

# California Business Law PRACTITIONER

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**Babak Nikravesh** is an attorney in the San Francisco and Palo Alto offices of Jones Day, where his federal tax practice focuses mainly on cross-border transactions and international tax planning for foreign and domestic clients. He is a frequent public speaker and the author or co-author of numerous publications, including the leading BNA treatise, *U.S. Income Taxation of Foreign Governments, International Organizations, Central Banks and Their Employees*. He received his B.A. from the University of California, Berkeley, his J.D. from the UCLA School of Law, his LL.M. from the London School of Economics, and his M.A. from Stanford University.



**Daniel Zimmermann**, a partner in the Corporate and Transactional Department of WilmerHale, Palo Alto, advises emerging growth companies and technology startups on corporate and corporate finance matters and counsels venture capital firms and global venture and private equity funds in their portfolio investments. He is a member of the California and New York bars and the International Law Sections of the American and New York Bar Associations, and a former chair of the Executive Committee of the International Law Section of the State Bar of California. He received his First State Exam from Albert-Ludwigs-Universität, Freiburg im Breisgau, and his LL.M. from the University of California, Los Angeles.

## A Practical Guide to International Joint Ventures

Babak Nikravesh  
Daniel Zimmermann

### INTRODUCTION

An international joint venture is a collaboration among two or more persons to achieve some business objective outside the United States. The hallmark of a joint venture is flexibility, and there is no particular recipe for its creation. It can take a number of forms or, in the case of a contractual arrangement, none at all. It may be employed to achieve short- or long-term objectives, or both. It can be designed to endure for a specified term, until a specified event, or indefinitely (although, in practice, that seldom happens).

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#### CONTRIBUTING AUTHORS FOR THIS ISSUE

**Melissa L. Barshop**  
Gibson, Dunn & Crutcher

**Linda L. Curtis**  
Gibson, Dunn & Crutcher

**Jeff Dasteel**  
Dasteel Mediation-Arbitration

**Babak Nikravesh**  
Jones Day

**Daniel Zimmermann**  
Wilmer Cutler Pickering Hale and Dorr LLP

#### PUBLISHER EDITORS

Suzanne L. Weakley  
Editor-in-Chief  
CEB Attorney

Paul Green, CEB Editor

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If you would like to write an article on any of the topics listed above, please contact Suzanne L. Weakley, California Business Law Practitioner, 2100 Franklin St., Suite 500, Oakland, CA 94612 (510) 302-2171; Suzanne.Weakley@ceb.ucla.edu. We would also like to hear from you if you would like to submit an article on any other topic appropriate for this publication.

The motivation for counterparties to enter joint ventures can also vary, as can their intended roles in the conduct of the joint venture. In some cases, a counterparty may have limited involvement aside from the contribution of a critical local business license, concession, or contract. In other cases, both parties may be expected to contribute substantial resources to the enterprise, from cash and assets to personnel and know-how. In short, a joint venture can mean different things to different people, taking shape in accordance with those different expectations and purposes, and it is that inherent flexibility that makes joint venture arrangements so attractive, yet also so fraught with complexity.

This article aims to provide a practical and straightforward discussion of some of the legal issues that arise in negotiating, structuring, organizing, operating, and eventually terminating an international joint venture when at least one counterparty is a U.S. person. To that end, this article is divided into six parts. The first part looks at the process of negotiating, concluding, and executing an international joint venture agreement, with an emphasis on practical considerations for the joint venture lawyer. The second part addresses the structural considerations, including tax considerations, that go into deciding what form a joint venture should take. The third part identifies the issues arising in capitalizing and financing the enterprise. The fourth part focuses on the manner in which the joint venture operates and is controlled, and how operational and control disputes between the counterparties may be resolved. The fifth part highlights the legal concerns arising at the conclusion of the joint venture, from events triggering termination to the division of business assets. The last part concludes with a summary and a few final insights.

