandate and, possibly, identify the clients assigned to it.

- The agent has the interest to be given the broadest possible mandate.
- The principal has the interest to optimize its own distribution network.

The **dimension** of the territory is calculated based on:

- Number of potential clients.
- Principal's organization on the territory.
- Possible mandatory rules that prevent or limit the principal's right to modify the assigned territory at a later stage.

c. Exclusivity right

In international commerce practices, it is the **agent and principal's duty** to define the *existence and limits* of a possible **exclusivity right**. *However*, some legal systems provide that a foreign partner **can't have more than one local representative**. These legal systems grant a sort of **"implied exclusivity right"**.

The alternatives usually available to the parties are:

- **Non-exclusive** mandate.
- **Exclusive** mandate in favor of the **agent**.
- **Exclusive** mandate in favor of the **agent with the principal's right to make direct sales**.
- **Exclusive** mandate in favor of the **principal**.

Non-exclusive mandate: The **principal** has the **right to assign the promotion** of its own product to **multiple agents** in the same area.

- This option is well suited when the principal has just begun its business in the new market.

- It is the option that involves the agent the least. The agent is not motivated in the promotion of the products because the principal or other agents may benefit from it.

*Exclusive mandate in favor of the **agent**:* The principal gives the **agent** the **right to be the exclusive beneficiary** of the potential success of the products in a given area "assigned" to him.

Usually, an exclusive mandate is combined with the following provisions:
- Obligation of the principal to communicate the exclusive agent any request from potential clients whose residence is in the contractual area.
- Prohibition for the agent to promote the conclusion of the agreement with clients outside the territorial scope and contextual commitment to submit to the principal any request from clients outside the area.

*Exclusive mandate in favor of the **agent** with the **principal's right to make direct sales**:* The **principal** has the **right** to get through potential clients and **conclude sale agreements for products** subject to the agent's mandate.

Usually, the right to conclude direct sales is **limited** to:
- **Particular categories of clients** for which the principal doesn't consider the involvement of the agent appropriate or adequate.
- **"Big clients"** dealing only with the principal.

It is appropriate to specify if any **commission** is due to the agent.

*Exclusive mandate in favor of the **principal**:* The agent is given an exclusive mandate, and the principal is given an **equal exclusivity right** (**covenant against competition**), otherwise the agent could promote the sale of goods of other principals (i.e., operating as indirect competitor).

Even though most legal systems provide for this condition of reciprocity, the parties are advised to provide for an appropriate contractual clause.

Powers of the agent

The agent can be given:
- Mandate **without representation**: The agent *doesn't* have the power to conclude an agreement on behalf of the principal.
- Mandate **with representation**: The agent **can conclude** agreements with clients in the name and on behalf of the principal. The agreement will take effect directly towards the principal (not frequent).

Mandate without representation

Usually, the **principal** doesn't give a mandate with representation because:
- He **wouldn't be able to select his clients**.
- The presence of an agent with powers of representation in a country may be understood, for **tax purposes**, as a **permanent organization** of the principal in that territory, exposing him to the **risk of taxation** of the profits arising from the agreements concluded by the agent.

Therefore, the parties should agree on specific clause providing that:
- The agent has **no power of representation**.
- The agent must avoid any conduct that might induce third parties in good faith to believe the principal is legally bound any promise or statement made by the agent.

Duration → The agency agreement can be made as follows:
- **Fixed term** contract: In some cases, local laws prohibit the conclusion of temporary agency agreements. In the EU, entering into subsequent contracts with the same agent could be considered as "simulation". Thereafter, it would be regarded as *open-ended*.

  - *Council Directive 86/653/EEC, Art. 14* provides that an agency contract for a fixed period which continues to be performed by both parties after that period has expired shall be considered as converted into an agency contract for an indefinite period.
- **Open-ended** contract: Either party may terminate the contract, according to the "termination provisions" of the contract, in accordance with the notice period prescribed by local laws.

Commission Guidelines on **Vertical Restraints**: *Art. 101(1)* of the *Treaty on the Functioning of the EU (TFEU)* **prohibits agreements** that may **affect trade** between EU countries and which prevent, restrict, or distort **competition**.

In an agency agreement, the **agent acts on behalf of the principal**, meaning he *doesn't* bear significant commercial or financial risks (which are on the principal's shoulders). Because the principal is responsible for these risks, obligations imposed on the agent are considered outside the scope of *Art. 101(1)*.

Typical obligations that are viewed as inherent to an agency agreement (and are allowed) include:
a. **Limitations on the territory** in which the agent may sell these goods or services.
b. **Limitations on the customers** to whom the agent may sell these goods or services.
c. **The prices and conditions** at which the agent must sell or purchase these goods or services.

DISTRIBUTORSHIP AGREEMENTS

Under a distributorship agreement, the ***independent distributor*** **purchases products** from the producer and **independently sells them to third parties** within the territory agreed by the parties.
- The distributor resells the products at his **own risk** through its **permanent organization** in the relevant market (≠ agent).
- The **terms and conditions** of the sale are regulated under the distributorship agreement.
- The distributor **doesn't represent an intermediary** between the producer and the end-user.

It is common that **national laws do not have specific provisions** regulating these agreements.
- *Commission Regulation (EC) 330/2010* says that certain vertical agreements are generally allowed, as long as they follow some rules.
- Under *Art. 101(3) of the TFEU*, these agreements are allowed even if they limit competition a bit – but only if both the producer and the distributor each have **no more than 30% of market share** in their markets.

The *EC Regulation 330/2010* provides a list of **hardcore restrictions** which represent **anti-competitive restraints** and determine the **invalidity of the entire agreement**:
- Any agreement which (directly or indirectly) has the effect or objective to set a **fixed price *or* a minimum resale price** of the products to be applied by the distributor.
- **Territorial or customer sales restrictions**, unless (exceptions) it's for **specific, limited reasons**. *Example:* **Active sales** (i.e., distributor actively seeking customers) can be restricted **if** a supplier has or has given another distributor exclusive rights to a territory or customer group. *But* **passive sales** (such as responding to requests or online orders from outside the assigned area) **cannot be restricted**.

In addition, the *EC Regulation 330/2010* provides a so-called **grey list**, and the **invalidity of single clauses** indicated under such list:
- **Non-compete obligations** (direct or indirect):
  - A supplier can stop a distributor from selling competing products but only for **up to 5 years**.
  - If the agreement says the non-compete lasts more than 5 years or automatically renews beyond 5 years then that clause is invalid (but not the whole agreement, just that part).
- **Post-termination obligations** – i.e., obligations causing the distributor, after the termination of the agreement, not to manufacture, purchase, sell or resell goods or services.

CASE 5: *Southern Int'l Sales v. Potter & Brumfield (1976)*

Facts:
- **Defendant:** Potter & Brumfield (P&B), manufacturer based in Indiana.

- **Plaintiff:** Southern Int'l Sales (SIS), manufacturer's sales representative in Puerto Rico.
- In 1969, the parties signed a contract to be interpreted under Indiana law. Either side could terminate it for any reason with 30 days' notice.
- In 1971, P&B gave notice to terminate.
- SIS objected, claiming it had performed well, and P&B just wanted to take over SIS's business contacts.

Arguments & analysis:
- SIS sued in a NY federal court (diversity case).
- SIS argued termination violated the Puerto Rico Dealer's Contracts Act, which requires a just cause for termination.
- P&B agreed the contract falls under the Act but claimed the just cause existed and Indiana law should apply (based on contract clause).
- **Conflict of law** issue:
    - NY follows the Second Restatement: Parties' chosen law applies unless it goes against a fundamental policy of a place with great interest (here, Puerto Rico).
    - Indiana was connected (defendant's base, manufacturing), but Puerto Rico had more significant contact (sales activity, contract signing, protected dealer role).

Court decision:
- Ruled that Puerto Rico law applies because it reflects a strong public policy (protect local dealer). Puerto Rico had a materially greater interest in the issue.
- Therefore, a just cause is required to terminate the contract.
- The case moved forward to decide whether a just cause actually existed.

Additional observations:
- Enforcement risk: A judgment that violates public policy in a country might not be enforceable there.
- The clause said the contract is "interpreted" under Indiana law. That may be too narrow; better to say "governed".
- Practical tip: Sellers should check for **local dealer protection laws** and consider:
    - Shorter-term contracts that require renewal.
    - But remember, local laws may require minimum contract duration, and dealers often want security for their investment.

LECTURE 8. LICENSING DISTRIBUTION AND PRODUCTION ABROAD. FRANCHISING AND TRADEMARKS

SIGNS OF IDENTIFICATION OF THE ENTREPRENEUR – **IP LAW** INTRODUCTION

Identification signs (which form an essential part of *franchising agreements*) are intended to enable consumers to:

- **Identify certain products** with a **specific enterprise**.
- **Distinguish** among the ≠ entrepreneurs, their companies and products.
- **Avoid confusion** to any possible extent.
- Build an entrepreneur's **reputation**.

Classification → Identification signs are:

- **Business (or commercial) name** *("ditta")* which identifies the person of the entrepreneur.
- **Banner** *("insegna")* which identifies the business premises.
- **Trademark** *("marchio")* which distinguishes the goods or services distributed by the enterprise.

Business name: The business name is the name used by the entrepreneur in carrying out his activities.

- It must comply with the **principle of truthfulness**. It must contain the entrepreneur's last name or initials.
- It must comply with the **principle of novelty**. It cannot be equal or similar to another one.

Banner: The banner is the **sign of the premises** where the **entrepreneurial activity is exercised**.

- It must have a **distinctive capacity** – i.e., it must be ≠ from the generic name of the object of the enterprise.

Trademark: The trademark **distinguishes the products**.

- The *purpose* is **identifying** the products or services of an entrepreneur, giving evidence of the **origin** of a product and guaranteeing its **quality**.
- Protection is granted to all **"marks" capable of distinguishing** the goods on which they appear from other goods.
- It may consist of *words, designs, slogans, devices, and symbols*.
- The ***service mark***, on the contrary, protects services.
- *Registration:* All trademarks are subject to the **principle of registration**. Unless the mark falls within a category of forbidden registrations, it becomes **valid for a term of years** following registration → **Exclusive use** for a period of time but can be **renewed** generally in perpetuity.

In most jurisdictions and international agreements, there are some **requirements** for the mark to be registered:

- **Lawfulness:**
  - Cannot contain signs that are against the law, public order or morality.
  - Cannot breach third parties' copyright, rights of IP or other granted to third parties on an exclusivity basis.
  - Cannot consist in flags, official logos or seals adopted by any state of the Paris Convention.
- **Truthfulness:** Cannot mislead people about the product's origin, nature or quality.
- **Distinctiveness:**
  - Must be distinctive from other competitive products.
  - Must be **original** – i.e., ≠ from the "generic name" of the products. *Descriptive* trademarks are not allowed.
  - If a registered trademark becomes **non-distinctive through *common use***, the so-called **vulgarization** occurs, and the trademark will be cancelled from the register.
- **Novelty:** Must be new and ≠ from any existing sign of identification, registered *or not*. It cannot be a word or sign that is commonly used in everyday language or course of trade.

COPYRIGHT

Franchise agreements usually require sharing information, essential for the business model, which must be protected, but cannot be registered as trademarks (e.g., layout and style of stores).

➔ The sole protection for these elements is **copyright**.
- It is not necessary to publish a work to obtain the copyright.
- It is sufficient that the work is **original and fixed** in a **tangible medium of expression**.

TRADE SECRETS

Some valuable and confidential business information cannot be protected with *trademarks, copyrights, or patents* (or even if they can, a party might prefer to avoid disclosing such information).

The US has specific rules protecting trade secrets (e.g., receipts, cooking techniques), at least to some extent → *Uniform Trade Secrets Act (UTSA, 1979)* → **Trade secret** means **information**, including a *formula, pattern, compilation, program, device, method, technique, or process* that:

i. Derives **independent economic value** (actual or potential) from **not being generally known** to other people who can obtain economic value from its disclosure or use *AND*
ii. Is the subject of **efforts** that are **reasonable** to maintain its secrecy.

- Some international agreements extend the scope of protection of trade secrets (e.g., NAFTA).
- Some countries do not have trade secret protection. Similar results are achieved through **unfair competition rules**.
- Trade secret protection might be difficult to invoke, especially in an international franchise contract.
- In international franchise contracts, **confidentiality agreements extended to employees** can be particularly important.

LICENSE AGREEMENTS

In a license agreement, the owner of an industrial property right (**licensor**) grants the other party (**licensee**):
- The **right to produce and sell** goods.
- The **right to use a brand name or trademark** *or* **use patented technology** owned by the licensor.

In exchange to the licensor's limitations to his exclusive rights, the licensee is subject to certain conditions on the use of the licensor's property and shall pay agreed fees (i.e., **royalties**).

Basic elements of **trademark** in license agreements

- **Products:** The agreement must define the products (or services) in connection to which the licensee is allowed to use a brand name or trademark.
- **Exclusivity:** The licensor may grant to the licensee an exclusive right to use the licensed products, or the parties may agree that the same right may be attributed also to third parties.
- **Territory:** The right to use the license can be subject to territorial limitations (especially when the license is related to agency agreements).
- **Right to sub-licensing:** The licensee may or may not have the right to grant sublicenses to third parties.

Essential **terms** in license agreements

- **Royalties:** The license agreement generally specifies the fees (**fixed** *or* **recurring**) that the licensee shall pay to the licensor in relation to each year of the relevant license period. The royalties may be based on *sales* or based on *turnover*.
- **Duration:** The term of the license agreement may be **fixed** *or* **renewable**.
- **Termination:** Early termination of the agreement may be connected to the following situations:
    1. **Material non-compliance** with the obligations of either party ("general principle") (*remember: fundamental breach*).
    2. **Supervening impossibility of performance.**
    3. **Express resolution clauses:** The parties might decide that termination will apply upon occurrence of certain events considered as serious violations of the agreement (e.g., failure to pay royalties).

FRANCHISE AGREEMENT

Franchising is a business technique that allows *rapid and flexible* **penetration of markets**.
- *More* than simply selling or having an agent/distributor, *less* than direct investment.

*General def. of **franchise**:* Practice of **leasing** for a prescribed period of time the **right to use a firm's business model, brand and trademarks**. *OR* The contract by which a **franchisee is granted by the franchisor**, in exchange for a consideration, the right to **market goods and services** under particular conditions and **using a trademark**.

Economic structure

The **franchise agreement** has found extensive development in international trade due to specific characteristics of the distribution system:
- There is a substantial reduction of the risks for the producer.
- The risk of loss is on the franchisee, and generally the franchisor is compensated with royalties on the sales (often around 8%) or selling goods and services to the franchisee (with more or less stringent obligations of the latter to buy).

A distinction (which is sometimes blurred, especially with services) should be made between:
- Franchise agreements that **only imply distribution** of goods.
- Franchisee agreements that **imply distribution *and* also production** of goods by the franchisee.

Often, almost by definition, franchise involves, well-established, successful and recognizable enterprises, generally catering to consumers: the **trademark** and **image of the franchisor** are often iconic of a certain **culture**. Often, franchising requires a high degree standardization.

The basic elements of the franchise relationship are:
- The **supply of products** and/or **uniform services** subject to **control on the activity** of the franchisee by the franchisor.
- The use of distinctive signs, trademarks, or packaging, **imposed/granted by the franchisor**.
- The transfer of industrial and commercial knowledge necessary to carry out the activity (**know-how**).
- The remuneration of the franchisor usually is represented by **royalties** paid by the franchisee.

Some **issues** that the franchise agreement needs to address:
- **Control by franchisor**, business standards that must be followed.
- **Trademark license** (the very core of the franchise agreement).
- Additional **services and goods** provided by the parties (from training of employees to obligations to buy certain goods/services from franchisor or to choose a designated provider).
- **Fees/royalties.**
- Accounting, advertising (who, how), pricing and taxes.
- Termination.
- Dispute resolution.

Quality control over the franchisee's activities *(Trade off)*

The franchisor has the interest to control that the franchisee keeps quality and standard products and may also coordinate advertising and pricing and/or check on accounting to calculate revenues.

On the other side, if the franchisor exercises too much control over the franchisee's activities, an agency relationship – or similar theories in other systems (e.g., *de facto control*) – might arise for which the principal (franchisor) is liable for contracts and torts of the franchisee.

ANTITRUST

In general, **antitrust regulation prohibits** the following practices:

- **Cartels and collusion.**
- **Monopoly** (abuse, exclusive dealing, price discrimination, tying).

Several important issues with respect to franchise agreements arise – e.g., **no price fixing**. For this reason, generally, the franchise agreements don't provide minimum prices (but maximum prices are allowed) *and* only "suggested" pricing indications are set forth.
An even more delicate and typical problem in franchising is **tying** – i.e., unlawful imposition to purchase non-essential product or service (tied item) to obtain the one that is necessary (tying item).

CASE 7: *Scotch Whisky Ass.n v. Barton Distilling (1973)*

Facts:

- **Barton Distilling** (US company) made whisky labeled *"House of Stuart"* and sent it to its **Panama distributor (D&U)**.
- D&U **mixed it with local spirits** but still sold it as if it came from Scotland.
- This was **misleading** because the label falsely indicated the whisky was Scotch.
- The **Scotch Whisky Association sued Barton** under the US **Lanham Trademark Act**, which prohibits false designations of origin.

Key issue: jurisdiction:

- **Barton argued:** US courts have no authority because all mixing and selling happened in **Panama**.
- The **court disagreed**, saying:
    - The US **can regulate its own citizens** even for actions abroad.
    - Barton's conduct **began in the US** (sending labeled bottles), so the US **Lanham Act applies**.
    - **Selling in the US-controlled Canal Zone** supported jurisdiction.

Court's reasoning:

- US law applies **even abroad** if:
    1. The defendant is a **US citizen**,
    2. The conduct **affects US commerce**, *and*
    3. There's **no conflict** with foreign law.
- Barton couldn't' avoid liability just by using a foreign distributor.

Takeaways:

- **US trademark laws can apply outside the US**, especially to US companies.
- US businesses must ensure their trademarks are **used correctly**, even abroad.
- If misuse affects US commerce or reputation, **liability may arise** under US law.

LECTURE 9. FOREIGN DIRECT INVESTMENT. BRANCH *VS* SUBSIDIARY

FOREIGN INVESTMENT - OVERVIEW

An **investment** commonly involves the ***ownership*** of some of the **equity in a business**. Depending on the amount of ownership, investment may also involve **control**:
- If investor owns *all the equity* in the FI, it is clear who has ownership and control.
- As the equity percentage owned by the foreign investor diminishes, it may be less certain. In particular, if the foreign investor has exactly half the equity.

Ownership of a **majority of the voting equity** of the foreign entity usually means the entity is a **subsidiary of the investor**.

Where the ownership is **less than 50%** (e.g., *joint venture*), control is likely to be the result of some sort of management agreement.

A ***foreign* investment** usually involves the **ownership and control** of some form of **service or manufacturing industry** that is located in another country.
The term **foreign direct investment (FDI)** describes an internationalization which involves an investment through **acquisition of the ownership** of a firm located in a ≠ jurisdiction from the original home location of the investor.
- It may be **difficult** to determine the **original location** of a firm, as some internationalized firms have several headquarters.
- For the purpose of FDI, the **home location** is the country of **residence of the investor** who **controls** the foreign investment (not necessarily the *ultimate owner* of the investment).
- For statistical purposes, the minimum percentage of ownership required to make a FDI is set at **10% ownership share**.

Reasons for establishing a foreign investment:
- After strong export growth, the foreign market becomes large enough to justify local production.
- Reduction of transportation costs.
- Use of local resources available at lower costs (especially *labor*).

Multinational companies

Firms that have **internationalized into more than two foreign countries** are called ***multinational companies***. In particular, they may consist of **subsidiaries, foreign-invested firms, foreign-owned firms, or foreign affiliates**. The distinction between these entities depends on:
- The ownership share.
- The legal status.
- The number of ≠ locations in which the multinational company is based.

The multinational company may **dislike transferring technology** to a company owned by a host nation party due to fear of loss of that technology or inability to control production quality.

The foreign investment that follows export sales or a transfer of technology tends to be **voluntary**. The company makes the decision for business reasons, not because the laws and policies of the foreign government require local production. ***However***, in some cases, especially in developing countries, the government may make it very difficult (if not impossible) for other nation's businesses to export to the country, due to tariffs, quotas, and other non-tariff barriers used to reduce import and considerable protection to domestic industries → The solution would be to establish a **FDI**, therefore it would be an **involuntary** investment (i.e., pushed by laws and policies of the foreign government).

WHO GOVERNS FOREIGN INVESTMENTS

The **source of governance** is the **host nation** where the affiliate or subsidiary is located. There may or not be an express foreign investment law, but there will be many rules of governance, such as: *corporation or company law, labor law, environmental rules, bankruptcy laws, investment incentive programs*.

However, the **home nation** may govern its multinational activities abroad in some areas: *antitrust, securities regulation, export restrictions, boycott or anti-boycott rules*.

Additional regulations may be by **multinational organizations** (e.g., UN, EU, NAFTA, WTO, customs).

FOREIGN INVESTMENTS RESTRICTIONS

Some nations place several **obstacles to approval** of the **establishment** of a foreign investment. Restrictions may occur at **≠ stages**:

- Formation (i.e., initial restrictions):
  - Mandatory joint ventures.
  - Export mandates (exports can only be made through a structured market).
  - Import substitutions.
  - Use of a subsidiary rather than a branch.
- During the operation of the business:
  - Currency controls.
  - Workers' participation in management.
  - Limits on profit transfers and payment for technology which may reduce profit expectations.
- During withdrawal:
  - Inability to repatriate capital.
  - Difficult insolvency laws.

Restrictions – developing countries

During the 60s, many large multinationals expanded in developing countries by acquiring locally owned enterprises. This led to the adoption of **laws regulating foreign investment**.

- Some areas of investment were often reserved for either exclusively state-owned enterprises *or* enterprises owned by nationals to the exclusion of all foreign participation.
- Other areas could have specific levels of participation by offering investors. A government agency, in some cases, had to approve the proposed investment.

To encourage more investment, many nations with restrictive laws began to **allow total foreign ownership** under written or unwritten **exception provisions**. The **foreign investor** was allowed to retain **total ownership** in some cases:

- If it transferred its most modern technology to the host nation.
- If it located the proposed plant in an area of high unemployment or a designated for economic development.
- If it located R&D facilities in the host nation.

[*Example:* **IBM**, in **Mexico**, expanded its production even after the enactment of restrictions by producing the most recent models].

Restrictions – developed countries

Also developed countries promoted the enactment of laws affecting foreign investment (e.g., Japan, Canada, France, Korea).

Until today the **US** have been regarded as an investment encouraging nation, where only a few areas (*national defense and nuclear energy & domestic air transportation*) are subject to ownership and control limitations.

A **Committee on Foreign Investment** in the US (**CFIUS**) was created in 1975 to monitor foreign investment. If a company notifies CFIUS about a planned foreign investment and gets approval, the deal is safe from future legal challenges. Between 2008 and 2010, 313 deals were reported to CFIUS.

The ***Exon-Florio law*** gives the **President of the US** authority to **block an acquisition** if two conditions are met:

1. There is credible evidence that foreign control could **harm national security**.
2. Other **US laws aren't strong enough to protect national security** otherwise.

Moreover, some US laws **prohibit** the **sale of some US companies** to certain foreign investors. Typically, those entities involved with **foreign governments**.

GLOBAL FDI: **FDI** is a crucial **financing source for sustainable development**. However, a combination of *slow economic growth, energy price fluctuations,* and *policy-driven geoeconomic fragmentation* has hindered FDI flows.

In the first H1 2024, FDI flows shoed mixed dynamics globally:

- *FDI – inflows* into the **OECD** area **increased significantly** compared to late 2023. However, this growth was largely driven by **volatile flows to Luxembourg and the Netherlands**. When these two are excluded, inflows actually **fell by 14%**, mainly due to reduced equity investments and growing disinvestment, particularly in countries like Ireland, Belgium, and Norway.
- *FDI – outflows* from the OECD area also **rose strongly**, reaching **USD 667 billion**, driven by large increases in Q1. However, like inflows, the picture is uneven: outflows dropped sharply in Q2, and **half of the OECD countries recorded declines**, especially the **US**, due to lower reinvested earnings and intra-company loan movements.
- The **US** remained a key player, being both a **top recipient** and the **largest global source of FDI**, followed by **China** and **Japan**.
- Among **non-OECD G20 economies**, **China** saw continued **declines in FDI inflows**, with outflows rising to a record high. **Brazil** remained stable, while other EMDEs experienced drops in new investment activity.

Key takeaway: While **headline numbers** suggest a recovery in FDI, the underlying trends reveal **caution and rebalancing**. There is a **clear divergence** between **developed and developing countries**, and **between Q1 and Q2 2024**, with overall investor confidence still sensitive to **geopolitical tensions**, **economic uncertainty**, and **structural shifts in global investment patterns**.

Cross-border M&A and greenfield projects

In H1 2024, **global equity capital flows** – which reflect new investment and divestment – remained weak, especially in **cross-border M&A activity**. Globally, deal values and volumes grew by only **1%** from H2 2023. However, this modest growth was uneven:

- **Advanced Economies (AE)** saw a **rebound**, with deal values up **16%** and the number of deals up **4%**.
- **Emerging Markets and Developing Economies (EMDE)** experienced sharp declines, with **deal values down 48%** and **deal counts down 12%**, reaching their lowest levels since 2018 – **Brazil and China** were the hardest hit.

BRANCHES AND SUBSIDIARIES

Two ways of **organizing *production, distribution, sale of products and services* abroad**:

1. Creation of *branches*.
2. Creation of *subsidiaries*.

The main **economic and organization advantages** of branches and subsidiaries (*vs* sale and distribution contracts) are:

- Economic advantages deriving from **delocalization** of productive processes (e.g., lower taxation regimes, lower cost of workforce).
- **Lower custom duties.**
- Greater capacity to collect **data and information on the target market** and to adopt more efficient marketing strategies.

- **Direct control** of the market and **customers** and independent management of product **pricing policies**.
- Easier to participate in **tenders organized locally**.

Main differences:

A **branch office** is not a separate legal entity of the parent company, it is a **longa manus**. The foreign parent remains **liable** for the branch's *obligations and liabilities*. Branches are taxed as **non-resident entities**, and local tax benefits are usually not available.

A **subsidiary** is a separate legal entity from the parent, although owned by the parent company (usually, *wholly owned*). Subsidiaries usually have limited liability, so liabilities can be separated from other companies in the group. They are taxed as **resident entities**, and local tax benefits are usually available.

In choosing between the two, the following aspects must be considered:

- In some cases, no choice is possible. Local rules mandate certain structures.
- If **subsidiary**, there are **≠ types** (e.g., joint-stock company, limited liability company).
- **Business/organizational issues:** costs, coordination, conditions to raise capital, etc.
- **Tax issues** (resident *vs* non-resident treatment).
- **Bankruptcy.**
- **Liability** of the parent for the obligations of the subsidiary.

LIABILITY OF THE PARENT FOR THE OBLIGATIONS OF THE SUBSIDIARY

Piercing the corporate veil doctrine → *Meaning:* Courts can disregard the typical corporate structure (i.e., corporation treated as a separate legal person) and hold the parent company (or individual shareholders) liable for the subsidiary's obligations. This happens when the **company is being used improperly** (e.g., fraud). [≠ theories for piercing the veil]

Alter ego theory: There is no proper separation between the owner and the business entity, so that the company is not its own entity but merely the *alter ego* of the owner.

Many indicators (e.g.): gross undercapitalization, nonpayment of dividends, mix of personal and business funds, operation out of the same facilities, failure to maintain minutes or adequate corporate records, confusion of records of the separate entities, sole ownership of all the stock in a corporation by one individual or the members of a family.

Single enterprise theory: The corporations are not operated as separate entities, but are so integrated as to constitute a single business enterprise.

Two requirements:

1. There is a **unity of interest and ownership** – the companies share resources, management, and operations – so that one corporation is a mere adjunct of the other *or* the two companies for a single enterprise.
2. It would be **unfair or inequitable** to let one company avoid liability just because it's a separate legal entity.

Note: alter-ego applies to parent-subsidiary, *single-enterprise* rule can be found between sister companies *(see CASE 8)*.

Agency theory *(see CASE 9):* Once company (like a subsidiary) acts as the **agent** of another (like the parent). If the parent company controls the actions of the subsidiary, it may be held responsible for the subsidiary's conduct.

Note: In **civil law systems** it is harder to pierce the veil because companies are required to have **minimum capital** and strict corporate formality. However, some countries have specific laws (e.g., Italy).

Note: In **international cases**, piercing may also allow a **foreign plaintiff to sue a parent company abroad** for jurisdiction purposes.

CASE 8: National Labor Relations Board (N.L.R.B.) v. Deena Artware et al. (1960)

Parties:

- NLRB – US government labor board (plaintiff).
- Deen Artware and Weiner – the business and its owner (respondents).

Facts and analysis:

- Deen Artware (a lamp company) broke labor laws by firing 66 workers who went on strike.
- NLRB ordered Artware to give them their jobs back and pay them.
- Artware agreed but then **closed the plant**, didn't reopen, and **never paid the employees**. Artware didn't pay the workers even after the court ordered it.
- **Weiner** was the main person behind the company. He set up a group of companies in a **corporate chain**:
  - At the top: **Deena Products** (based in Illinoi), which owned **other companies**, including Artware.
  - Weiner owned **almost all** of Deena Products.
  - His **family and secretary** were the officers and directors of all the companies.
- The structure suggested that Weiner used **multiple companies to limit liability**.
- The court allowed discovery (fact-finding) to explore if **Weiner or the parent company could be held liable**.

Takeaways:

- The **US Supreme Court** said that if a person or parent company **completely controls** a corporation, the company can be treated as the **agent** of that person or entity.
- In international cases, this means a **US subsidiary of a foreign company** could lead to **liability for the parent**, especially, if the parent has assets in the US.

CASE 9: *Choc V. Hudbay Minerals Inc. (2013)*

The plaintiffs and the lawsuit:

- The plaintiffs are members of the **Mayan Q'eqchi' community** in **El Estor, Guatemala**.
- They sued **Hudbay Minerals Inc.** (Canadian mining company) and its **two subsidiaries in Ontario, Canada**.
- They claimed **serious human rights abuses** (including shooting, killing, and gang rapes) happened during the **Fenix mining project** in Guatemala.
- Although the harm happened in Guatemala, they sued in Canada, arguing the **Canadian parent company was directly responsible** for what happened.

The defendants:

- **Hudbay Minerlas** is the Canadian parent company.
- In 2008, it bought **Skye Resources**, which owned the Fenix mining project through its **Guatemala subsidiary, CGN**.
- They alleged abuse happened **between 2007-2009**. Hudbay sold the mine in **2011**.
- Hudbay argued the case should be thrown out because:
  - It's **legally separate** from its subsidiaries.
  - There was no **clear legal duty (negligence)** owed to the plaintiffs.

Analysis – Main legal questions:

- **Piercing the corporate veil:**
  - Usually, companies are treated as separate entities.
  - To break that rule ("pierce the veil"), there must be **total control** by the parent *and* use of the company for **fraud or wrongdoing**.
  - Just saying Hudbay did something bad through its subsidiary is **not enough** to pierce the veil.
- **Agency:**
  - *Did the **subsidiary act on behalf of the parent**?*

    - Evidence showed **Hudbay had direct control** over security staff, including decisions and local relations.
- **Negligence by Hudbay:** Plaintiffs say Hudbay failed to stop the violence committed by its security personnel.
- **Novel duty of care (*Ann's test*):** To prove Hudbay owed a duty of care:
    - *Foreseeability:* Hudbay should have known there was a **high risk of violence** by untrained, armed security, especially with a history of conflict and poor justice in Guatemala.
    - *Proximity:* Hudbay made **public promises** to protect local communities and was directly involved in the project.
    - *Policy concerns:*
        - For plaintiffs: Victims of abuses by Canadian companies abroad should have **access to justice**.
        - For defendants: Danger of disrupting the rule that **companies are separate entities**.

Preliminary decisions: The court **rejected Hudbay's attempt to dismiss the case**. It said it was **possible** that Hudbay could be found liable, depending on the evidence.

Takeaways: **Parent companies are usually separate** from their subsidiaries *but* if the parent company **directly controls** the actions of a subsidiary *or* the **subsidiary acts as its agent**, then the **parent can be held responsible**. This case shows that **Canadian companies might face liability in Canada** for **harm caused abroad**, if the court finds enough controls and connections.

CREATION OF A BRANCH

A **branch** can carry out every activity included in the **business purpose of the parent company**.

The branch is included in the *concept* of **permanent establishment** → Described in **Section 5 of the OECD Model** in the field of double taxation, and taken up by *Art. 162 of the Italian Income Tax Code* as a **fixed business place** in which an enterprise carries out, wholly or in part, its activity.

A **branch office** is a business center which carries out its activities on the territory of a state ≠ from the one of its parent company. It carries out its activities on a continuous basis, in the interest and on behalf of the parent company. It appears an extension of the parent company itself.
The branch office of a company is characterized by:

- **Stability of establishment** – i.e., there must be a stable system dedicated to carrying out the activity of the enterprise.
- **Permanent representation** – i.e., a person responsible for carrying out the business activity must be identified; he's responsible for legal representation of the brand towards third parties → He has power to carry out business transactions and a certain degree of managing autonomy.

Branches are usually **subject to the laws of the State of establishment**, and they must comply with local corporate rules. Companies willing to establish abroad, must pay attention (for e.g.) to the *tax regime,* and *any administrative requirements*.

Creation of a branch – Italian perspective *(Italian legislation on foreign companies' branch)*

Art. 2508 of the Italian Civil Code requires the foreign company to comply with Italian law with regard to:

- Publicity of corporate records.
- Publicity of personal data of those called to permanently represent the company.
- Compliance with rules on the exercise of an enterprise.
- Exhibition in corporate correspondence of data indicated by *Art. 2250 of the Italian Civil Code*.

In any case, no prior verification of the legality of incorporation of the foreign parent company is provided, as the Italian domestic system can't interfere in foreign legal systems.

Art. 2509 of the Italian Civil Code provides that if a foreign company operates in Italy and doesn't follow company model that's similar to what the Italian Civil Code recognizes, Italian law applies certain rules to it. In particular, they will be subject to the rules of SpA (joint stock company) with regard to:

- The obligations related to the **filing of corporate records** with the Register of Companies.
- The **liability of directors**.

In case of non-compliance, *Art. 2509-bis* provides for the unlimited liability of those who act in the name of the company.

Creation of a subsidiary – Italian perspective

When a company creates a **subsidiary**, this new entity is considered a **separate legal entity** from its parent by which it is constituted. This means it is governed by the law of the destination country.

Art. 15 of Italian Law 218/1995 on Private International Law provides that:

- *Par. 1:* A company is generally governed by the law of the State of the country where it was incorporated (i.e., where it was legally created). *However*, if the **administrative seat is in Italy** *or* the company's **main business activity is in Italy**, **Italian law applies** – even if the company was incorporated elsewhere.
- *Par.* 2: In particular, the applicable law governs:
  - **Legal nature.**
  - Name or business name.
  - **Incorporation**, transformation or termination.
  - Capacity to act.
  - **Formation, powers and operating modalities of the corporate bodies.**
  - Entity representation.
  - Modalities of gaining and losing the quality of associate or member as well as the rights and obligations related to this quality.
  - Liability for the entity's obligations.
  - Consequences of violations of the law or of the articles of incorporation.

Hence, in dealing with the establishment of a subsidiary in a foreign country, the entrepreneur must bear in mind the applicable law in the State where he intends to settle. The choice of the place must be preceded by a series of considerations on the convenience of the applicable law. These considerations must consider in particular:

- The **minimum amount of capital required** for the incorporation and the **modalities** of the incorporation.
- The most convenient **type of company** based on the need of the enterprise and on the local company law.
- The **easiness of carrying out tasks** related to the management of the company.

In evaluating the place in which to incorporate the subsidiary, the entrepreneur should consider:

- The **most convenient legal type** of company.
- The **applicable company law** (in particular, regulatory rules).
- **Authorizations and permissions** needed for the activity as well as the **costs** for their obtainment.
- The **choice of the place** for the company's **seat**.
- The **initial amount of capital** and the possibility of contributions in kind or in cash.
- The possibility to incorporate a **single shareholder company** and possible consequences of this choice (restrictions and administrative requirements),
- Any **legislative terms for the payment of the company's capital**.
- Awareness of the **possible maximum terms of duration of the company** provided by local laws and regulations.
- Which **corporate bodies are required** by the foreign law for the type of company chosen and the modalities of appointment of them.
- **Tax regime.**

INCORPORATION *VS* REAL SEAT

The **incorporation theory** determines the applicable company law by reference to the country in which the company was incorporated (and registered). *Connecting factor:* The country of **incorporation**.

The **real seat theory** determines the applicable company law by reference to the country in which the company has its actual real seat (head office). *Connecting factor:* The **actual corporate seat**.

- The US apply only the incorporation test, and not the real seat test.
- The real seat doctrine was developed in France in the 19th century, and it was used in most continental countries.