### PROCESS AND PRACTICAL CONSIDERATIONS

There can be various reasons for parties to pursue a joint venture. Risk sharing, cost savings, and access to technology, customers, local business knowledge, production sources, financing, or any number of other resources can inspire collaboration. The decision to enter into a joint venture is typically motivated by a recognition by one or more parties that pursuing a particular foreign business opportunity alone is not, for whatever reason, feasible at a particular time. Of course, a counterparty may hope to capture the opportunity for itself in the future, and therefore may build into the joint venture agreement the ability to buy out its co-venturer(s) or otherwise to secure greater control over the enterprise. Yet, at the time the joint ven-

ture is consummated, the parties usually believe that they need to cooperate and pool their resources in order to succeed.

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**Defining the purpose and scope of the venture comprehensively and clearly is particularly important in the international context because language barriers and negotiation styles may lead to fundamental misunderstandings with respect to each party's expectations.**

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### Preliminary Considerations

Defining the purpose and scope of a joint venture for parties that are looking to combine their resources and know-how, while allowing them to remain independent for other purposes, involves important strategic decisions that the parties must clearly understand and agree to. Defining the purpose and scope of the venture comprehensively and clearly is particularly important in the international context because language barriers and negotiation styles may lead to fundamental misunderstandings with respect to each party's expectations. Co-venturers typically do not commence their relationship by surgically limiting their allocations of resources or by specifically curtailing the purpose and scope of the joint venture. Nonetheless, each party may find it beneficial to determine for itself what the contemplated joint venture should not do and where the joint venture would compete with that party's existing or anticipated activities or business lines. Often, counsel is asked to limit the scope of the collaboration in the definitive agreement, after the term sheet stage, which can lead to protracted negotiations and frustrations on both sides. Once the purpose and scope of the joint venture are well defined, the parties and their counsel will have a much easier time rounding up the remaining terms of the contemplated deal and crafting a definitive joint venture agreement.

### Preliminary Agreements: Framing the Relationship With NDAs and MOUs

Joint ventures often involve highly sensitive technical and business data that need to be exchanged without jeopardizing each co-venturer's respective interest in its own confidential information. Therefore, comprehensive and tightly drafted nondisclosure or confidentiality agreements (NDAs) are a necessity.

NDA in domestic or other commercial contexts may have different terms for protection of technical and nontechnical information (*e.g.*, nontechnical information may not be subject to an absolute nondisclosure obligation without a time limitation). In an international joint venture, however, even nontechnical business information may remain sensitive over a longer period of time and should therefore be protected by a robust NDA between the co-venturers. NDAs often also include nonsolicitation and no-hire provisions and usually allow the parties to seek injunctive relief through courts of regular jurisdiction when necessary, even if alternative dispute resolution is mandated for certain other contested issues. Given different cultural and legal expectations, NDAs may take time to negotiate. In addition, determining choice of law and choice of venue in the international realm has obvious importance.

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**[N]egotiation styles in the cross-border context vary greatly, and these differences can easily obstruct successful completion of the joint venture agreement.**

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Once an NDA has been concluded, the parties are well advised to prepare a detailed memorandum of understanding, term sheet, or heads of agreement (MOU). An MOU typically contains a host of provisions fleshing out the joint venture structure, including governance matters, and reflects a common understanding about the nature of the joint venture's activities. In most circumstances, the MOU is nonbinding and simply an expression of interest by the co-venturers. Nevertheless, because the parties are potentially exchanging highly confidential information about their respective intellectual property positions, organizational structures, and inner workings in general, certain provisions can be expected to be binding. Aside from the nondisclosure obligations of the parties (which may be subject to separate agreements), certain binding provisions such as exclusivity or no-shop provisions, noncompetition provisions, and no-hire provisions are often included. In some situations, break-up fees or reverse break-up fees may also be warranted, although these mechanisms are rarely used, mainly because the co-venturers are typically optimistic at the start of their relationship.