ECJ Case-Law on Freedom of Establishment:

The following cases clarify how companies can operate across **EU MS**, based on ***Art. 49*** and ***Art. 54 of the TFEU***, which protect the **freedom of establishment**.

- Centros - C-212/97 (1999): A company legally incorporated in one EU country (MS B) can set up a **branch** in another EU country (MS A), even if it does **no business** in MS B.
- Überseering - C-208/00 (2002): A company incorporated in one MS A with **real seat in MS B** can sue in MS B and must be recognized even if not incorporated according to B's laws.
- Inspire Art - C-167-01 (2003): A company incorporated in MS A wanted to open a branch in MS B. MS B cannot impose its minimum capital requirements to a foreign company that has already fulfilled the rules of MS A ← A foreign company is subject to the company law of its **state of incorporation**.
- Sevic - C-411/03 (2005): **MS B can't deny merger of national corporation with corporation incorporated in MS A** because its legal system only regulates domestic mergers.

CASE 10: *Centros ECJ Case C-212/97 (1999)*

Facts:

- Two Danish nationals created *Centros Ltd* in the **UK**, where company law allowed **low capital requirements**.
- They then tried to open a **branch in Denmark** but did **all business** there and **none in the UK**.
- Denmark **refused to register** the branch, arguing that the setup was just to **avoid Denmark's stricter minimum capital rule** for limited companies.

*Legal issue: Can a MS (Denmark) **deny a branch registration** of a company legally incorporated in another MS (UK) **just because the founders wanted to avoid stricter national laws**?*

ECJ ruling:

- The Court ruled **in favor of Centros**.
- Said that the company was **exercising its right to freedom of establishment** under the **EU Treaty *(now TFEU, Art. 49)***.
- **Denmark's refusal was a restriction** on this freedom and therefore **not allowed** under EU law.
- It didn't matter that the founders wanted to **avoid Danish law**. What matters is that they legally formed a company in another EU country.

Key takeaways:

- **Freedom of establishment** lets EU citizens set up companies in any MS and operate across borders.
- A country **cannot block or discriminate** against a foreign company just because it's using more favorable foreign laws.
- Even if the **real business** is done in another country (Denmark), the legal form (UK company) must be respected.

LECTURE 10. AGENCY PROBLEMS: DIRECTORS AND SHAREHOLDERS

CORPORATE GOVERNANCE

Narrowly defined, it concerns powers, rights, and duties of ≠ corporate bodies and internal organizational structure of the corporation and its functioning.

Broadly defined, it concerns legal and economic instruments affecting the conduct of directors and shareholders.

OECD def. → **Corporate governance** is the system of rules, roles, and processes by which a company is directed and controlled, defining responsibilities among the board, management, shareholders, and stakeholders to ensure accountability and guide decision-making.

The separation of *ownership and control* creates a principal-agent problem, which corporate governance tries to constraint.

3 corporate governance models based on *3 pillars*:
- Shareholder meeting.
- BoD.
- Monitoring.

AGENCY PROBLEM: OVERVIEW

This problem occurs when a person (i.e., **principal**) engages another person (i.e., **agent**) to act on behalf of the principal, delegating some decision-making powers to the agent.

The *agency problem* refers to a **conflict of interest** between the two parties, where one of the agents is supposed to make decisions that will maximize the principal's wealth. The problem lies in **motivating the agent** to act in the **principal's best interest**.

MANAGERS AND SHAREHOLDERS

The managers-shareholders relationship:
- The advantages deriving from the separation of *ownership and control* (i.e., management) are partly equal to those of limited liability.
- The existence of a **hierarchical system of control** allows making decisions more quickly and efficiently.

What creates **divergence of interests**:
- **Managers** will try to **maximize their advantage** in terms of *remuneration, personal satisfaction, status, power or prestige* which don't necessarily coincide with the maximization of the company's value.
- **Managers** might **not devote as many efforts as possible** to their job, obtaining a non-pecuniary benefit in terms of relaxation or *"dolce vita"*.
- **Directors and shareholders** might have **≠ term perspectives** that might induce them in making selfish decisions.
- **Directors** might take **advantage** of a **business opportunity** to the **detriment** of the company.

The solution is to create an **alignment of interests** → Plan **institutional mechanisms** that align managers' incentives with investors' preferences *or* that are used to monitor agent's harmful conducts. **Time and resources** used to structure these mechanisms are called **agency costs**.

Interest pursued by directors

*What interests should directors pursue? Do they only have to consider **shareholders' interests** or should they also consider **other stakeholders** (creditors, employees, the community in general)?*

This question can have important implications and has been framed in Europe as the distinction between **2 ≠ views of the corporation**:

- **Contractual view:** The creation of value for shareholders is directors' primary obligation.
- **Institutional view:** Interest is not limited only to shareholders.

Legal Example: Dodge v. Ford Motor (1919) – US → The court directed Henry Ford to pay dividends rather than retaining the profits. *However,* this is a *unicum*; US courts usually don't interfere with decision concerning dividends.

An interesting middle ground (known as the **enlightened shareholder value**) can be found in the ***UK Companies Act*** *(2006)*: Directors must promote the **company's success for the benefit of shareholders**, **but** they must also **consider** other elements (e.g., long-term impact, employees' interests).

MECHANISM TO REDUCE AGENCY COSTS

The **market** is the most important mechanism to reduce agency costs through:

i. **"Change of control"** (e.g., take-over bid) of the company.
ii. Managers' **remuneration and reputation** and their resulting market value.
iii. Investors' **Investment decisions**.
iv. **Monitoring** by other stakeholders or reputational gatekeepers (e.g., banks, auditors, insurance companies).
v. **Competition.**

The **monitoring of the activities** (and obligations) of the agent is a necessary part of the agent-principal relationship. This can shape up as:

a. **Budgetary restrictions** to directors' activities.
b. Requirements for **external or internal audits**.

Problems concerning the monitoring of the activities:

- It's difficult to **decide *ex post facto*** if the company's performance is determined only by the managers' skills or by multiple external factors.
- The principal isn't always able to assess the **professionalism and commitment** of his agents.
- *Who oversees the monitoring activity:* The person who suffers the most from the manager's inefficiency is the most suited to exercise the ultimate control. This person is the company's owner.

Explicit or implicit contract → The commitments that the agent will make to ensure a diligent and faithful performance of his duties (**bonding**) can take the form of:

- *Implicit agreement:* The **manager's reputation** encourages the manager to fulfill his obligations in the best way possible.
- *Explicit agreement:* The **obligations** that the managers assumes, including regularly reporting the company's performance to shareholders and in general to comply with the applicable rules of corporate governance.

Another method to reduce the difference of interests is **stock options**. By turning him into a company shareholder, part of **business risk** is transferred to the agent.

- It should reduce the manager's temptations of adopting opportunistic behavior, because **maximizing the company's value** would have a **positive effect** on its wealth as well.
- *However*, they may create **asymmetrical incentives** if their implementation is structured as to make **excessive risks** appealing for managers.

Company law rules aimed at reducing agency costs are:

- **Substantial rules** which provide for managers and shareholders' *rights and obligations*.
- **Procedural rules** which have the purpose of enforcing substantial rules.

These rules may have **administrative** *or even* **criminal sanctions** *OR* they may be **general rules of conduct** (so-called standards; in particular, the directors' fiduciary duties vis-à-vis the company).

Italian company law to reduce agency costs:
- **Directors' duties** vis-à-vis the company *(See later).*
- Procedure for **controlling directors** such as:
  - **Approval of FS** by the shareholders' meeting.
  - If directors harm the company, even **minority shareholders** can **sue** them on behalf of the whole company.
  - **Statutory auditors** monitor directors' actions. If something is wrong, they can go to court.
  - **Shareholders' liability action** – i.e., shareholders themselves can bring a **direct legal action** against directors if they cause damage to the company.

Agency costs can be reduced through **ownership concentration**. As a consequence, agency costs are lower when the owner of a majority stake of shares is also actively involved in the company's management and can personally direct his managers.

Problems of ownership concentration:
- It often triggers a severe divergence of interests between majority and minority shareholders.
- Large shareholders may extract **private benefit out of control** to the detriment of the company.
- In the absence of a legal structure to protect small investors, an **excessive ownership concentration** might **discourage investment by the public**.

INSIDER AND OUTSIDER SHAREHOLDERS

The relationship between **insider** (i.e., the **controlling group**) and **outsider shareholders** is an **agency relationship**.

Where outsiders have better protection, this has positive effects on the company's value. If outsiders believe that insiders will act fairly and responsibly, they are more likely to be willing to **invest more capital**.

CORPORATE GOVERNANCE MODELS

The **one-tier, Anglo-Saxon** model
- The **general shareholders' meeting** appoints the BoD.
- The model is structured with a **single board** that has both **managerial and supervisory** functions.
  - Executives, non-executives, independent, affiliated, constituency.
- The **Management Control Committee** is appointed by the BoD among its members. **By-laws** can allow **shareholders** to appoint this committee among members of the BoD.
- The BoD forms within its structure also the *audit committee, remuneration committee, nomination committee, risk management committee.*
- The possibility of appointing a **sole director** is **excluded**.

The **two-tier, German** model
- **Stric separation** between *management* and *supervision* → Two separate boards.
  - The **management board** (at least 2 members) carries out the company's management.
  - The **supervisory board** monitors the actions taken by the management board.
- The **accounts** of the company are audited by an **external auditor**.

This model promotes accountability and protects shareholder and stakeholders' interests.

Mitbestimmung –German codetermination peculiarity: **Codetermination** *(mitbestimmung)* is a special feature of German corporate governance. It promotes **collaboration** by giving **employees a voice in major corporate decisions**.

Workers are **represented on the supervisory board**, where:
- They **elect up to half the board members**, depending on the company's size.
- These representatives sit alongside shareholders' representatives
- They help **oversee the management** and **influence decisions**.

The **traditional** model (Italian corporate governance)

- **Shareholders' general assembly** appoints the **BoD** (which manages the company) and a **board of statutory auditors** (which supervises the company's actions to ensure they comply with the law and the company's by-laws).
- The BoD appoints and controls **management**.
- By default, **accounts** must be **audited** by an **external auditor *or* auditing firm** enrolled in a special register kept by the Minister of Justice. *However,* if the company is not a public entity and isn't required to prepare consolidated financial statements, the **board of statutory auditors** can perform the audit.

STRUCTURE OF THE BoD

Directors appointed by minority shareholders

Some jurisdictions require or allow that **minority shareholders** appoint one or more directors to enhance representation and protect their interests.

Classified board

A board structure where there are ≠ share classes with **varying voting and economic rights**.

Example: dual-class structure → Class A & Class B shares.

- *Class A:* Often held by the general public. Typically come with limited voting rights or few votes per share.
- *Class B:* Usually held by founders, executives, or specific insiders. Typically carry enhanced voting rights, enabling these shareholders to retain greater control over the company.

Staggered Board

A board structure where directors are divided into classes serving **staggered terms** (i.e., with staggered election cycles – e.g., 2007, 2008, 2009), making it harder to change the full board in a single election. *Goal:* Prevent hostile takeovers or promote continuity.

Officers

Officers within a BoD include the company's executives appointed to run daily operations (e.g., CEO, CFO, COO).

Executive and outside or independent directors

Executive directors are the members of the board who are also involved in the company's management team, while independent or outside directors are not employees and provide oversight.

Committees

Boards typically delegate responsibilities to specific committees:

- *Executive* (for strategy and urgent matters).
- *Nominating* (board composition).
- *Audit* (financial oversight).
- *Compensation* (executive pay).

TYPICAL BoD COMPOSITION (except two-tier)

- **Senior managers**, with executive functions (CEO, CFO, COO).
- **Non-executive directors** (i.e., directors who are not currently part of the company's management), who bring their skills and experience to the board's discussion.
- All core jurisdictions now require that at least some non-executive directors have **independence requirements** with respect to the firm's management → They act as **monitors of managers or controlling shareholders** on behalf of other shareholders and non-shareholder constituencies.

LECTURE 11. FIDUCIARY DUTIES

OVERVIEW

Directors are the **agents** of the **corporation** and of the **shareholders**. As such, they owe *fiduciary duties* to their principals.

- Traditional distinction: *duty of care* and *duty of loyalty*.

Duty of care refers to the duty to **act diligently** in the best interest of the corporation.

Duty of loyalty includes ≠ aspects:
- Duty not to act in conflict of interest.
- Transactions with related parties.
- The so-called ***"business opportunity"*** doctrine → A director must **offer business opportunities** that he became aware of **to the corporation** before taking advantage of them personally.

Note: Some scholars and courts identify the **duty of good faith** (a middle ground between *care* and *loyalty*). Not necessary for our purposes.

CREDITORS

Creditors only have **contractual rights** towards the corporation.

Generally (especially in *common law*) directors **don't have** fiduciary duties towards creditors. However, when the corporation is close to insolvency (i.e., incapacity to repay its debts) (**zone of insolvency**), directors **can** have **fiduciary duties towards creditors**.

- In *common law,* the case law is not well settled and varies among jurisdictions.
- In *civil law,* specific statutory rules concerning liability of directors towards creditors exist, sometimes also independently from insolvency.
- However, these rules are rarely enforced outside bankruptcy.

DUTY OF CARE

The **duty of care** is the **duty of directors to manage the corporation diligently**.

Note (very important): Directors don't have an obligation of result, they only have an **obligation of means**.
- *Obligation of result* are performed only if a **specific result** is **achieved**.
- *Obligation of means* are performed simply by **being diligent** (even if a specific result expected is not achieved).

DIRECTORS' OBLIGATIONS

Directors must manage the corporation in **compliance with the law** and the **governing documents** of the corporation. They must **act diligently**.

The fact that the corporation doesn't achieve good economic results (or even that it becomes insolvent or bankrupt) is not automatically a source of liability.

The care required by directors is primarily **procedural care**. Therefore, directors are generally not liable if:
- They act on an informed basis.
- They devote sufficient time to their decisions.
- They acquire – when necessary – opinions from independent experts on a business decision.
- They make an honest error of judgment.

The emphasis is more on **the way** in which **a decision has been reached**, rather than on the merits or results of the decision. This is also because:

- In case of a lawsuit, judges are careful not to replace the director's decision with their opinion – because they are not business experts. Judges usually just check if the decision was made carefully and honestly, rather than judging whether it was a smart or profitable one.
- Some elements might have been unforeseeable when the decision was taken (so-called **hindsight bias**).

BREACH OF THE DUTY OF CARE

In circumstances when – based on all information collected – the **actual decision** was **completely irrational**, a breach of duty of care could be found.

Directors must follow the **standard of diligence** which means they must act how a prudent director would do in similar circumstances.

Therefore, the duty of care doesn't require directors to be particularly conservative. As long as the **risks** taken are properly **evaluated and balanced** by the **reasonable expectation of higher returns**, they have significant margin of maneuver.

- It is a vague standard.
- A more precise meaning can be given by case law.
- In many countries, directors are only held responsible in case of **gross negligence** (i.e., seriously careless).

OBJECTIVE OR SUBJECTIVE STANDARD?

If a director has specific knowledge in a certain filed – based on his education and past experience – would he be held to a higher standard than the "average director"? In some legal systems (e.g., Italy), the corporate statute provides that **all directors** are held to the standard of diligence of the **"average director"**, but specific additional competences are considered.

BUSINESS JUDGMENT RULE

It is **presumed** that, in carrying out their duties, directors acted:
- In **good faith**.
- On an **informed basis**.
- In the **best interest of the corporation**.

In case of dispute, it is up to the plaintiff to prove the contrary.

DUTY OF LOYALTY

A director **breaches** his duty of loyalty when he **acts in conflict of interest** with the corporation.

The classical notion of **conflict-of-interest** concerns situations in which there is a **zero-sum game** between the director and the corporation – i.e., when a gain of the director implies a loss or a lower gain for the corporation.

There are **three regulatory strategies** to address conflicts of interest of directors:
1. All conflicted transactions might simply be **prohibited**.
    - Risk of missing good business opportunities. *Note:* Directors often have more knowledge about the company's assets than outsiders, so they may be in a better position to make a good deal.
2. Conflicted transactions might **not** be **regulated at all**.
3. A middle ground strategy is to require that the **decision** is **taken with some procedural protections**.
    - This is the usual regulatory strategy.
    - *Example: Delaware General Corporation Law (section 144)* → Conflicted transactions are not automatically invalid if:

1. The decision was approved by **uninterested, fully informed directors**.
   OR
2. The decision was approved in good faith by **fully informed shareholders**.
   OR
3. The **transaction is "fair" to the corporation** at the time of approval by the BoD or shareholders.

The concept of **fairness** isn't easy to define, but clearly it might include **fair dealing** and **fair price**. However, the mere fact that the corporation paid a *fair price* might not be sufficient to cure the transaction [*Example:* Purchasing some goods at a fair price when the corporation doesn't need those goods].

In most systems, even if **procedural protections are not followed**, there should be **no liability if the transaction was fair** to the corporation.

- However, in these cases, sometimes directors could be required to give up any personal profits (i.e., **disgorgement**).

Whether **fairness alone** can "save" a conflicted transaction is debated.

- Some courts might accept *entire fairness* as a possible defense for directors against a claim based on a duty of loyalty.

LECTURE 12. SHAREHOLDERS' AGREEMENTS

Definition: Shareholders' agreements are **contracts** among some (or all) shareholders governing **their relationships** or the **exercise of their rights**. In some cases, the corporation itself is also a party to the agreement.

Main purposes:

- Set **limitations** to the free **transferability of shares**. (A)
- Establish **voting agreements**, governing how shareholders will exercise their voting rights. (B)

OVERVIEW

Shareholder's agreements constitute a **separate contract**, distinct from the articles of incorporation and the by-laws. However, most of the provisions contained in shareholders' agreement might be included in the articles or by-laws.

So, why are they into a separate contract?

- Shareholders might want to be bound only with some shareholders (not all).
- Shareholders might want to keep the agreement confidential (*note:* in some jurisdictions, disclosure is mandatory).
- Reasons concerning how the agreement can be modified or available remedies in case of breach.
- Tax reasons (in some jurisdictions).

LIMITATIONS ON THE FREE TRANSFERABILITY OF THE SHARES (A)

In theory, **corporate shares are freely transferable** (≠ in partnerships where the identity of partners really matters). So, you don't usually need permission to sell your shares in a corporation.

In practice, however, it is very important for shareholders (especially in **closely held corporation**) to know and trust the other shareholders – *intuitu personae* matters. That's why **restrictive stock transfer agreements** are used in closely held corporations.

Purposes:

- Ensure that the **shareholding structure** of the company either **remains unchanged** or, if it changes, a safe **exit strategy** is guaranteed to shareholders who don't like the change.
- Maintain the existing **balance of power** among shareholders.