The necessity for and the benefit of a well-negotiated MOU in most cases cannot be overemphasized. MOUs usually constitute the roadmap for the joint venture and incorporate the spirit of the relationship that the co-venturers are seeking to establish.

Even when the provisions of an MOU are nonbinding, the parties view those provisions as the foundation on which the joint venture will be built. Moreover, while the MOU is being negotiated, the organizations behind the co-venturers will be able to explore how the relationship will work in the future.

### **Obtaining Specialist Input**

In drafting the MOU, it is often advisable to seek the advice of knowledgeable tax and intellectual property advisors to ensure that the parties' goals are achievable and will be implemented within an efficient framework that can produce the desired outcome. Many joint ventures involve a rigorous tax-structuring exercise as clients and their advisors consider tax objectives and weigh tax minimization strategies. Further, in technology joint ventures, the ownership of the resulting intellectual property is an important piece of the joint venture puzzle. At this stage, it is also equally important to have the proposal reviewed by local foreign counsel. This input is usually most valuable in the early stages of the drafting of the MOU, because certain assumptions of the counterparties will be based on this fundamental advice.

### **Negotiating the Definitive Joint Venture Agreement**

On completion and signing of the MOU, co-venturers typically proceed quickly with negotiation of the definitive joint venture agreement. The negotiation itself is usually guided by the spirit embodied in the MOU. If the MOU clearly states that the parties are equal partners, the negotiations for the joint venture should reflect that spirit. The parties need to tread carefully and should engage in a respectful negotiation because the ultimate relationship will be based on (and potentially tainted by) these discussions. Further, negotiation styles in the cross-border context vary greatly, and these differences can easily obstruct successful completion of the joint venture agreement. Sometimes even the location of the venue where the joint venture is negotiated may have negative connotations. Thus, in a joint venture of equals, the parties often choose a neutral venue so as to emphasize the balanced nature of the relationship between them.

### **The Definitive Joint Venture Agreement**

The joint venture agreement is the guiding document between the co-venturers and should allow the co-venturers to understand their respective positions and ultimately to achieve their respective goals. Structural choices, discussed below, can influence whether the agreement will be embodied in the organizational

documents of the venture or in a separate agreement. For instance, if the joint venture is structured as a foreign corporation, the joint venture agreement is typically an instrument separate and apart from the corporation's constitutive documents. However, if the joint venture is structured as a pass-through entity such as a partnership or limited liability company (LLC), the joint venture agreement can be either a separate agreement or incorporated in the governing partnership or LLC operating agreement.

The joint venture agreement should not necessarily dictate every aspect of the relationship between the co-venturers, although it should define clearly each co-venturer's governance and veto rights. If there are more than two co-venturers, careful consideration must be given to the agreement's provisions for amendment. The agreement should, of course, include the necessary protections for important assets and interests of each co-venturer. Because joint venture relationships tend to develop organically over time, however, the co-venturers should take care not to legislate every detail, but rather to allow their representatives on the venture's governing body to work productively on solutions to the real-world issues that arise over the life of the joint venture. The definitive joint venture agreement will be symbolic to the extent that it embodies the spirit of the relationship between the co-venturers. The ideal agreement should be clear and precise, yet also forward looking and flexible.

## STRUCTURAL CONSIDERATIONS

There are numerous business and tax considerations driving the structure of an international joint venture, and the unique facts of each proposed arrangement will inform the joint venture lawyer of the structure that makes the most sense for his or her client. Structuring is best addressed early in the negotiation process, and timely coordination with domestic and foreign tax counsel is essential. The complexity of this analysis cannot be overstated.

### Location of Activities and Assets

Does the joint venture need to operate in, or have employees who reside in or work from, a particular place? If the venture's operations need to be located in a particular place, selecting a vehicle that can conduct business in that place is paramount. Moreover, the assets that a joint venture may need must be housed and used somewhere, and the place where certain assets are to be housed may differ from where they are to be used. Thus, counsel must take stock of a joint venture's personnel and assets and then consider

how and where they are to be used in the conduct of the venture's business in a particular location.

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**The joint venture agreement should not necessarily dictate every aspect of the relationship between the co-venturers, although it should define clearly each co-venturer's governance and veto rights.**

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### Regulatory Considerations

Once it has been determined where a joint venture needs to operate, the next question is whether local law demands that the business take a particular form, have particular owners, or possess a particular license. Often the requirements are more strict when a new enterprise seeks a governmental grant or tax concession. Therefore, in selecting a structure, it is important to be cognizant of local legal and regulatory limitations. To appreciate fully these requirements, it is advisable to consider each proposed local activity and the regulatory regime applicable to each activity. If a particular form is mandated, the ability of the joint venturers to accommodate their own business and tax concerns may be more challenging.

### Liability and Operational Considerations

It is desirable from a commercial law perspective to select a joint venture form that will afford its owners limited liability protection in the places where the joint venture will operate. The structural considerations for the joint venture should always include a practical assessment of what the joint venture should be able to accomplish commercially. This assessment normally requires careful consideration of the local rules and regulations that guide the choice of entity. In certain jurisdictions, the choice of entity may indicate commitment to the marketplace and may also be important to gain market access to local sales channels. More importantly, the co-venturers may be guided by practical considerations such as easy access to local talent and licensing and regulatory environments that are conducive to facilitating and simplifying venture operations. In many instances, management of the joint venture will be located in a specific place, which may implicate the choice of jurisdiction. Further, minimum capitalization requirements may be a consideration in some cases that will influence the location of the joint venture. Depending on the specific exit strategies of the joint venture, a particular jurisdiction may be more or less advantageous. If an acquisition scenario is likely, then corporate govern-

ance structures of potential acquirers may also be taken into account when choosing a jurisdiction. Similarly, if an exit would most likely occur through a public offering of joint venture interests, corporate governance rules would form an integral part of the considerations for the decision on where to locate the entity *ab initio*. Finally, employee compensation, especially deferred equity compensation, may be a feature that would require careful review of the locale's corporate governance and tax regimes to ascertain the feasibility of the expectations and goals of the co-venturers.

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### **[A]pplication of U.S. anti-inversion rules could cause foreign corporations to be treated as domestic companies for U.S. income tax purposes.**

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#### **Tax Considerations**

Once the parties have determined where the joint venture needs to locate its assets, people, and operations, and once the legal and regulatory requirements of those locations have been identified, the joint venture lawyer should consider matters of taxation. To do so, counsel must be familiar with the tax regimes of the jurisdictions in which the co-venturers and the joint venture itself are or will be formed and operated, being mindful of the many types of taxes that may apply. Income taxes, gross receipt taxes, sales taxes, value added taxes, stamp duties, taxes levied on contributions of property, withholding taxes, and employment taxes are among the taxes that should be considered, with varying degrees of emphasis. Counsel must also be sensitive to the peculiar tax goals of each joint venturer, which will be largely driven by each venturer's own tax position and vision for the enterprise. For instance, one venturer (carrying forward operating losses) may intend for earnings of the venture to be repatriated as earned, but the other venturer (having neither losses nor an immediate need for additional revenue) may prefer for earnings to accumulate in the joint venture. The competing objectives of the parties cannot always be reconciled in the joint venture itself, but sometimes can be accommodated through separate tax planning by each venturer. For example, a venturer's interest in a partnership joint venture vehicle may be held through a corporate holding company.

Counsel must also be aware of any anti-abuse rules that could defeat the parties' tax planning. For instance, application of U.S. anti-inversion rules could

cause foreign corporations to be treated as domestic companies for U.S. income tax purposes. With these points in mind, counsel must seek to achieve tax goals that are relevant to every joint venture, namely to (1) minimize tax costs on formation and capitalization of the venture, (2) maximize operational tax efficiencies, and (3) maximize tax-efficient exit strategies.