Risks:

- Some shareholders may become **"prisoners" of the corporation** (that's why an exit strategy must often be made available).
- **Pyramid effect:** Some shareholders can control the corporation with a limited investment via shareholders' agreements and other structures, facilitating the extraction of private benefits from the corporation.

Examples of clauses that restrict free transferability

Right of first offer provisions: Before executing a transfer of shares to a third party, a shareholder must **offer the shares to fellow members** of the shareholders' agreement. These fellow members have a **call option** (i.e., an option to buy) these shares.

Two kinds:

- **Right of first option:** The option is exercised for a price calculated on a formula or for the same price the third party is willing to pay.
- **Right of first refusal:** The option is exercised for a pre-determined strike price.

Russian roulette: If a shareholder finds a potential buyer that wants to buy the shares, under request of other shareholders, he must purchase their shares at the same conditions that the buyer is willing to pay him.

Consent restraint provisions: Before transferring shares to a third party, the shareholder must have the consent or approval of other shareholders or corporate bodies.

Note: In several systems, completely discretionary restraints are disliked by courts, or appraisal rights (i.e., evaluation of shares and right to sell them) are mandated in case of prohibition to sell.

Limitations to certain possible buyers: A provision might limit the freedom to transfer shares only to individuals that meet certain requirements.

Absolute prohibition to transfer the shares (lock-up): Shareholders are not allowed to transfer their shares at all. However, courts and corporate law systems have **little tolerance** on these clauses (i.e., dislike total ban).

What is more common is to have **lock-up periods** (e.g., 3 or 5 years).

Drag-along: It is the obligation of a party (generally, the **minority shareholder**) to **sell** his shares **together** with the shares of another party (generally, the **majority shareholder**) to the **same buyer** identified by such other party and under the **same conditions**.

Purpose: **Facilitate the exit of the majority shareholder**, who can then reassure the buyer that he won't have to deal with minority shareholders, as they will sell their shares too.

Tag-along: If a party (generally, the **majority shareholder**) is about to **sell** his shares to a given buyer, the other party (generally, the **minority shareholder**) has the **right to "follow him"** and sell his shares to the **same buyer** under the **same condition**.

Therefore, the majority shareholder must make sure that the buyer is ready to buy not only his shares, but also those of the minority shareholder (similar to *Russian roulette*).

Purpose: **Grant an exit strategy to the minority shareholder**, at fair conditions.

Additional notes:

- It is possible to include a combination of these provisions in a shareholders' agreement.
- Overall: These agreements are to be determined under **contractual freedom**, but **unreasonable restraint to the free transferability of shares** is **not allowed**.
- There are some **balancing mandatory provisions** (to balance freedom and fairness):
    - **Maximum duration** of shareholders' agreements.
    - **Break-through provisions** in case of **hostile takeover**.
    - **Appraisal (or withdrawal) rights**.

CASE 11 (hypothetical): *The Jiminy Corporation*

Scenario:

- Ownership:
    - Cat: 55%
    - Pinocchio: 20%
    - Fox. 25%
- Concerns:
    - **Pinocchio** is worried that **Cat and Fox** might sell their shares to people he doesn't trust (**Stromboli and Lampwick**).
    - He wants to **prevent changes in ownership** that he can't control.
    - At the same time, **Cat and Fox need Pinocchio** to invest, so he has some leverage.

The draft clause (Pinocchio's proposal): "No stockholder shall sell to third parties without giving written notice to the company and other shareholders. In the next 15 days, the other shareholders can buy those shares in proportion to their holdings, on the same terms as the third-party offer".

Main issues with the draft:

1. *What type of transfers are covered?* The clause only mentions **sales**. It should **also include donations, barter, inheritance, or other transfers** (or people could use loopholes).
2. *Who are "third parties?* It's unclear whether sales **between Cat and Fox** would be allowed. Pinocchio may still want to be involved in those too.
3. *"Same conditions"* → *What if a **foolish buyer offers an unrealistic price**?* Solution: Ask for an **independent valuation** to set a fair price. Alternative: Use a **tag-along clause**, allowing Pinocchio to sell his shares under the same deal.

Validity and formality of the notice:

- The **notice of sale** should be **complete** and based on a **real binding offer** *AND* it should trigger the 15-day period **only upon receipt**.
- *Is **15 days enough** to decide and arrange purchase?* Maybe not – consider extending it.

What if Cat or Fox breach the clause? Remedies to consider:

- Include a **liquidated damages clause** (pre-agreed compensation).
- Add that a **breach causes irreparable harm**, making it easier to obtain an **injunction** (i.e., court order to stop the sale).

Location of the clause: shareholders' agreement vs by-laws

- If in **by-laws**:
  - In Italy, a sale that violates the by-laws is **not valid toward the company**.
  - Stronger protection for Pinocchio – the sale could be **blocked**.
- If in **shareholders' agreement**:
  - Violations can only lead to **damages**, not invalidate the sale.
- in the **US**:
  - Even if the restriction is in the by-laws, **third parties must be aware** of it for it to be binding.

Italian law: what's best?

- **Stronger protection** if the clause is in the **by-laws**.
- But attention: Cat and Fox can **easily amend the by-laws** due to their majority.
- Solution: Require a **supermajority** or give **Pinocchio veto power**.

Best practices for Pinocchio:

- Add **veto rights** on important decisions.
- Include **clear remedies** and **definitions** in any clause.
- Consider an **alternative structure**, like a **trust**, to control ownership more strictly.

VOTING AGREEMENTS (B)

Definition: Shareholders' agreements in which shareholders agree to **vote at the shareholders' meeting** of the corporation **in a certain way** and **following certain rules**.

- Three types: *consultation, unanimity, majority.*

Consultation agreements (not so intrusive): Shareholders only undertake to get together and consult one another before any occasion in which they must vote.

Unanimity agreements (fairly intrusive): Shareholders are bound to **vote** according to the **outcome of a "pre-vote"**, but only **if** they **all agreed on how to vote** at the upcoming meeting. Each member has the **right to veto** a shared and binding decision.

Example: A owns a 30% stake, B owns a 20% stake, C owns a 5% stake. If A, B and C agree to vote in favor of the merger, this decision is binding. They must attend the meeting and vote in favor (liability in case of breach). *But,* if even **one shareholder disagrees**, the others **cannot be forced** to vote in a certain way (i.e., free to attend or not the meeting and vote as they wish).

Majority agreements (very intrusive): The decision of the majority of the members of the agreement is binding also on the others.

Example: A owns a 30% stake, B owns a 20% stake, C owns a 5% stake. If A, decides to vote in favor of the merger, B and C must vote in favor too.

Therefore, there is an **alteration of proportionality** between economic interest and voting powers. Therefore, **higher agency costs**.

Majority agreements are generally valid, although subject to some **restrictions** (e.g., disclosure duties).

Why should B and C accept to enter such agreement? Many possible reasons:
- Family ties.
- Sale of shares to B and C might have been contingent on them entering into the agreement.
- Mutual interlocking understandings (B or C might be in the same position as A in other companies, with A being in the same position as B or C).

Additional notes:
1. Voting agreements are **rarely included in by-laws**, as they might violate mandatory corporate governance rules and are not binding for the corporation.
2. Voting agreements are **hardly effective *if not* coupled with restrictions to free transferability of shares**, otherwise they would be easily circumvented by selling the shares to a party not bound by the voting agreements.
- If a contracting party **breaches** a voting agreement, the **vote is nevertheless valid**. Other shareholders participating in the agreement may only claim for the damages suffered.
- The **breach** of voting agreements can be **avoided** by using one (or more) of the following techniques:
    - Since damages are difficult to determine, a **liquidated damages clause** might be included in the agreement, which will operate as a deterrent for possible breaches.
    - Granting an **irrevocable mandate** to an **independent third party**.
    - Establishing a **voting trust** with **instructions** for the trustee to vote according to the agreement.
3. **Directors** must act in the company's best interest. So, it is questionable whether they can enter into voting agreements governing *how* they shall vote in the BoD meetings. They are expected to use their **independent judgment**.

DISCLOSURE AND DURATION OF SHAREHOLDERS' AGREEMENTS

International law aspects

Shareholders' agreements have an impact on the ownership structure of the corporation.
- *Voting agreements* foster separation of ownership and control.
- *Transfer restrictions* can freeze the ownership structure and make changes difficult.

Although they are dangerous to some extent, shareholders' agreements are not banned. Rather, **regulations** are generally enacted to **avoid pitfalls** → Typically, two kinds of restrictions are provided:
- **Mandatory disclosure** (for listed companies only).
- **Maximum duration.**

In **Italy**:
- Most stock transfer restrictions and voting agreements in listed corporations are **null and void *IF*** they are not disclosed to **Consob**, published in a **national newspaper** and filed with the **Companies' Register**. In case of failure to comply, voting rights cannot be exercised and the resolutions can be challenged also by Consob.
- Shareholders' agreements of listed companies must be **deposited** with the company and their existence must be **disclosed** at the beginning of each **shareholders' meeting**.
- **Duration cannot exceed 3** (listed) **or 5** (closely held) **years**, but it can be extended.

In **France**:

- Stock transfer restrictions (not the entire agreement) on listed shares amounting to 0.5% of the voting rights or more must be **submitted to AFM**. In case of failure to comply, the restrictions are ineffective.

In the **US**:

- Voting agreements shall have a term **not exceeding 10 years**.

In the UE, MS can adopt a **breakthrough provision** (under *Art. 11 of Directive 2004/25*) which **limits** the effects of **stock transfer restrictions** and of **voting agreements** when a **public offer is launched**.

- Estonia, Latvia, and Lithuania have mandated this rule, so most shareholders' agreements would remain binding also in case of a takeover bid.

Additional notes:

- **Choice of law:** In principle, shareholders' agreements may be governed by the law chosen by the parties. Absent any specific choice, the law that governs the corporation applies.
- **Choices of forum** (or arbitration clauses) are generally admissible, if they do not undermine the public policies of the country in which the decision will have to be enforced.

LECTURE 13. MERGERS

A **merger** is a **transaction** in which the **assets and liabilities** of a corporation (**A**) are **transferred** to another one (**B**).

This transaction:
- Doesn't affect pending relationships among shareholders of the merging companies.
- Doesn't affect the contractual relationships between the companies and third parties.
- ➔ The merged company takes upon itself all the **rights and obligations** and assumes all **pending relationships**.

Two types of mergers:
- *By absorption.*
- *By incorporation of a new company*.

MERGER BY ABSORPTION

Company **A ceases to exist**, and all its assets are **absorbed by company B**, which will distribute its shares to the shareholders of A so that they become shareholders of B in proportion to the value of assets A as compared to that of B.

As a result:
- **Assets and liabilities** of the absorbed company are **merged into the absorbing company**.
- The **share capital** of the absorbing company is **increased**, with newly issued shares to be given to the shareholders of the absorbed company.
- **Shares of the absorbed company are cancelled**, and its shareholders are given **newly issued shares** of the absorbing company in such a quantity that the relevant value equalizes the value of the shares of the absorbed company previously owned.

MERGER BY INCORPORATION OF A NEW COMPANY

Companies **A and B cease to exist** and there will be an **entirely new company** C. The new company will have **incorporated** all the assets of companies A and B, whose shareholders will become shareholders of C in proportion to the value of the assets of their respective companies.

THE MERGER PLAN

The managing bodies of all merging companies shall draft a **merger plan** in which the **basic features** of the **upcoming merger transaction** are outlined. The *aim of the plan* is to:
- **Formalize the agreements** reached on the methods and terms of the merger.
- **Set the content** of the merger and submit the approval of the shareholders' meetings.

The plan shall provide an indication of:
1. **Type, business name and registered address** of all companies participating to the merger.
2. **Deed of incorporation of the new company** or of the absorbing company, with all amendments deriving from the merger transaction.
3. **Exchange ratio of shares or quotas**, as well as the **amount of any cash balance payment**. The balance payment cannot exceed 10% of the nominal value of the assigned shares or quotas.
4. The **terms relating to allotment of the shares or quotas** of the new company or of the absorbing company.
5. The **date** since which the above-mentioned **shares or quotas** will participate in the company's profits. It is possible to postpone or anticipate the participation only for accounting purposes.
6. The **date** since which all **operations** by the merging companies will be ascribed to the financial statements of the new company or of the incorporating company.
7. **Particular treatments** reserved to special categories of shareholders or security holders, if so agreed.
8. **Particular rewards**, if any, offered to the persons in charge of the management of the participating companies.

Public disclosure of the merger plan

The **merger plan** shall be disclosed at least **30 days before the merger decision is put to vote** (unless shareholders or quota-holders unanimously waive such term) by way of:

1. **Submission to the Companies Register** where the companies participating in the merger have their registered office.
   OR
2. **Publication on the website** of the companies involved in the transaction.

Other documents to be disclosed

Assets and liabilities statement → The boards of the companies participating to the merger shall draw-up a statement of **assets** and **liabilities** of the companies, in compliance with the rules on yearly accounts.

The statement shall refer to a date **not earlier than 120 days prior to the date of submission or publication of the merger plan**.

The statement:

- Can be **replaced** by the **financial statements of the previous financial year**, where no more than 6 months have elapsed between the closing date of the financial statements and the date of submission (or online publication) of the merger plan.
- Can be **waived upon unanimous consent** of the shareholders and the holders of any other company's security that provides voting rights.

Management report → The managing bodies of each merging company shall draw-up a **management report** indicating:

- All **criteria** used to define the **exchange ratio**.
- All **issues** that they might have encountered in the process of defining such ratio.

This report is meant to illustrate the **merger plan** under a **legal and financial perspective**, particularly with respect to the exchange rate of shares/quotas.

Experts' report → One or more experts for each merging company, chosen among auditors or auditing companies, must draft a report on:

- The **consistency** of the **exchange ratio**.
- The **methods** adopted to calculate it.

The experts are **liable** for all **damages** caused to the merging companies (and their shareholders) and third parties in connection to the report.

MERGER RESOLUTION

The **approval** of the merger only occurs when the **shareholders' meeting of each company** involved in the merger **approves the relevant resolution**.

- In **partnerships**, the majority is calculated based on each shareholder's portion of participation in the profits of the company.
- In **companies limited by shares**, the resolution shall be passed by the extraordinary shareholders' meeting, and the relevant quorum will apply.
- In **companies limited by shares** involved in a **heterogeneous merger**, participating companies shall also apply the qualified majority quorums provided for in case of conversions.

The **verbal** of all shareholders' meeting must be **filed** within **30 days** from the date of the shareholders'' resolution.

Who can challenge a merger resolution:

- Creditors.

- Holders of bonds and convertible bonds, as long as the merger resolution was passed without their consent.

What is the timeframe for challenges

Mergers can be challenged **within 60 days from the date of filing of the shareholders' meeting verbal approving the transaction** at the Companies Register.

When **no company limited by shares participates** in the merger, the deadline is **30 days** from the date of filing.

Challenge is not allowed when:

- The creditors waive it.
- Those creditors who didn't give their consent have been paid.
- The amounts due to them have been deposited in a bank.
- The auditing firm which drafted the experts' report declares – under its own responsibility – that the assets and financial situation of the merging companies show that further guarantees for protection of the creditors are not necessary.

THE MERGER DEED

Only after a **60-day period** from the filing at the Companies Register has expired, and no formal challenge has been broughte by the creditors (or by the holders of convertible bonds), the **merger deed** can be stipulated, and the **merger becomes effective**.

→ The **parties can proceed to prepare the merger deed**, which is to be completed **no earlier than 2 months from the registration of the merger resolution** in the Companies Register.

The *merger deed:*

- Must **always be drafted in the form of a public deed** (i.e., before a notary public).
- In **merger by incorporation**, it also embodies the deed of incorporation of the new merged company.
- Must be **filed with the Companies Register of the place where the new (or incorporating) company has its registered office within 30 days from its drafting**, the notary public or by the managing persons of the incorporating or merged company.
- Upon filing of the merger deed in the Companies Register, the **surviving company will succeed** (by means of universal succession) **in all assets and liabilities belonging to the merging company** → Following the **registration of the merged deed**, the **validity** of the merger procedure **cannot longer be challenged**. Shareholders and creditors will be allowed only to ask for damages.

EXCHANGE RATIO

The **share-exchange ratio** is designed to give shareholders an asset with the **same relative value** of the asset they owned before the merger.

The ratio is calculated based on the **intrinsic value of the shares** – also deriving from the **underlying value of the company** – rather than the value of the shares resulting from the financial statements.

Example: Company B merges into A. The exchange ratio is 1 share of A every 3 shares of B → B's shareholders will receive 1 share of A in exchange for 3 shares of company B handed in.

FINANCIAL STATEMENTS AND MERGER

In the first financial statements drafted following the merger, **assets and liabilities should be entered at the same values they had in the financial documents issued on the day of the merger's execution** by the companies that have merged or have been incorporated.

The ***principle of financial continuity*** prohibits the super-evaluation of the balance sheet items of the companies participating in the merger, in accordance with the general principle whereby relations between the companies' shareholders don't suffer any interruption throughout the merger transaction.

SPECIAL TYPES OF MERGERS

Incorporation of wholly owned subsidiary (simplified procedure):

- The merger by absorption by a parent company of a wholly owned subsidiary doesn't result in the issuance of new shares or quotas by the absorbing company.
- All tasks relating to the issue of new shares have no reason to exist (e.g., exchange ratio).
- The companies are exempted from drafting the managing reports and the experts reports.

The deed of incorporation or the company's by-laws can provide that the **merger** by absorption of a wholly owned subsidiary may be **approved**, in the form of a public deed, **by the managing body** of each merging company, as long as:

- All companies satisfy the requirements relating to the merger plan and to its filing with the Companies Register (or online publication) within the above-mentioned term.
- The merger plan, together with the parent company's annual financial statements for the previous 3 financial years, is made available at its registered office (unless the shareholders unanimously waive this right).

Incorporation of 90%-owned subsidiary

When a parent company merges with an at least 90%-owned subsidiary, **no experts' report is required**.

The shareholders holding the remaining percentage of the target's share capital are entitled to have their own **shares acquired by the surviving company** for a consideration determined in accordance with the same criteria provided in case of withdrawal.

The articles of association or by-laws of the parent company may provide that the **merger** may be **approved**, by means of a public deed, directly **by its managing body**, as long as:

- The merger plan, together with a report of the managing body and the annual balance sheets for the previous 3 financial years, is deposited at the company's registered offices (unless the shareholders unanimously waive such right).
- The parent company files the merger plan with the Companies Register at least 1 month in advance of the subsidiary's shareholders' meeting called to approve the merger.

LECTURE 14. INTRODUCTION TO INTERNATIONAL LAW

LEGAL ENGLISH VOCABULARY:

- **Legal obligation:** A legal duty by which a person is bound to do or not to do a certain thing.
- **Legal right:** A right that is recognized by the law and can be carried out by the law if necessary.
- **To abide by something:** To follow a rule, decision, or instruction.
- **A breach:** A failure to follow a law or rule.
- **A claim:** (1) A demand for something due or believed to be due. (2) A right to something.
- **Party:**
  - Each of the sides involved in a legal dispute is a party to the case.
  - Each of the sides that concludes a contract is a party to the contract (i.e., contracting party).
  - In international law, a *high contracting party* is a state that has concluded an agreement by treaty.
- **Prescriptive** – i.e., relating to the imposition or enforcement of a rule or method. SYN: **binding**.
- **Substantive (law):** Law defining rights and duties (**≠ procedural** – i.e., giving the procedural rules by which those rights and duties are enforced).

INTERNATIONAL LAW AS A SUBJECT

Law is the idea that order is necessary to a **just and stable existence** → ***Public international law*** is a field of law **regulating States** in their **cross-border** interactions with each other's.

- International law is predominantly **made by States**.
- Law can only be made with their **consent**.

Is international law really law?

National Law (vertical system)	*International Law (horizontal system)*
- Recognized body to legislate. - Hierarchy of courts with compulsory jurisdiction to settle disputes over such laws. - Accepted system of enforcing those laws.	- No legislature. - No system of courts with compulsory jurisdiction to settle disputes. - No executive or governing authority. - **No identifiable institution to either establish rules or to clarify them or see that those who break them are punished.**

MAIN **FEATURES** OF INTERNATIONAL LAW

- **Absence of a single overarching authority.**
- It works quite well and is respected most times due to **mutual recognition, adherence to international agreements, and the need for cooperation** among states.
- It creates **rights and obligations** on *States*, but it also **grants limited rights** and **imposes limited duties** on *individuals*.

SOURCES OF INTERNATIONAL LAW

Art. 38.1 of the ***Statute of the International Court of Justice****:* The Court, whose function is to decide in accordance with international law on disputes that are submitted to it, shall apply:

a) **International conventions** (general or particular) establishing rules expressly recognized by the contesting States.
b) **International custom**, as evidence of a general practice accepted as law.
c) The **general principles of law** recognized by civilized nations.
d) [*supportive, not primary*] **Judicial decisions** and the **teachings** of the **most highly qualified legal scholars** of the various nations.

+ sources agreed upon in international agreements (parties may decide to apply specific rules).

SUBJECTS OF INTERNATIONAL LAW

- **States** – i.e., the **key legal persons** of international law. *(See the notion of 'State')*.
- **International organizations:**

    - Created by states through international agreement (*legal instrument*).
    - They have **limited competences** (i.e., only those specified by the agreement).
- **Non-state actors:**
    - Individuals (in international law, they have some rights and duties but no legal personality).
    - National liberation movements (with limited legal personality)

THE NOTION OF 'STATE'

Montevideo Convention, Art. 1: The **state** as a **person** of international law should possess:

a) A **permanent population**.
b) A **defined territory**.
c) **Government** – i.e., an organized political authority. The *form* doesn't matter, while its **effectiveness** (*internal face of sovereignty*) does – i.e., the exercise of effective governing power by an authority over a territorial community (≠ ownership).
d) Capacity to enter into **relations** with other states. Each state must have (formal) independence (*external face of sovereignty*) – i.e., the State has an independent legal system.

Formal vs actual independence:

- **Formal** independence means a state is **legally recognized** as independent **by international law**.
- **Actual** independence means a state has **real control** over its **own affairs**, without outside influence.

Microstates (YES): Tiny countries (e.g., Monaco), small in size and population, they are **recognized as independent states** even if they rely on bigger countries for defense or diplomacy.

Units within federal States (NO): Regions that have **local governments** but are **not fully sovereign**. They are **not considered independent states** under international law (e.g., California and Bavaria).

Puppet states (NO): Regions that **claim independence** but are actually **controlled by another country**. Although they have their **own government**, they **lack actual independence** and are **not widely recognized** as sovereign states.

Recognition by other States

- **Unilateral declaration** by a State.
- Consequences both on the **international level** and within **domestic law**.
- **Recognition** by other States allows participation in the international process.
- It is a **political judgment** (i.e., depends more upon political considerations than legal factors).
- Once recognition has occurred, it **cannot be denied** after.
- The **recognizing State** accepts the other as entitled to exercise all the **capacities of statehood in international law** (in the bilateral relations).
- The *"statehood status"* isn't necessary. A **state can exist without recognition** if it meets the *(four)* basic criteria, but recognition is crucial for **practical purposes** (e.g., trade, diplomacy, security).
- Premature "recognition": what is it? (intervention in the internal affairs of another State).
- When a country **recognizes a region** that has declared independence **before it meets the requirements of statehood**, we speak of **premature "recognition"**. This may be seen as **interference** in another country's **internal affairs**. It can cause diplomatic tension or violate international norms.

THE USE OF **FORCE** IN INTERNATIONAL LAW

In the past, **war** was the traditional instrument for settling disputes in international relations → Measures to limit the use of was:

- 1899, First Hague Peace Conference (European powers, States from Asia and Latin America).
- Treaties controlling the means of warfare (rather than the right to wage war).

- Convention on the Laws and Customs of War on Land – Rules for fair treatment in war.
- Convention on Pacific Settlement of Disputes – Promoted peaceful alternatives to war + Created the Permanent Court of Arbitration to settle disputes without violence.

Historical evolution: towards repudiation of war as instrument to settle disputes

- Covenant of the League of Nations (1919): Obligations for members to **resort to arbitration** in case of **dispute**. In no case it is possible to resort to **war** until **3 months** after the judgement (*cooling off period*).
- Kellog-Briand Pact (1928): For the first time, parties **condemn recourse to war** for settling international disputes.

UNITED NATIONS CHARTER

Art. 1 – Main **goal** of the UN: **maintain international peace and security**. To do this:
- Prevents and stops threats to peace.
- Stops acts of aggression.
- Encourages countries to settle dispute peacefully, using justice and international law.

Art. 2.4 – **General and absolute prohibition on the use of force** → UN member states must **not use or threaten to use force** in international relations.
- *Note:* It is limited to international relations of member states (i.e., doesn't address civil wars), but there are other articles of the UN Charter dealing with internal affairs.

The exception of **self-defense**

If a country is **attacked**, it has the **right to defend itself**.
- The **collective security system** is an agreement between states whereby an attack against one member is considered an attack against all, and state are collectively committed to respond in order to stop the aggression. This system is **regulated** through the **UN Security Council** which can authorize the use of force to stop aggressions.
- The five permanent members (P5) of the Security Council have **veto power**. This means they can **block action**, even if most countries agree (i.e., could be used to abuse smaller states). That's why the Charter still allows self-defense, so a country can protect itself even if the Security Council doesn't' act.

Art. 51 – If attacked, a state has automatic right to **individual *or* collective self-defense**.
- *Note:* The use of **force** is **allowed only** if under **attack**. Preventive attacks aren't justified.

Limits on Art. 51 self-defense: As just said, *Art. 51* allows self-defense if an armed attack occurs, *and Art. 2.4* prohibits the threat of use of force. *Can a state defend itself because it was **threatened**?* This is **controversial**. Some argue that if the threat is **immediate and pressing**, self-defense should be allowed before the actual attack happens.
- Consider also that, for small states, **waiting to be attacked** could mean **total destruction**.

That said, we must differentiate anticipatory *vs* pre-emptive self-defense:
- **Anticipatory** self-defense is a response to an **immediate and clear threat** – i.e., the attack is about to happen, there's **no time for diplomacy**.
- **Pre-emptive** self-defense is a response to a **non-immediate** (i.e., just suspected or possible) threat. This is **not accepted** under international law.

Conditions for a **lawful self-defense** (i.e., immediate and pressing threat):
- Alternative measures are impossible to apply.
- The force used is proportionate to the danger posed.
- Response is immediate to the offence.
- It is necessary to act.

- No punitive actions are allowed (e.g., temporary occupation is allowed, long-term occupation or annexation are not).

Rescue of nationals abroad

Rescue of nationals abroad refers to a situation in which a country uses **force in another state** (**without its permission**) to **save its own citizens** who are in danger.

Under **customary rule**, this is allowed **if**:
- The **host state cannot or don't want to protect** the foreign nationals.
- There is a **serious and immediate** danger of life-threatening harm.
- **Force** must be the weapon of **last resort** and must be **limited to what's necessary**.
- The rescuing state must **leave the territory** as soon as possible.

Self defense alliances

Art. 51 allows **individual and collective self-defense**.

NATO – Art. 5: An armed attack against a member may be seen as an armed attack against all members and gives the other members the **right** (not the obligation) to **act in defense of the attacked state**.

- Despite tensions, *Art. 5* was never used during the Cold War.
- It was **invoked for the first time** after **9/11 terrorist attack** on the US.

Humanitarian intervention

Humanitarian intervention refers to the **use of force** in the territory of another state for **humanitarian reasons**, to protect individuals' human rights in that state. [*Example:* NATO action against Serbia (Kosovo)].

- It isn't necessary to have a link between the acting state and the individuals in danger.
- There's an **alleged general right** to intervene in such cases, even without the Security Council's approval (*Note:* This is not clearly accepted in international law).
- It's a **highly controversial principle** and there is **no uniform state practice**, meaning there are no identified limits which could cause abuse of power by powerful countries.

Terrorism

Art. 2.4 prohibits the use of force by states in international relations, but it doesn't directly cover **non-state actors**.

If non-state actors act under effective control of another State, their actions can be **legally attributed to states**.

There are major challenges in **defining terrorism**, especially in distinguishing it from acts of resistance.
- Terrorist groups are **not states**, but they still use **violence across borders**.

Combatting terrorism: International treaties:
- **Prohibit specific acts of terrorism**, regardless of the motive.
- **Target support activities** related to terrorism – e.g., the *Convention for the Suppression of the Financing of Terrorism* prohibits providing or collecting funds to support terroristic acts.

After the **9/11 terrorist attack** on the US, the **UN Security Council** adopted **Resolution 1373 (2001)**:
- It imposed **binding obligations** on all UN members to **prevent and stop** terrorist financing and all other kind of support to terroristic acts.

At the same time, **Resolution 1368 (2001)** of the **UN Security Council** recognized the **right of self-defense** in response to terrorist attacks. However, using force against a state that harbors terrorists is

controversial. It is generally accepted **only if new attacks are imminent**, and the host state is **unwilling or unable to act**.

LECTURE 15. INTERNATIONALLY WRONGFUL ACTS AND THE LAW OF ECONOMIC SANCTIONS

WRONGFUL ACTS UNDER INTERNATIONAL LAW

Art. 2 of the ***Draft Articles on the Responsibility of States for International Wrongful Acts*** *(2001)* states that there is an internationally **wrongful act** of a state when conduct consisting of an **action or omission**:

a. Is **attributable to the state** under international law – *subjective element.*
   AND
b. Constitutes a **breach of an international obligation** of the state – *objective element.*

If another state is **harmed** by the wrongful act, **determination of injury** occurs, and the harmed state may take **countermeasures** (including economic sanctions).

SUBJECTIVE ELEMENT: *WHO DID WRONG?*

Art. 4 – **Conduct of organs of a state**.

1. The **conduct of any state organ** shall be considered an **act of that state** under international law, whatever power and position it holds.
2. An organ includes **any person or entity** which is **officially recognized** in accordance with the **internal law of the state**.

Examples of 'organs' of the state:

- Legislative, government, or judiciary **state bodies**.
- Central or local **administration**.
- Excess of **authority or contravention** of instruction.
- **Organs** placed at the **disposal of a state** by another state.
- ***De facto* organs** – i.e., not officially part of the government, but act under the control of the state.
- **Individuals, *if:***
  - If it **fails to prevent** harmful acts.
  - If it **acknowledges** the individuals' action.
  - If the person was performing a **public function** in exceptional situations.
  - If the person was an **insurgent**.
  - If the person **acted under direct instructions or directions** of the State.

Responsibility of state organs *vs* personal responsibility

Internationally, wrongful acts **are not attributable to individuals**. However, there are some exceptions:

- Genocide, war crimes, crimes against humanity and the crime of aggression → These cases fall under **personal responsibility**.

Individuals are held responsible under:

- The **International Criminal Court** – i.e., a permanent court that prosecutes individuals for the most serious crimes.
- **Ad-hoc Courts and Tribunals** – i.e., temporary courts created for specific conflicts or regions.

OBJECTIVE ELEMENT: *DOES THE ACT VIOLATE INTERNATIONAL LAW?*

There is a **breach** of an international obligation by a state when an act of that state is **not in conformity** with what is required by that obligation.

A state can also be **responsible for an act of another state** when:

- It **helps** another state commit a wrongful act *(Art. 16)*.
- It **guides or controls** how another state commits the wrongful act *(Art. 17)*.
- It **forces** another state to do something illegal.

CIRCUMSTANCES PRECLUDING WRONGFULNESS

There are some **special situations** in which a State **does not incur international responsibility**, even if it technically violated an international obligation:

- If it has advanced **consent of the affected state**.
- If it acted for **self-defense** *(Art. 51)*.
- If a state takes **temporary, limited measures** (i.e., **lawful countermeasures**) that would otherwise be unlawful, to pressure another state to stop a prior violation.
- If the state cannot comply with the obligation due to **force majeure**.
- If the state acts due to **distress**.
- If the state acts for **necessity**.

THE **CONSEQUENCES** OF WRONGFUL ACTS

*Response of the **affected** state:*

- Countermeasures.
- International dispute resolution.
- Other possible measures.

*Obligations for the **wrongdoer** state:*

- Cease the wrongful conduct.
- Offer guarantees of non-reiteration.
- Provide reparation.

"SANCTIONS" IN UN LAW *(ART. 41)*

The article gives the **UN Security Council** the power to impose **non-military sanctions** when a state is **threatening or breaching international peace**.

- Economic sanctions, transport restrictions, communication cut-offs, diplomatic measures, etc.

Examples of economic sanctions under *ART. 41*

First-generation of sanctions (broad, total sanctions): South Rhodesia and Iraq.

- South Rhodesia → **Total embargo** (i.e., complete ban on trade, transport, and economic support).
- Iraq → **total embargo** with **explicit liability** for commercial party losses.

Second-generation of sanctions (more focused): South Africa, Yugoslavia, Iran, Libya.

- South Africa → Bans on arms, nuclear cooperation, and certain materials.
- Yugoslavia → Targeted arms embargo, restrictions in sports and aviation.
- Iran → Restrictions on nuclear-related materials, technical help, and freezing of private assets.
- Libya → Arms embargo, freezing assets of leaders, and a no-fly zone.

THE USE OF FORCE IN UN LAW *(ART. 42)*

The article allows the **UN Security Council** to authorize the **use of armed force** when **non-military measures** *(under Art. 41)* are **not enough** to maintain or restore international peace and security.

- Actions may include demonstrations (i.e., show of force), blockades, military operations, etc. These can involve **armed forces of UN Member States**, acting under UN authorization.

CATEGORIES OF SANCTIONS:

- **Full embargo** – i.e., a **total ban** on all *economic, trade, and diplomatic relations* with the target state.
- **Targeted sanctions** on arms and related goods, strategic goods, financial assets (state- or privately-owned), transports (from bans on flights to no-fly zones).

Efficacy *vs* human rights: The international community now prefers **targeted sanctions** to balance **effectiveness** with **respect for human rights**, especially after criticism of past full embargoes (which hurt the **civilian population** more than decision-makers).

STATE-ISSUED SANCTIONS

Legitimacy under national law: A state has **sovereignty** over its own policies. So, it can **internally impose sanctions** as long as they **comply with its own legal system**.

Legitimacy under international law: A state can impose sanctions at an international level **if**:
- It **has the right** to do so under international law.
- It **doesn't violate treaties or agreements** that prohibit such actions.

SANCTIONS: HOW AND WHEN THE **EU** ADOPTS **RESTRICTIVE MEASURES**

Restrictive measures or sanctions are an essential tool of the **EU's Common Foreign and Security Policy (CFSP)**. Sanctions seek to **influence the policy or conduct** of those targeted, with a view of promoting the objectives of the CFSP *(peace, security, human rights)*.

They can target:
- Governments of non-EU countries because of their policies.
- Entities (companies) supporting the targeted policies.
- Groups or organizations such as terrorist groups.
- Individuals supporting the targeted policies, etc.

CLASSIFICATION OF EU SANCTIONS

Aimed at specific policies, acts or situations: Sanctions are **preventive measures** which allow the EU to respond to political challenges and developments that go against its objectives and values. For instance, sanctions can target *terrorism, nuclear proliferation activities, human rights violations, annexation of foreign territory, deliberate destabilization of a sovereign country*.

Sanctions in a **broad sense** (or **diplomatic sanctions**) include actions such as the interruption of diplomatic relations with the targeted country, or the coordinated recall of diplomatic representatives of the EU and its member states.

Sanctions in a **narrow sense** require a **specific legal basis** in the EU Treaties, and include:

- **Arms embargoes.**
- **Restrictions on admission** of listed persons (i.e., travel ban). Targeted persons cannot enter the EU or travel beyond their member state of nationality if they are an EU citizen.
- **Freezing of assets** belonging to listed persons or entities. All their assets in the EU are frozen and EU persons and entities cannot make any funds available to those listed.
- **Economic sanctions** or restrictions concerning **specific sectors** of economic activity, including import or export bans on certain goods, etc.

EU *vs* UN mandated sanctions

- **EU autonomous sanctions:** The Council of the EU may impose sanctions on its **own initiative**.
- **EU sanctions based on UN initiative:** The EU implements all sanctions adopted by the UN Security Council and is involved in a **permanent dialogue with the UN** to better **coordinate EU member states' actions** on sanctions.
- **Mixed sanctions regimes:** The EU may also **reinforce UN sanctions** by applying additional measures to those imposed by the UN Security Council.

Example: EU restrictive measures against Russia over Ukraine (since 2014): The EU has adopted **six packages of sanctions** in response to Russia's attack against Ukraine. The measures are designed to:
- Weaken the Kremlin's ability to finance the war.
- Impose clear **economic and political costs on Russia**'s political elite responsible for the invasion.

The measures include individual and economic sanctions, restrictions on media, diplomatic measures, and restrictions on economic relations with the non-government-controlled areas of Donetsk and Luhansk.

Restrictions are applied also in other sectors:

- *Energy* – Including bans on exporting oil refining technology, investing in the Russian energy sector, and importing coal.
- *Transport* – Including closing its airspace to Russian aircraft and banning exports of aviation, space, maritime, and radio communication technologies.
- *Defense:* Ban on exports to Russia of dual-use goods, military technology, and arms.
- *Metallurgical industry:* Prohibition of exports of iron and steel products.
- *Luxury goods:* Ban on exports of luxury goods to Russia.