#### **Joint Venture Structure**

A joint venture may be structured in several ways. It may be a contractual undertaking (perhaps to pursue a joint marketing or development program) that does not require formation of an actual entity. Care is warranted, however, because even a contractual alliance may create a separate entity for U.S. income tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits from it.

More commonly, a joint venture will take shape as a separate business entity, in which case the parties must decide (1) what kind of entity to form and in what jurisdiction, (2) whether to own an interest in the entity directly or through special purpose holding companies, and (3) whether the entity should conduct its business in other jurisdictions directly (as through a branch) or through subsidiaries. When these choices are taken into account, the joint venture can easily evolve into a complex multi-tier structure involving one or more intermediate holding and operating companies. There are many factors to consider in establishing a multi-tier structure, including (1) each entity's potential exposure to local taxation; (2) the exposure to capital tax or duty on the initial issuance of shares; (3) potential withholding taxes—and the availability of domestic law or treaty relief—on intercompany dividends, interest, and royalty payments; and (4) thin-capitalization rules and transfer pricing limitations on intercompany transactions.

#### **Holding Company Considerations**

In a multi-tier structure, it is imperative that cash and assets are able to move between the top-tier joint venture vehicle and the lower-tier operating companies as freely as possible with minimum tax and transaction costs. Intermediate holding companies formed in tax-favorable jurisdictions are employed largely to achieve this objective by exploiting favorable domestic law and treaty relationships to minimize withholding taxes, facilitate earnings removal strategies (to lessen the impact of operating in high-tax jurisdictions), and minimize tax on a disposition of a subsidiary. Thus, selection of the ideal holding company jurisdiction would require, among other things, that (1) the operating company's jurisdiction

of formation or operation imposes no (or low) withholding taxes on payments of dividends to the holding company parent, (2) the holding company's jurisdiction of formation or operation imposes no (or low) taxes on dividend income, and (3) the holding company's jurisdiction of formation or operation imposes no (or low) withholding taxes on payments of dividends to the joint venture parent entity.

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### **The ability of taxpayers to elect the tax characterization of foreign entities adds a considerable element of complexity, as well as opportunity, to tax planning.**

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#### **U.S. Tax Classification of Entities**

When choosing among entity types, it is important to recognize that foreign entities are generally classified in one of three ways for U.S. income tax purposes: as a corporation, a partnership, or an entity disregarded from its owner. A corporation is an entity that is itself subject to income tax on its earnings. See IRC §11. A partnership is a fiscally transparent, or "pass through," entity, whose earnings flow through to its owners directly without an entity level of taxation. See IRC §701. A disregarded entity is a "tax nothing," meaning it is treated as a branch or division of its 100-percent owner rather than as a separate taxpayer. See Treas Reg §301.7701-2(a). Under the so-called "check the box" entity classification rules (Treas Reg §§301.7701-1—301.7701-3), taxpayers are largely permitted to choose which U.S. tax classification they would like an entity to have (although corporate classification is mandated for certain foreign entities, and partnerships require at least two owners). The ability of taxpayers to elect the tax characterization of foreign entities adds a considerable element of complexity, as well as opportunity, to tax planning. The joint venture advisor must help the client decide whether the venture (or a constituent entity) should be fiscally transparent for income tax purposes, and if so, whether it should be a hybrid entity (*i.e.*, one that is fiscally transparent for U.S. income tax purposes but not for local tax purposes) or a reverse-hybrid entity (*i.e.*, one that is fiscally transparent for local but not for U.S. income tax purposes).

#### **U.S. Tax Consequences of Entity Classification**

There are numerous tax considerations when choosing among entities, including the following:

**Opportunity for Tax Deferral.** A fundamental difference between corporate and fiscally transparent entities is the opportunity for deferral of U.S. tax, which is at the heart of U.S. international tax planning. U.S. taxpayers are subject to U.S. tax on their worldwide income. Foreign corporations, however, are only subject to U.S. tax that is effectively connected with a U.S. trade or business or earned from U.S. sources. See IRC §§881–882. But for the application of certain anti-deferral rules (discussed below), the earnings of a foreign corporation doing business abroad are not subject to U.S. tax until such time as those earnings are repatriated to the U.S.