The EU has also adopted sanctions against **Belarus** in response to its involvement in the invasion.

LECTURE 16. INTERNATIONAL TRADE AND THE WTO: MAIN FEATURES, INSTITUTIONAL ASPECTS AND DISPUTE SETTLEMENT

TRADE WARS THEN AND NOW: *SMOOT-HAWLEY ALL OVER AGAIN?*

The **revival of protectionism** started by **Trump** in 2017 and 2025 has been accompanied by warnings of repetition of the **30s** (full scale **trade war**).

Examples of protectionist measures adopted in the 30s:

Trade	*Monetary Sector*
- High tariff on imports. - Quotas. - Discrimination of imported products based on their origin. - State subsidies to domestic production and exports - Discriminatory internal taxes on imported products. - Economic sanctions (antidumping, ban to import of some products).	- Competitive devaluation of currencies. - No convertibility of domestic currency. - Limitation to capital movement. - Expropriation of foreign properties. - Discriminatory exchange rates.

Similarities and differences between the 30s and current trends:

Similarities	*Differences*
- **Jobs** are the motivation. - Both episodes started during **economic expansion**. - Protectionist measures followed by **retaliation** (i.e., responses) by other governments.	- **Import tariffs** were much **higher in the 30s**. - Today, **non-tariff barriers** are **more relevant**. - World trade is now characterized by **international value chain**.

Consequences of the 30s trade war

America's trading partners reacted with tariffs on US exports, after the **Smoot-Hawley Tariff Act** of the **30s**, which imposed high **tariffs** on roughly 20,000 imported goods. Consequently, US exports fell by 61% from 1929 to 1933. The tariffs were removed in 1934.

There is almost universal agreement that no one "won" the trade war.

The biggest losers, though, were **American and European consumers** deprived of choices in the marketplace and forced to pay higher prices for what was available.

- *Note:* In the 30s, a US trade war escalated into a real war.

From trade wars to WW2: Mercantilist policies > Trade retaliation > Politicization of trade policies > Trade wars as a political tool > (Trade-related) Nationalism.

Lessons learned

One of the key lessons learned from past economic conflicts and trade wars is that while **international law recognized states' sovereign rights**, this sovereignty allows countries to **act independently** in several areas **unless there is international cooperation**.

In absence of such cooperation, states are free to apply:
- Import duties and other restrictions on imports.
- ≠ domestic legislation among countries.
- Limitations on circulation of persons.
- Limitations on capital movements.
- Limitation on the protection of foreign property.

Without international cooperation, trade wars might result in:
- Obstacles to imports and promotion of exports.
- Management of currency exchange rate.

- Limitation of monetary transactions.
- Limitation on inflows of foreign service providers.
- Domestic legislation discriminatory to foreign products, services, investors.

After WW2 – Rebuilding confidence promoting cooperation and multilateralism

Bretton Woods institutions:
- **ITO** (International Trade Organization – Planned to manage international trade issues.
- **IMF** (International Monetary Fund) – Planned to manage international monetary issues.
- **World Bank** – Planned on reconstruction and development *and* post-de-colonization development.

Main principles:
- ***Multilateralism*** – Promoting **cooperation** among states.
- ***Neo-liberalism*** – Emphasizing **free markets and trade liberalization**.
- ***Non-discrimination*** – After the end of decolonization, special and differential treatment for **developing countries**.

The creation of an international organization is a complicated task: **the failure of ITO**

The **ITO** was an organization aimed at **regulating trade**. Its organs could enact **binding decisions**, operating on a **"one-head, one-vote"** voting system (i.e., every country had equal say, big or small).

The **US contested** this system → The **US Congress didn't ratify** the constitutive agreement of the ITO – i.e., it didn't want to be bound by decisions made by a global trade body where it had no extra voting power. Without the support of the US, the ITO **never came into force**.

After the failure, states feared that the absence of rules would have led to the same anarchy existing before WW2. As a consequence, **23 states** met in Geneva, took *Part IV* (**trade rules**) from the **ITO Chart** and **signed** it as an **autonomous treaty** → They called it the **GATT**.

GATT BETWEEN "DIPLOMACY" AND BINDING RULES

The GATT was born as a ***de facto* organization** (i.e., no formal international organization).
- No formal organs, no power to enforce decisions. **Decisions** were adopted by ***consensus***.

Main principles:
- **Non-discrimination.**
- **Agreed cap** to import tariffs.
- **Periodic meetings and negotiations** between states for the reduction of **trade barriers** (Rounds).
- **Prohibition of quantitative restrictions** (with some exceptions).
- Rules aimed at **controlling** certain **trade policy instruments** of states (e.g., antidumping, public subsidies).

The 70s: GATT getting "old". The oil and economic crisis

The **oil and economic crisis** caused **instability**. Countries faced high inflation, unemployment, and slow growth. As a reaction, GATT members:
- Turned to **new protectionism**. Tools included dumping, subsidies, trade countermeasures, etc.
- The **GATT** couldn't **only partially limit** members' protectionist behavior. *Why?*
    - Rules sometimes weren't precise and easy to circumvent.
    - It was an inadequate system for settling disputes (based on "positive consensus").
    - There was no institutional framework (*remember: de facto* organization).
    - Fragmentation of the GATT legal system.
    - It was never formally ratified as a full treaty and countries were allowed to keep their old trade-restrictive laws ('grandfather clause').
    - No direct effect of its rules in national legal orders.
    - Rules were limited to trade in goods.

The danger was a reoccurrence of the trade wars of the 30s.

As a counter-reaction, countries pursued **regional trade arrangements** and pushed to strengthening the **multilateral system** for the regulation of **international trade**.

THE WTO

HOW **WTO** IMPROVED THE GATT-SYSTEM:

- Rules **more precise** and more **difficult to circumvent**.
- Improvement of the **dispute settlement system** (e.g., introduction of the "negative consensus").
- WTO is an **international organization** (new **institutional framework**).
- Fragmentation has been eliminated through the application of a 'single undertaking rule'.
- WTO agreement has been **signed and ratified as a treaty** (and not as a provisional protocol).
- **Extension** of the multilateral rules to trade in **services**.
- New rules on the protection of **IP rights**.
- New agreement for textiles and clothing sector and for agriculture.

Remaining issues: WTO rules have **not direct effect within the national legal systems**.

WTO **OBJECTIVES**:

1. Increase of **standards of living**.
2. Achievement of **full employment**.
3. Growth of **real income** and **effective demand**.
4. Expansion of **production** of, and **trade** in, goods and services.

WTO BROAD **FUNCTIONS**:

- Facilitate the **implementation** of **WTO agreements**.
- Provide a **forum for negotiation**.
- Administer the **Trade Policy Review Mechanism** (TPRM).
- **Cooperate** with other **international organizations**.
- Provide **technical assistance** to **developing countries**.

LEGAL INSTRUMENTS OF THE WTO:

- **Uruguay agreements** (Final Act) – A package of results from the Uruguay Round of negotiations which led to the creation of the WTO and its rulebook.
- **Marrakesh Agreement** – The **foundation treaty** of the WTO.
    - *Annex 1A GATT* covers **trade in goods**. It includes 6 understandings and 12 other agreements.
    - *Annex 1B GATS* covers **trade in services**.
    - *Annex 1C TRIPS* covers **IP rights**.
    - *Annex 2 DSU* sets out the **rules for resolving trade disputes** between WTO members.
    - *Annex 3 TPRM* sets out a system for regularly reviewing WTO members' trade policies and practices for **transparency**.
    - *Annex 4 Plurilateral Agreement* – i.e., optional agreements.
- **Uruguay Ministerial Decisions and Declarations** – Political declarations and specific commitments made by countries at the end of the Uruguay Round.
- **Understanding on Commitments in Financial Services** – A separate agreement detailing specific rules for financial services.
- **Countries' schedules of commitments** – Each WTO member lists its **market access commitments**.
- **GATT 1947** – i.e., the original GATT still used for historical reference and some provisions carried into WTO law.
- **Post-1994 legal instruments**, including new agreements and legal texts created **after the WTO was established** (e.g., accession protocols).

WTO **INSTITUTIONAL ASPECTS**

- **Director General** (top administrator of the WTO; acts as spokesperson and facilitator).
- **Ministerial Conference** (decides on the development of the WTO).
  - Meets once every 2 years.
- **General Council** (**executive body**).
- **WTO Secretariat** (permanent staff in Geneva providing general support).

WTO **MEMBERSHIP**

The WTO counts **164 members**, comprising:
- Many **developing** and **least developed** countries.
  - For these, special and differential treatment is provided in the WTO agreements.
- **States** and separate **customs territories**.

In the EU, both the EU and its member states are members of the WTO.

There are 2 ways to become a member:
1. **Contracting parties to the GATT 1947** would become **original WTO members**.
2. A state or a separate customs territory may **negotiate accession** (a long process).

WTO members must ensure that their laws, regulations and administrative procedures **comply with obligations under the WTO agreements**, but they can:
- **Opt out** of the application of WTO rules with respect to another member.
  AND
- **Unilaterally withdraw** from the organization.

WTO: **DECISION MAKING** PROCESS

Art. IX:1 → Decisions at the WTO are **first** taken by ***consensus***.
- In practice, WTO decisions are taken almost exclusively by *consensus*.

When a decision cannot be taken by *consensus*, it is taken by **voting**:
- One state, one vote.
- Expect for the EU (i.e., vote as a block, not per individual member state).

Economic and business impact:
- Countries are **integrated in world trade**.
- **Liberalization and competition** can promote both economic efficiency and societal values.
- Businesses gain **equal opportunity to compete internationally**.

WTO: **DISPUTE SETTLEMENT SYSTEM**

- It is the **most active dispute settlement system** between states in international law.
- A system known also by the public.
- Based on experience under the GATT 1947.
- Established with and based on the **Dispute Settlement Understanding (DSU)**.
- It serves to **preserve rights and obligations** of the parties under the WTO agreements.
- The main goal is encouraging **mutually agreed solutions** through **consultation and negotiations**.
- Avoids unilateral actions and **promotes multilateral procedures**.
- **No judicial activism** – i.e., rights and obligations of the members cannot be added or diminished.
- The dispute settlement **jurisdiction** is **compulsory** and covers all disputes under all covered agreements.
- Only **WTO members** can bring a dispute (no civil society, companies, etc.).
- The **dispute settlement body (DSB)** procedure involves *consultations, panel, and appellate body*.

Economic and business impact:
- **Legal certainty** for countries and businesses on international trade rules.
- **More law and less politics** in trade relations.

LECTURE 17. PRINCIPLES APPLYING TO INTERNATIONAL TRADE (MOST-FAVORED NATION AND NATIONAL TREATMENT)

DISCRIMINATION IN INTERNATIONAL TRADE

Economic and political considerations:

- State A might prefer to have privileged trade relations with State B rather than with State C because of political alliances, economic advantages, or historical and cultural ties.
- A State would want to discriminate against another granting advantage to its own products to protect its economy, promote local industries, or as political relation.

PROHIBITION OF DISCRIMINATION

The **most-favored nation** treatment obligation generally prohibits discrimination among goods, services and service suppliers of ≠ foreign origin or with ≠ foreign destinations.

- A state **cannot favor** one foreign country over another.
- Countries must be **treated equally**.

The **national treatment** obligation generally prohibits discrimination among goods, services and service suppliers and domestic goods, services and service suppliers.

- A state **cannot treat its own goods or services better** than foreign ones.

MFN IN GATT 1994

Art. I has the fundamental purpose of ensuring **WTO members' equality of opportunity** to **export to**, or to **import from**, other WTO members. *It covers both de jure and de facto discrimination.*

To assess whether a measure imposed by a WTO member is consistent with *Art. I*, we must ask:

1. *Is the measures covered by Art. I?*
2. *Does the measure confer a trade advantage?*
3. *Are the relevant products 'like products'?*
4. *Is the advantage granted immediately and unconditionally to all like products concerned?*

Example: Spain tariff treatment of unroasted, non-decaffeinated coffee beans.

- Columbian mild (Arabica): 0%
- Other mild: 0%
- Unwashed Arabica: 7% ad valorem (Brazil)
- Robust: 7% ad valorem
- Other: 7% ad valorem.

- *Equality of opportunity to compete?* ≠ tariffs may **distort competition** between products form ≠ countries.
- *Likeness of coffee? Are all types of coffee 'like products'?* If yes, then applying ≠ tariffs **violates MFN treatment**.

Art. II:1 has the fundamental purpose of ensuring **WTO members quality of opportunity to supply services**, regardless of the origin or destination of the services, or the nationality of the service suppliers. *It covers both de jure and de facto discrimination.*

To assess whether a measure imposed by a WTO member is consistent with *Art. II*, we must ask:

1. *Is the measure covered by Art. II:1?*
2. *Are the relevant services or service suppliers 'like services' or 'like service suppliers'?*
3. *Are the services or service suppliers of all WTO Members immediately and unconditionally accorded treatment no less favorable than the like services or service suppliers of any other country?*

Art. III provides that **WTO members** treat **imported products**, once they have entered the **domestic markets**, **no less favorably than 'like' domestic** products so as not to afford protection to domestic production (**equality of competitive conditions**). *It covers both de jure and de facto discrimination*.

NATIONAL TREATMENT IN GATT 1994

The NT obligation concerns both:

- **Internal taxation** of like products and of directly competitive or substitutable products *(Art. III:2).*
  - *Art. III:2, 1st sentence:*
    - *Is the measure an internal tax directly or indirectly applied on the relevant products?*
    - *Are the imported and domestic products 'like products'?*
    - *Are the imported products taxed in excess of the domestic products?*
  - *Art. III:2, 2nd sentence:*
    - *Is the measure an internal tax directly or indirectly applied on the relevant products?*
    - *Are the imported and domestic products directly competitive or substitutable?*
    - *Are these products not similarly taxed?*
    - *Is the dissimilar taxation applied so as to afford protection to domestic production?*
- **Internal regulation** *(Art. III:4)*.
    - *Is the measure a law, regulation or requirement covered by Art. III:4?*
    - *Are the imported and domestic products 'like products'?*
    - *Are the relevant imported products accorded less favorable treatment than domestic products?*

It doesn't apply to:

- **Government procurement** measures *(Art. III:8(a)).*
- **Direct subsidies** to domestic producers *(Art. III:8(b)).*

NATIONAL TREATMENT IN GATS

Art. XVII GATS applies only to **measures affecting trade in services** to the extent that a WTO member has ***explicitly committed* to grant NT** in respect to the specific service sectors in their '**Schedule of Specific Commitments'** (i.e., ≠ *Art. III GATT – See above*).

Art. XVII:1 has the main purpose to **ensure equality of competitive opportunities** for like services and like-service suppliers of the WTO members. *It covers both de jure and de facto discrimination*.

To assess whether a measure imposed by a WTO member is consistent with *Art. XVII*, we must ask:

1. *Has the member made a commitment to provide national treatment with regard to the service sector and mode of supply at issue?*
2. *Is the measure at stake a measure by a member affecting trade in services?*
3. *Are the foreign and domestic services or service suppliers at stake 'like service' or 'like-service suppliers'?*
4. *Are the foreign services or service suppliers granted treatment no less favorable than domestic services or service suppliers?*

MFN & NT: ECONOMIC AND BUSINESS IMPACT:

- Promotion of **free and fair trade**, while preventing inefficiencies.
- MFN tariffs help **lower cost** of exports while providing more opportunities to grow for business.
- National companies enjoy **access to other members' markets on an equal footing** with other manufacturers or service suppliers producing 'like products/services'.

MFN RULE: PROBLEMS:

- **Free rider** problem (something for nothing) → Countries that **don't** make the **same level of trade concession** still benefit from **preferential access to markets** due to the MFN clause.
- **Disincentive** for strong traders → Countries with **strong economies or trade power** may be less motivated to make further trade concessions since others will also benefit.
  - Less incentive in creating *FTAs, RTAs, PTAs*, which often offer deeper trade commitments.

➔ As a result, much of world trade is not conducted on an MFN basis.

Result: Spaghetti Bowl Problem → It refers to the **complex web of overlapping trade agreements** that create confusion and inefficiencies in global trade.

CONCLUDING REMARKS:

- Trade in goods and services have a **≠ application** of the **non-discrimination principle**.

- The non-discrimination principle remains an important instrument to secure trade liberalization, and is embodied in virtually all trade agreements, both within and outside the WTO.
- The MFN and NT obligations stem also from other WTO agreements.

LECTURE 18. PRINCIPLES APPLYING TO INTERNATIONAL TRADE (RULES ON MARKET ACCESS)

MARKET ACCESS BARRIERS TO TRADE IN GOODS

Access for goods and services from other countries to the market of a WTO member is frequently restricted by **tariff barriers** (e.g., duties/charges) and **non-tariff barriers** (e.g., quantitative restrictions).

TARIFF BARRIERS

A **custom duty** or **tariff on imports** is a financial charge or tax on imported goods. They can be:
- ***Ad valorem*** – i.e., a percentage of the value of the imported product (e.g., 15% on each computer).
- **Specific** – i.e., based on a unit of quantity such as weight, length, area, volume or number of that product (e.g., $3,000 on each car).
- **Compound or mixed** – i.e., a combination of *ad valorem* and specific.

A WTO member's customs duties or tariffs imposed are set out in its **tariff** or **customs tariff**.

Customs duties are generally allowed but WTO members are called upon to **negotiate the reduction** of customs duties to **increase market access** of products.
- Negotiations have been successful in reducing the avg. customs duties of developed countries on industrial products.
- However, customs duties remain an important barrier to international trade:
  - Many developing countries still maintain relatively high customs duties.
  - Tariff peaks on sensitive products.
  - Tariff escalation.

Basic rules governing tariff negotiations:
- **MFN** treatment obligation under *Art. I GATT 1994*.
- The **principle of reciprocity and mutual advantage**.
- Under WTO law, the imposition of customs duties requires specific determinations of:
  - Proper classification of the imported good.
  - Customs value of the imported goods.
  - Origin of the imported goods.

The results of successful tariff negotiations are referred to as **tariff concessions** or **tariff bindings**. They are listed in each member's *Schedule of Concessions* or *Goods Schedule*.
- Each member must treat imports from other members no less favorable than what provided in its Goods Schedule *(Art. II:1(a) GATT 1994).*
- Once a product is listed in the Schedule, it **cannot be charged a higher tariff** than the one agreed upon *(Art. II:1(b) GATT 1994).*
- Tariff concessions can be **amended or withdrawn** *(Art. XXVIII GATT 1994)*.

Others and charges: Other duties and charges are **financial charges and taxes** on imported products.
- Import sub-charges.
- Security deposits.
- Customs fees.
- Foreign exchange fees and statistical taxes.

Art. II:1(b) sets that no other duties or charges may be imposed in excess of those already imposed at the **date of the Agreement** (15 April 1994) or the **date of accession** to the WTO *or* of those provided for in **mandatory legislation** in force on that date.

'Other duties and charges' **must be recorded** in each member's Goods Schedule at the dates mentioned above. Those not properly recorded or in excess are prohibited, with some exceptions:
- Border tax adjustment.
- WTO-consistent anti-dumping or countervailing duties.
- Fees or other charges commensurate with the costs of the services supplied.

Export → **Export duties** are financial charges on products due because of their exportation.
- Fell into disuse in the mid-19th century.
- However, their use has increased recently.

There are no WTO rules specifically regulating export duties. Therefore:
- General GATT obligations apply to export duties.
- Some WTO members have taken on additional obligations in their Accession Protocols.

NON-TARIFF BARRIERS

Quantitative restrictions (QRs) are measures that limit the quantity of a product that may be imported or exported. A QR may take the form of:
- **Quota**
- **General** import/export **restriction**.
- Another restriction on importation or exportation.

Art. IX:1 GATT 1994 broadly prohibits QRs, including both direct and *de facto* restrictions. Yet, it only covers measures limiting the quantity (no other restrictions – e.g., standards). Some exceptions are allowed.
- *Art. XIII* declares that if applied, QRs must be administered in a **non-discriminatory manner**.
- *Art. XIII:2* declares that if applied, QRs must **respect** certain **requirements**.
- QRs are usually administered through **import licensing procedures** (according to the *WTO Agreement on Import Licensing Procedures*).

Other non-tariff barriers to trade in goods:
- TBT and SPS measures.
- Lack of transparency in national legislation.
- Unfair and arbitrary application in national trade laws and regulations.
- Customs formalities and procedures.
- Government procurement rules and practices.
- Other measures or actions.

MARKET ACCESS BARRIERS TO TRADE IN SERVICES

Unlike trade in goods, trade-restrictive measures applied for trade in services applied **at the border** are **barely significant**. Conversely, barriers primarily result from **domestic regulations** that govern the production and consumption of services.

We distinguish:
- **Market access barriers** to trade in services.
- **Other barriers** to trade in services.

Trade in services modes:
- **Cross-border supply** → Service supplied from the territory of one country into another.
- **Consumption abroad** → The consumer travels to another country to receive the service.
- **Commercial presence** → A service provider establishes a business in another country to provide services locally.
- **Temporary movement of people** → Individuals (workers or professionals) from one country temporarily enter another country to provide services.

Regulations in services relate to **public policy**. The **Preamble of the GATS** explicitly recognizes the right of WTO members to regulate services within their territories to achieve national public policy objectives.

At the same time, *Art. XVI GATS* regulates on **market access barriers** to trade in services, providing an exhaustive list of market access barriers to trade in services → **5 QRs + 1 non-QR***:
- Limitations on the **number** of service **suppliers** that may be active in a specific market.
- Limitations on the **total value** of services **transactions**.
- Limitations on the **total number** of service **operations**.

- Limitations on the number of **natural persons** that may be employed by a service supplier or in a service sector.
- Limitations on the **participation of foreign capital** in enterprises supplying services.
- *Limitations on the supply of services to specific **forms of legal entity *or* joint venture**.

Art. XVI:2 GATS covers market access barriers restricting access to both **foreign** and **domestic** services and service suppliers. Whether a member may adopt or maintain market access barriers falling under this article with regard to a specific service sector depends on a members' *Service Schedule*.

- Current market access commitments for trade in services are not very far reaching.
- A member *Service Schedule* is annexed to the *GATS* and forms an integral part of it.
- Market access commitments for services can be modified or withdrawn.

Other barriers to trade in services → The *GATS* addresses also other barriers to trade in services:

- Transparency obligation.
- Reasonable, objective and impartial administration of measures of general application affecting trade in services regarding a member's specific commitments.
- Maintenance of objective and impartial procedures, whether judicial or administrative, which allow service suppliers to challenge administrative decisions affecting them.
- Licensing requirements.

Oversight of these rules is carried out by the **WTO Council for Trade in Services**.

ECONOMIC AND BUSINESS IMPACT

- Market access barriers **obstacle flows of international trade** in goods and services. Hence, countries have been putting efforts to reduce both tariff and non-tariff barriers.
- Barriers could **increase trade costs** through complicating the process to trade, making exports more expensive and/or less competitive in other members' markets.
- **GATT Rounds** were able to substantially **reduce tariff rates** for several product lines contributing to further **trade liberalization**.
- **Non-tariff barriers** are becoming **more prevalent**, while **tariff barriers** have been further **reduced** through other bilateral and regional trade agreements.

CONCLUDING REMARKS:

- Market access rules have ≠ application for trade in goods and services.
- Tariff barrier remains a lawful instrument for protectionism with respect to trade in goods, while non-tariff barriers have increasingly become an import tool to restrict both trade in goods and services.
- The WTO is taking extensive commitments for both trade in goods and services.

LECTURE 19. WTO AND ITS EXCEPTIONS. TRADE LIBERALIZATION *VS* SOCIETAL VALUES AND INTERESTS

How do WTO members justify the creation of barriers based on non-economic values (such as national security) and still comply with WTO rules?

GATT EXCEPTIONS

Exceptions allow WTO members to **deviate** from their WTO obligations, provided that they comply with certain conditions.

Among exceptions:
- **General exceptions.**
- **Security exceptions.**
- RTAs.
- Balance of payments.
- Waivers.
- Trade defense mechanisms (to remedy the situation of unfair competition or surge of imports).

Exceptions are necessary tools to balance trade and non-trade values.

GATT **GENERAL** EXCEPTIONS

Art. XX GATT allows countries to make exceptions to their trade obligations in certain specific situations, as long as these measures are not discriminatory or used as a restriction on international trade.

Examples of permitted exceptions include:
a. *Necessary* to protect public morals.
b. *Necessary* to protect human, animal, or plant life or health.
c. …
d. …
e. …
f. …
g. *Relating to* the conservation of exhaustible resources if such measures are made effective in conjunction with restrictions on domestic production or consumption.

Note: The article uses ≠ terms in its sub-paragraphs. In particular "necessary" and "related to". This is (1) *Is the measure necessary to achieve the intended objective?* And (2) *Is the measure related to the achievement of the objective?*

Nature of *Art. XX*
- **Defensive in nature:** It is a defense clause. It can only be invoked after a measure has been found to violate a GATT rule.
- **Balancing tool:** It seeks to balance countries' obligations under the GATT.

Application of *Art. XX*
It is applicable if a **two-tier test** is passed (both must be met):
- *Does the measure fall under an exception listed in Art. XX?*
- *Does the measure in question satisfy the requirements of Art. XX?*

Art. XX(g): conservation of exhaustible natural resources
- The **policy objective** pursued by the measure must be the **conservation of exhaustible natural resources**.
  - *"Conservation"* – i.e., preservation of the environment, especially of natural resources.
- The measure must **relate to** this policy **objective**.
  - Relationship between the means (i.e., the measure) and the end (i.e., the conservation of exhaustible natural resources) must be close.
  - The measure cannot be disproportionately wide in its scope.

- The measure must be **made effective "in conjunction with" restrictions on <u>domestic</u> production and consumption**.
    - The measure must work together with domestic restrictions which operate as well to conserve an exhaustible natural resource.
- The measure applies to both **foreign and domestic** products (i.e., no unfair discrimination).

CASE 12: *US-Shrimp (India, Malaysia, Pakistan and Thailand v. US)*

<u>Case summary:</u>
- Measure at issue: The US banned imports of shrimp from countries not using turtle-excluder devices (TEDs) to protect sea turtles.
- Complaints: India, Malaysia, Pakistan, Thailand.

<u>WTO legal questions:</u>
1. *Did the US violate Art. IX GATT (QRs)?* **Yes.** The US imposed a prohibited import ban, which qualifies as a quantitative restriction.
2. *Can the US justify this under Art. XX GATT? (See below).*

<u>Step 1: Paragraph (g) of Art. XX:</u> Is the measure provisionally justified under Art. XX(g)?
- Objective: Conservation of exhaustible natural resources (i.e., sea turtles? **Yes.**
- Relation between the measure and objective? **Yes.** There was a real and substantial relationship.
- In conjunction with domestic restrictions? **Yes.** US also required TEDs from its own domestic shrimpers.

Conclusion: The measure satisfies *Art. XX(g)*.

<u>Step 2: Chapeau of Art. XX:</u> Does the measure meet the general conditions (non-discrimination, no disguised restriction)? **No.** The US failed the chapeau test because:
- It applied the ban unilaterally and rigidly.
- It didn't give sufficient flexibility to ≠ conditions in exporting countries.
- It didn't pursue multilateral solutions before imposing the ban.

Conclusion: The measure was arbitrary/unjustifiable discrimination and disguised trade restriction.

<u>Final ruling:</u> The US measure wasn't justified under *Art. XX*. Although it aimed to protect the environment, the manner of its application violated the WTO rules.

<u>Lesson learned:</u> Even when pursuing legitimate policy goals (e.g., environmental protection), WTO members must apply measures fairly and cooperatively – not unilaterally.

GATT **SECURITY** EXCEPTIONS

This type of exceptions are found in *Art. XXI* and provide that a country is **not prevented** from taking actions it considers necessary to **protect its essential security interests**, especially when related to:
a. Nuclear materials.
b. Arms and military supplies.
c. Times of war or international emergencies.

Concerns: The phrase *'it considers necessary'* suggests a **self-judgement** clause (i.e., subjective language), giving states **discretion** on when to invoke the exception. However, **full deference** could **undermine the WTO system** by making obligations optional.

- **Self-judging *vs* objective determination:** WTO case law supports a **hybrid**. Members may judge their security interests, but **WTO panels can still review** the context and good faith.
- There is **some deference**, particularly on <u>what a member considers to be its essential security interests</u>, **but not unlimited**. Panels can assess whether the situation qualifies as an emergency and if the measure is taken in good faith and is proportionate.
- *Problem:* Key terms (i.e., <u>*emergency, war, essential security interests*</u>) are **not defined** in the GATT, leaving room for **interpretative disputes** and **potential abuse**.

- Lack of authoritative interpretations: Until recently, **WTO panels and the Appellate Body avoided** ruling on these issues.

The WTO must define a **delicate balance** between allowing legitimate national security measures and maintaining **trust in the rules-based trade system**.

Revival of security exceptions → *[Example]* CASE 13: *Ukraine v. Russia*

Facts:

- **Complainant:** Ukraine *vs* **Respondent:** Russia.
- **Issue:** Russia restricted transit of goods from Ukraine to Kazakhstan and Kyrgyzstan, allegedly violating *GATT Art. V:2* (freedom of transit).
- **Russia's defense:** Invoked *GATT Art. XXI(b)(iii)* → **Security exception** due to an "emergency in international relations".

Panel ruling (April 5, 2019):

- The Panel **rejected the idea** that *Art. XXI* is entirely self-judging. It **asserted its authority** to review security exceptions.
- **Russia's measures justified:**
  - A real "emergency in international relations" existed between Russia and Ukraine.
  - The measures were taken during this emergency.
  - Russia acted in good faith in designating and linking its essential security interests to the transit restrictions.

Legal reasoning of the Panel:

1. **Essential security interests** must be designated in **good faith**.
2. **Link between interests and measures.**
3. **Good faith requirement.**
4. **Plausibility test** → Measures must have a **minimum level of credibility** in how they relate to the stated security interest.

Conclusion: The Panel held that Russia's actions **met all four criteria**, and thus *Art. XXI(b)(iii)* was **validly invoked**. This case established that **security exceptions are reviewable by WTO panels**, but under strict conditions, such as *plausibility, linkage, and good faith*.

EU DEFENSE: PUBLIC MORALS

The EU can defend a trade-restrictive measure under ***Art. XX(a) GATT*** by claiming it is **necessary to protect public morals**.

Public morals are the standards of right and wrong conduct accepted by a community or nation.

- Each WTO member, including the EU, has **some freedom** to define and apply this concept.

LECTURE 20. TRADE REMEDIES (DUMPING & ANTI-DUMPING, SUBSIDIES AND COUNTERVAILING MEASURES, SAFEGUARD MEASURES)

DUMPING AND ANTI-DUMPING MEASURES

Dumping: Exporting a product to the market of another country at a **price less** than the ***normal value*** of that same product sold in the exporting country.

Anti-dumping measures: Action of the importing state, normally in the form of a *customs duty*, to offset an export at a dumped price considered harmful to the domestic industry.

Regulatory framework of antidumping within the WTO: The WTO **doesn't regulate dumping** (done by private entities) but **regulates anti-dumping** through *Art. VI GATT 1994* and the **Anti-Dumping Agreement**. The objective is **controlling the use** of anti-dumping measures used by states to **prevent protectionist measures**.

Art. VI GATT and Anti-Dumping Agreement: A WTO member can impose specific anti-dumping duty on imports from a particular source, in addition to import tariffs, when the **importing member** fulfills certain **substantive and procedural conditions**.

The importing country shall start an investigation to demonstrate 3 ≠ criteria:

1. The existence of a practice of **dumping**.
2. The existence of the **material injury** for the **domestic industry** producing the 'like product' that the importing country is suffering.
3. The **causal link** between the two (i.e., injury must be the consequence of the dumping practice).

DUMPING → Dumping exists when the **export price is less than the *normal value*** of that product.

Determination of ***'normal value'*** → Based on **domestic sales** transactions, it is defined as *the price of the product at issue in the ordinary course of trade* (i.e., regular sales) *when destined for consumption* (i.e., not for resale or export, but intended for use within the exporting country) *in the exporting country market*.

Note: Under certain circumstances, the **domestic price** of the product **can't be used** to determine the **normal value** because it **doesn't reflect market conditions**. This happens when:

- Sales are made below cost.
- No or too few domestic sales of the 'like product'.
- Indirect exports (i.e., the product is only exported and not sold domestically).
- Non-market economy (e.g., China) (i.e., domestic prices are not market-driven and are considered unreliable).

In this case, the export price should be based on the **transaction price** at which the product is sold to a **third country**. However, there may be **exceptions**:

- **No export price** for a given product.
- The transaction price at which the exporter sells may be **unreliable** because of an **association or a compensatory arrangement** between the exporter and the importer or a third party.

In case there is **no export price** (or not reliable), **importing authorities** shall use an **alternative method** to determine the export price:

- A **domestic price** of an appropriate **third country**.
- The **"constructed value"** of the product which is calculated based on the cost of production, plus selling, general, and administrative expenses, and profits.

In any case, according to ***Art. 2.4 ADA***, the **comparison** between *normal value* and *export price* must be **fair**, and adjustments must be made for factors affecting price comparability.

Margin of dumping can be positive or negative:

- **Positive:** Export price < normal value (dumping exists).
- **Negative:** Export price > normal value (no dumping exists).

INJURY TO THE DOMESTIC INDUSTRY

- *Who must be injured?* **Domestic industry** – i.e., all producers of the **'like product'** in the country *or* a group of producers whose **combined output is a major part** of the total domestic production.
- A 'like product' is an identical product or another which has characteristics closely resembling those of the product under consideration.
- Not all domestic producers are counted in injury analysis. We **exclude** producers who are **related** to the exporter or producers who are **importing** the dumped product themselves.

Three types of injury:

- **Material injury** to the domestic industry.
- **Threat of material injury** to the domestic industry.
    - Identified through the analysis of the increase rate of dumped imports, the capacity of the export, the likely effects of prices of dumped imports, and inventories.
- **Material retardation** of the establishment of a domestic industry.

Determination of the injury:

- The volume of dumped imports and their effect on prices in the domestic market for like products.
- The consequent impact of the dumped imports on domestic producers of the like products.

Causation

A **causal relationship** between the **dumped imports** and the **injury** to the domestic industry shall be established → The dumping must be a **genuine and substantial cause** of the injury.

PROCEDURAL MATTERS

Art. 1 ADA: Anti-dumping measures may only be applied after proper investigations that prove they are consistent to detailed rules. **If** after an anti-dumping investigation, the existence of dumping is established, a member may impose definitive anti-dumping duties that:

- May never exceed the margin of dumping.
- May be applied for counteracting injurious dumping.
- Must be terminated within five years after having been imposed.

SUBSIDIES

WTO AND SUBSIDIES: DEFINITION

Art. SCMA (Subsidies and Countervailing Measures Agreement): **Subsidy** is a **financial contribution by a government** or any public body within the territory of a member, which confers benefit to the recipient, who is better off than it would have been without this financial contribution.

- Direct transfer of funds (e.g., grants, loans).
- Government revenue that is otherwise due is foregone (e.g., tax exemption).
- Provision of goods and services other than general infrastructure below market price.

The *SCMA* covers only specific subsidies:

- *De jure* (i.e., explicitly limited by law to certain entities).
- *De facto* (i.e., law doesn't limit the subsidy, but in practice only a few actually benefit).
- Industry, enterprise or regional specificity (i.e., subsidy is only available for certain sectors, firms, or geographic areas).

PURPOSE OF SUBSIDIES

Governments use subsidies to:

- **Correct market failure** – i.e., act there were markets underprovide certain goods or services that are beneficial to society.

- **Promote social and economic objectives.**

Governments also impose "extra import taxes" (**countervailing duties**) on foreign products that benefit subsidies in their home country to **protect domestic industry**.

WHY IS THE WTO CONCERNED? The WTO is concerned about subsidies and countervailing duties because:

- Subsidies can give an unfair competitive advantage, **disrupting natural competition** in international markets.
- The WTO wants to ensure **fair competition** – i.e., avoid that unsubsidized goods find it impossible to compete with subsidized one.
- While meant to offset the effects of unfair subsidies, **countervailing duties are trade barriers**. The WTO aims to regulate their use to prevent abuse and maintain open trade.

CATEGORIES OF SUBSIDIES UNDER THE WTO

The *SCM Agreement* identifies three types of subsidies based on the criterion of **alleged harm**: *prohibited* (red light)*,* actionable (yellow light)*, non-actionable* (green light).

Prohibited subsidies *(Art. 3 SCMA)*

These are not allowed under any circumstances:

- **Export subsidies** (i.e., contingent to export performance).
- **Import substitution subsidies** (i.e., contingent on using domestic over imported goods).

If found, the WTO must recommend **immediate withdrawal** of the subsidy by the member.

Actionable subsidies *(Art. 5 SCMA)*

There are **not automatically illegal**, but **can be challenged** if they cause harm to another WTO member → Types of **adverse effects**:

- **Injury** to the domestic industry.
- **Nullification or impairment** of benefits (e.g., reduced market access).
- **Serious prejudice or threat** (i.e., unfair increase in market share or distortion of competition).

If found, the subsidizing member must either **remove the adverse effects** or **withdraw the subsidy**.