Deferral is desirable to the extent the U.S. effective income tax rate on joint venture income exceeds the rate that is imposed locally (including taxes imposed at the intermediate holding company and operating company levels). Deferral is possible when a foreign entity that is treated as a corporation for U.S. income tax purposes is used, but not in the case of a fiscally transparent entity like a partnership. As noted above, a partnership is a conduit for U.S. tax purposes, and its partners are taxed currently on its earnings. The unavailability of deferral can be a major impediment to the use of a fiscally transparent entity if the U.S. tax on the entity's earnings is not expected to be fully offset by foreign tax credits (discussed below). Thus, if deferral of U.S. tax is a critical driver, either the joint venture vehicle itself, or a foreign holding company interposed between the U.S. owner and a joint venture vehicle, must be a corporation.

**Exposure to U.S. Anti-Deferral Rules.** The ability of taxpayers to defer from U.S. tax the earnings of foreign corporations is limited by anti-deferral rules. See, *e.g.*, IRC §§951, 1291. These rules are intended to deny the benefits of deferral in circumstances where Congress felt the use of foreign corporations was abusive, *e.g.*, in the case of income of certain controlled foreign corporations (CFCs) from tax haven activities and investments. A foreign corporation is a CFC if those of its U.S. shareholders who own 10 percent or more of its stock (measured by voting power) own more than 50 percent of its stock (measured by voting power or value). See IRC §§951(b), 957–958. If the anti-deferral rules apply, a 10-percent U.S. shareholder may be required to recognize, as a deemed dividend, so-called "Subpart F" income earned by a CFC. See IRC §951.

Subpart F income includes, among other things, passive income like most dividends, interest, rents, or royalties. See IRC §§952, 954. Subpart F treatment of such passive income can be largely avoided, however, when CFCs have elected to be fiscally transparent for U.S. income tax purposes (see Treas Reg §301.7701–

3(a)(2)), although such an election does not necessarily resolve Subpart F concerns with respect to other types of income, *e.g.*, income from intercompany sales or services. Avoiding application of anti-deferral rules allows the efficient reallocation of resources among the joint venture's subsidiary operations and facilitates earnings removal strategies, *e.g.*, by financing high-tax foreign subsidiaries with debt from low-tax jurisdictions so as to maximize deductible interest payments.

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**Foreign corporations . . . are only subject to U.S. tax that is effectively connected with a U.S. trade or business or earned from U.S. sources.**

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**Flow-Through of Losses and Special Allocations.** A fiscally transparent entity has a number of advantages over a corporate entity, including the ability for losses incurred at the joint venture level to flow through to its owners and thereby offset their taxable income. If substantial losses are anticipated in the early years of the joint venture, counsel should consider selecting partnership classification for U.S. income tax purposes.

Entities treated as partnerships for U.S. income tax purposes afford owners a greater degree of flexibility in structuring their business relationship than corporations. Unlike shareholders of a corporation, partners of a partnership are generally free to allocate among themselves income, loss, credits, deductions, and other tax items. See IRC §704(a). Thus, partnership classification may be more desirable to the extent joint venture partners intend particular allocations of income, loss, or other tax items. However, special allocations that lack "substantial economic effect" may be disregarded. See IRC §704(b).