Non-actionable subsidies *(Art. 8 SCMA)*

Originally (until 1999) **allowed without risk of challenge**, these included:

- **R&D** subsidies.
- **Environmental protection** subsidies.
- Subsidies to **disadvantaged regions**.

From **2000**, these subsidies are **actionable** again and can be challenged if they cause adverse effects.

SAFEGUARD MEASURES

Safeguard measures are **"emergency" measures** applicable in the presence of increased imports of a particular product, where such imports have caused or threaten to cause serious injury to the importing member's domestic industry *(Art. 2 WTO Safeguard Agreement)*.

GENERAL PRINCIPLES:

- Regulated by *Art. XIX GATT 1994*.
- Can consist of **quantitative import restrictions** or of **duty increases** to higher than bound rates.
- Must be **temporary**.
- Can be imposed only when imports are found to cause or threaten **serious injury** to a competing domestic industry.
- Must be applied on a **non-selective basis** (**MFN**).
- Should be **progressively liberalized** while in effect.

- The member imposing the must (generally) **pay compensation** to the member whose trade is affected.

CONDITIONS FOR APPLICATION OF SAFEGUARD MEASURES *(Art. 2 Safeguard Agreement):*

- **Increased imports.**
- **Serious injury** (or threat) caused by such increased imports.
- The measure must be applied on an **MFN basis**.
- **Domestic industry is affected** → The producers of the 'like product' or directly competitive product operating within the territory of a member (or producers who collectively account for a major portion of the total domestic production) are affected.
- **Causation** → There must be a **causal link** between increased imports and serious injury. **If other factors** are also hurting the industry, their impact must be separated.
- **Need for investigation** conducted by competent authorities in accordance with established procedures provided by the agreement.
- **Procedural transparency** is required → Obligation to publish a detailed analysis of the case in form of a report presenting and explaining their findings on all pertinent issues.
- **Interested parties** must have a change to **present their views** and **respond to others' arguments** through public hearings or other appropriate procedures.
- **Definite safeguard measures** must be proportionate, justified, and fairly allocated among trading partners.

DURATION AND REVIEW OF MEASURES:

- Maximum duration: **4 years**.
- Can be extended with specific provisions – i.e., if it is found (through a new investigation) that its continuation is necessary to prevent or remedy serious injury, and only if evidence shows that the industry is adjusting.
- Initial period + extension must be in any case **<= 8 years**.
- Importing countries shall **progressively liberalize safeguards** in force for more than 1 year at regular intervals during the period of application.
- Measures in force for more than **3 years** are subject to **revision**.

COMPENSATION

When WTO members impose **safeguard measures**, it may **hurt exporters** from other members. To address this some **compensation obligations** exist.

The **importing member** applying the safeguard must maintain a **substantially equivalent level of trade concessions** for the affected exporting members. This means offering **trade benefits of similar value** to offset the impact of the safeguard measures.

Affected members can request **consultations** to agree on **mutually acceptable trade compensation**.

If no agreement is reached within 30 days, the affected member may **suspend equivalent trade benefits** it had previously granted to the importing country. This **retaliation** is allowed **unless** the **Council for Trade in Goods** disapproves it.

However, there are limitation on retaliation → Retaliation is **not allowed during the first 3 years** if the measure is based on an **absolute increase in imports** and it is in line with the **Agreement on Safeguards**.

TRADE REMEDIES AND DEVELOPING COUNTRIES

Developing countries are given **special and differential treatment** with respect to other members' safeguard measures.

They get **protection through a *de minimis* rule**: If their exports to a country is **very small**, they are exempt from that country's safeguard measures.

They also have **more flexibility** on using safeguards. They are granted an **extension of duration** (extra.2 years – i.e., total of 10 years) and **reapplication of measures**.

LECTURE 21. WTO AND REGIONAL TRADE AGREEMENTS. RULES OF ORIGIN

REGIONAL TRADE AGREEMENTS

RTAs are **binding trade agreements**.
- Between two or more countries.
- Countries of the same or ≠ geographical region.

The goal is achieving **enhanced trade liberalization** (goods and services) through a **reduction or elimination** of **tariffs and restrictions**.

RTA types:
- Free Trade Agreements (FTAs).
- Customs Unions (CUs).
- Partial Scope Agreements.
- Preferential Trade Agreements (with developing countries).

RTAs AND THE WTO: *A CLASH?*

RTAs award a more-preferential treatment to their participants; therefore they are **discriminatory** → *How can they co-exist with the WTO non-discrimination principle?*

The **GATT/WTO has adapted** to the need of a state to enter a RTAs.

WTO members are allowed to form RTAs, but only under **strict conditions**:
- RTAs must aim at achieving **closer integration of the economies** of the members involved.
- RTAs must **prevent** the creation of **stumbling blocks** and **favor the building blocks** (i.e., facilitate trade between the participants and not raise barriers to third parties).

However, the interpretation of these rules is controversial, often leading to disputes and inconsistency.

Relevant obligations to be respected by WTO members

Art. XXIV.5: When members create FTAs or CU the **duties (tariffs)** and other trade rules applied to **non-members** (i.e., countries outside the agreement) at the same time the agreement is formed must **not become higher or more restrictive** than before the agreement.

The **level of protection** (i.e., the overall trade barriers the group imposes on outsiders) should be compared based on an overall assessment of the **weighted average of tariffs** before the agreement and at its formation (ensuring no overall increase).

CU (Art. XXIV.8(a)): The CU is a **substitution of a single customs territory** for two or more separate customs territories.
- Within the CU, **duties and other trade restrictions are eliminated on substantially all trade between members**.
- The CU members must apply **substantially the same duties and other trade regulations to non-members** – meaning external trade policy is unified.

FTA (Art. XXIV.8(a)): An FTA is a group of two or more customs territories that agree to **eliminate duties and other trade restrictions on substantially all trade between them**. This elimination applies only to products originating within the FTA members' territories.

ENABLING CLAUSE

The **enabling clause** applies to RTAs involving **developing countries**.

Parties in such RTAs must **mutually reduce or eliminate tariffs**.

Unlike the rules of *GATT Art. XXIV*, this clause allows for a **simple reduction of tariffs**, not necessarily a full elimination. Moreover the phrase *"substantially all the trade"* doesn't appear in the enabling clause, meaning less strict liberalization requirements.

However, it's **unclear whether parties must also reduce or eliminate non-tariff measures** under such clause.

- This condition must be set by the WTO Ministerial Conference.
- There is ongoing debate over whether RTAs involving developing countries introduce discrimination through non-tariff measures, which could conflict with WTO principles.

GATS, *ART. V*

This article delas with **Economic Integration Agreements** in **services trade**.

Like GATT, *GATS Art. 2* members must teat all others equally (MFN). But *Art. V* allows **exceptions**. Countries can enter into agreements that **liberalize trade in services** between them, even if it means not applying the MFN.

These agreements, called Economic Integration Agreements, must:
- Help **trade flow more freely between the members** of the agreement.
- **Not increase overall barriers** to trade in services for outsiders.

MOTIVATIONS TO ENTER INTO RTAs:

Economic reasons	*Political* reasons
- Access to larger markets. - Increased integration. - Defensive necessity. - Lock out competition. - Lock in investment.	- Increase bargaining power. - Prevent backsliding on political and economic reforms. - Ensure or reward political support.
PROS	*CONS*
- Economies of scale - Laboratories for change. - Provide competition. - Attract FDI. - Allow countries to train negotiating skills.	- Strains negotiation capacity. - Dampens enthusiasms for multilateral negotiations. - Creates vested interests. - Labyrinthine rules of origine. - Trade and investment diversion. - Weakest countries are left out.

RULES OF ORIGIN

Rules of origin (RoO) determine where goods are considered to come from for customs purposes and they assist the administration of preferential regime (e.g., reduced tariffs).

There are two types of RoO:
1. **Preferential RoO** – Used in RTAs and PTAs to grant **trade benefits**.
2. **Non-preferential RoO** – Used for **general trade rules** like MFN tariffs or anti-dumping measures.

Both types are usually based on the same criteria: **value added** (i.e., how much processing was done in a country) and **specific processes** (i.e., certain manufacturing steps done locally).

However, there is **no global standard** or full harmonization of RoO. The WTO aimed to harmonize them by 1998, but it hasn't been fully achieved → There are ≠ non-preferential RoO in ≠ states (often used unilaterally).

Note: If RoO are **difficult to comply** with, they can actually **restrict the volume of trade**.

Functions of RoO in RTAs:

- Secure the **free circulation of goods** only to the products originating in the area.
- Particularly relevant in FTAs to **avoid the deflection** of trade.
- Particularly relevant for **investment purposes**.

Other functions of RoO

- Anti-dumping and countervailing duties.
- Managing of QRs.
- Securing the benefit of preferential treatment only to developing countries.
- Basis for the labelling of products.

CONCLUSIONS

- The popularity of RTAs has increased discrimination in world trade.
- With the creation of multiple layers of RTAs, a 'spaghetti-bowl' situation has arisen.
- RTAs facilitate trade among signatories.
- RoO have become more complex due to the popularity of RTAs.

LECTURE 22. THE PROTECTION OF FOREIGN INVESTMENT

EXAMPLE: THE SUEZ CANAL

The **Suez Canal case** is a classic example of the risks foreign investors face, especially **expropriation** – i.e., when a host country takes control of foreign-owned assets.

Built between 1854 and 1869, the Canal was largely controlled by other counties (as foreign investors).

In **1956**, Egypt's President **Nasser nationalized the Canal**, taking it from foreign shareholders but promising compensation. This sparked an international **crisis** due to *economic, pollical, and strategic tensions,* showing how exportation – even with compensation – can lead to conflict.

This case highlights the challenges in balancing a country's right to control its resources with the protection of foreign investments, a key issue in international investment law and FDI today.

FOREIGN INVESTMENT

FDI is one of the many ways of **doing business cross-border**. It is an **investment to acquire a lasting interest** (i.e., owns at least 10% of the voting power of the target company) in an enterprise operating in a **foreign economy** (≠ from investor's nationality).

WHY FOREIGN INVESTMENTS

As the world economy becomes more connected, companies seek to operate in multiple countries (**economic integration and rise of MNEs**).

- Key factors affecting the decision:
  - **Technology transfer** (especially if the host state doesn't ensure a sufficient enforcement of IP).
  - **High trade costs** associated with exporting (→ Decide to produce locally through FDI).
  - **Location of natural resources.**

Types of FDI:
- ***Brownfield*** (M&A with existing businesses in the host country).
- ***Greenfields*** (building new facilities or expanding existing ones from scratch in the host country).

THE PROTECTION OF FOREIGN INVESTMENTS UNDER CUSTOMARY INTERNATIONAL LAW

Many of the protections to foreign investor come from **customary international law** – i.e., general rules developed through the consistent practice of countries.

Each state has a **discretionary power** to admit (or not) the investor – i.e., a country has the right to decide whether to allow a foreign investor in or not. There is no legal obligation under international law to accept foreign investments. Moreover, foreign investors **don't atomically get the same treatment as domestic ones**. Countries are not required to give foreign companies national treatment.

However, even if countries can set their own rules, there is a **minimum standard of treatment** to comply with. Another important protection is that **against illegal expropriation** – i.e., when a government takes over a foreign investor's property.

CUSTOMARY MINIMUM STANDARD OF TREATMENT

The **customary minimum standard of treatment** is a rule in international law that protects foreign investors from very serious misconduct by the host state. This include **protection against illegal expropriation** and **grossly unfair or unjust behavior**.

Whether this standard changes over time (i.e., if it is **static or dynamic**) is still debated.

PROTECTION AGAINST ILLEGAL EXPROPRIATION

The **host state** has the **power to expropriate**. However, this power is subject to some **conditions**:
- **Non-discriminatory.**
- Must have a **public purpose**.
- Must grant prompt, adequate, and effective **compensation** (known as the ***Hull formula***).

These rules are based on a **bourgeois conception of property**, which emphasizes strong private property rights.

Note: This regime tends to **favor capital-exporting (Western) countries**.

THE CONTESTATION OF THE CUSTOMARY REGIME ON EXPROPRIATION

Background: Between 1945 and the 70s, many newly independent states, socialist countries, and some Latin America led to a wave of **expropriations**.

The UNGA (**UN General Assembly**) proposed a **new set of rules** (several Resolutions):
- Both **peoples and nations** have the **right** to exercise **permanent control** over natural resources.
- **Foreign capital** is governed by **international and national law**.
- Expropriation requires the **payment** of appropriate **compensation** (equivalent to the *Hull formula*).
- States can choose their **own economic and social systems**.
- **International economic cooperation** is aimed to **improve** the situation of **developing countries**.

THE 'BILATERAL INVESTMENT TREATY (COUNTER)-REVOLUTION'

After the wave of expropriations and the call for a **New International Economic Order** (**NIEO** – *Resolution 3201, 1974*), there was a strong **pushback** from **developed countries**. This shift is called **counter-revolution** in international investment law.

There was (and still is) an **economic divide** between **developed countries** (i.e., capital, ***investors***) and **developing countries** (i.e., capital recipient, ***hosts***).

Developed countries demanded **high standards of protection** for their investors abroad. The **goal** was to **promote and protect foreign investment**.

This led to the **"treatification"** of **international investment law** ← Shift from customary to **conventional international law +** establishment of the **ICSID** (International Centre for Settlement of Investment Disputes).

- The first **Bilateral Investment Treaty** (BIT) was signed in 1959 between Germany and Pakistan.
- As of today, there is a dense web of BITs (approx.. 3000).
- Many developing countries signed BITs – despite being supporters of the NIEO (ambiguous conduct). *Why?* To attract foreign investment.

THE 'GRAND BARGAIN' → **Developing states forgo** part of their **sovereignty** to get the benefits of increased flow of **foreign capital and technology** *vs* **Developed states** protect their companies **investing in developing countries**.

BITs (Bilateral Investment Treaty)

A **bilateral investment treaty** is an agreement between two countries that protects and promotes investments made by investors from one country in the other.

BITs: SCOPE OF APPLICATION

- Apply to both **physical** (i.e., individuals) and **juridical** (i.e., companies) **persons**.
- They have a **broad material scope**, covering many kinds of investment, typically including **FDIs** and **portfolio investments**.

The term **"investment"** generally includes:

a. **Movable or immovable property**, including mortgages and pledges.
b. **Shares, debentures, stock**, and other company interests.
c. **Claims to money or economic performances**, related to investments.
d. **IP rights** such as copyrights, patents, trademarks, etc.
e. **Business concessions** granted by law or contract, including rights to explore or exploit natural resources.

BITs – STANDARD OF TREATMENT: NON-DISCRIMINATION

National treatment: The **host state** must treat **foreign investors** the same way it treats its nationals.

- This treatment may apply pre- and post-establishment, depending on the BIT (e.g., pre and post in Canada and US, post in Europe).

MFN treatment: Investor/investment from a party shall be treated by the other party **no less favorably** than an investor/investment from any third country.

- This clause is used to 'import' more favorable provisions contained in a 'third-party' treaty.
- This treatment may apply pre- and post-establishment application.
- There are some **exceptions**.

BITs – STANDARD OF TREATMENT: FAIR AND EQUITABLE TREATMENT (FET)

FET is the most invoked provision, although it is vague and imprecise (extensive interpretation). **Arbitral case law** has interpreted FET to include:

- Denial of justice (unfair legal treatment).
- Protection of the investor's legitimate expectations (i.e., consistent behavior by the host state).
- Duty of transparency.
- Prohibition against arbitrary and discriminatory conducts.
- Protection from violence and harassment.

BITs – PROTECTION AGAINST ILLEGAL EXPROPRIATION

The host state's power to expropriate is subject to some conditions:

- It must serve a **public interest**.
- The procedure must be **fair** and **non-discriminatory**.
- The investor must receive prompt, adequate, and effective **compensation** for what is taken.

Indirect expropriation occurs when the government doesn't actually take physical possession of the property, but makes rules that hurt the investment, severely reducing its value.

Example: If State A bans a harmful chemical for environmental reasons, a foreign investor making that chemical might claim this ban ruins the value of his investment. He may argue this is an indirect expropriation because, although the government didn't take his property, the regulation effective harmed its value.

THE BACKLASH AGAINST INTERNATIONAL INVESTMENT LAW: CAUSES

- There is no clear proof that BITs increase FDI or help the host country develop.
- Emerging economies have started investing abroad, so even developed countries face investment claims now.
- Sometimes, investment laws limit a country's ability to regulate in its own interest.
- Because many big cases got attention, people started criticizing the system's problems more openly.

THE NEW TREATY-BASED REFORM

In response to the above-mentioned challenges, major players such as the US and Canada introduced Model BITs in 2004 that advocated a more balanced approach, giving greater regulatory capacity to the host state. The EU also adopted similar principles, while emerging economies like India and South Africa pushed for even stronger reforms.

These new treaties provide important innovations:

- Narrower scope of application.
- More precise standards of treatment, particularly the FET standard.
- Clearer definition of the notion of IE.
- Exceptions.

INVESTOR-STATE DISPUTE SETTLEMENT (ISDS)

An **investment dispute** is any dispute that arises from an investment made by a foreign investor. Parties to the disputes are **states** and **foreign investors**.

The legal basis for investment claims can come from:

- **Contractual arrangement** between the host state and the foreign investor.
- **Treaty** between the host state and the state of the investor (i.e., home state of the investor).

ISDS MECHANISMS (multiple forms for ISDS)

Traditional ISDS mechanisms	*Modern ISDS mechanisms*
- Going to **domestic courts** in the host country. - **Diplomatic protection** (the investor's home country steps in). - **Negotiations** between the investor and the host state. - **Inter-state arbitration** (i.e., home and host states).	**Investor-state arbitration** (i.e., directly between investor and host state). This arbitration can be: - **Ad hoc** (set up for a specific case). - **Institutional** (i.e., handled by established organizations like ICSID, UNCITRAL, etc.)

ISDS CRITICISM:

- **Regulatory chill** (governments may hesitate to pass new laws because they fear being sued by investors).
- The system is seen as to **favoring investors** over host countries.
- Lack of an **appeal system** (i.e., decisions can't be easily challenged or reviewed).
- **Fragmentation and inconsistency** (≠ cases sometimes get very ≠ interpretations – i.e., **diverging interpretation**).
- Lack of **transparency**.
- Lack of **judicial independence and impartiality**.
- Double hatting (of arbitrators) – i.e., some arbitrators act as judges in multiple cases, raising concerns about conflict of interest.

IMPACT AND PROSPECTIVE TRENDS

- International investment law has traditionally served the interests of capital-exporting countries and MNEs.
- The change in the direction of capital flows led to a change in the legal superstructure leading to a more balanced approach (*note:* the reform is still ongoing).

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