**Availability of Foreign Tax Credits.** The U.S. system of worldwide taxation places U.S. persons doing business abroad at risk of double taxation on the same income: once by the foreign country in which business is conducted, and then again by the U.S. To mitigate this risk, U.S. persons are allowed a tax credit against their U.S. income tax liability for certain foreign taxes paid. The credit is allowed for any income, war profits, or excess profits tax paid or accrued during the tax year by the taxpayer to any foreign country or U.S. possession. See IRC §901. Taxpayers who are eligible to claim a foreign tax credit generally include U.S. citizens and residents as well as U.S. corporations. See IRC §901(b). U.S. partners of a partnership also are eligible to claim

their share of creditable foreign taxes incurred by the partnership. See IRC §901(b)(5). However, if the foreign joint venture entity is classified as a corporation, a foreign tax credit is generally available only to corporate owners holding 10 percent or more of the foreign corporation's voting interests. See IRC §902. Thus, noncorporate U.S. persons (or corporate persons with a less than a 10-percent voting interest) who wish to claim a foreign tax credit should consider using a fiscally transparent entity to conduct business abroad.

A joint venture structured as a foreign corporation may be desirable to a 10-percent corporate owner because it would provide that owner control over the timing of income recognition (generally, at the time a dividend is paid) and over the use of foreign tax credits. Foreign tax credits are subject to limitation, and when a U.S. corporation is not in a position to use certain credits, it may be desirable to keep them preserved in the foreign subsidiary until they can be used. Fiscally transparent entities do not allow this degree of control because their earnings are subject to immediate U.S. tax.

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**The advantages of fiscally transparent entities are magnified in the international arena. . . . [N]o gain or loss is generally recognized on a transfer of property to a foreign partnership in exchange for a partnership interest.**

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**Tax Efficient Contributions of Property.** It is generally easier to transfer appreciated assets to fiscally transparent entities in a tax-efficient manner than to corporations. For example, a transfer of assets to a corporation is tax free only if the transferors are in "control" of the transferee following the transfer, meaning that the transferors as a group must own, immediately after the transfer, at least 80 percent of the total combined voting power and value of the corporation. See IRC §§351, 368(c). This control requirement may inhibit parties from contributing additional assets to the corporation other than at the initial formation stage. In contrast, transfers to partnerships are not subject to any similar requirement. See IRC §721(a).

The advantages of fiscally transparent entities are magnified in the international arena. A U.S. shareholder's transfer of tangible assets to a foreign corporation in a transaction that would ordinarily be tax-free in the domestic context generally will remain tax-free in the cross-border context, provided that those



assets are used by the foreign corporation in the conduct of an active trade or business outside the U.S. See IRC §367(a)(3). Certain types of assets, such as inventory and accounts receivable, are not eligible for this exception. See IRC §367(a)(3)(B). In addition, even when eligible tangible assets are transferred, a U.S. shareholder incorporating an existing foreign branch will still recognize gain to the extent it had previously deducted branch losses in the U.S. See IRC §367(a)(3)(C). Moreover, the active trade or business exception is unavailable when a U.S. shareholder contributes intangible property such as patents, copyrights, trademarks, or licenses to a foreign corporation. See IRC §367(a)(3)(B)(iv). When that occurs, the U.S. transferor is treated as if it sold the intangible property in exchange for a stream of royalty payments contingent on the productivity, use, or disposition of the intangible and payable over the useful life of the transferred intangible, capped at 20 years. See IRC §367(d); Temp Treas Reg §1.367(d)-1T(c)(3). In light of this deemed royalty regime, taxpayers often prefer to transfer intangible property to a foreign corporation by way of a license rather than as a contribution to capital.

In contrast, no gain or loss is generally recognized on a transfer of property to a foreign partnership in exchange for a partnership interest. Although the Internal Revenue Service is authorized to issue regulations treating as taxable certain transfers of property to a partnership with foreign partners, to date no such regulations have been issued. See IRC §721(c).

**Tax-Efficient Removal of Property.** Assets generally may be removed from a partnership without triggering U.S. tax. See IRC §731(a). There are exceptions, however, such as when the amount of cash (or cash equivalents) distributed exceeds a partner's adjusted basis in its partnership interest. See IRC §731(a)(1). Moreover, any built-in gain or loss on a distribution of property must be allocated to the partner who contributed the property if the distribution occurs within 7 years of contribution. See IRC §704(c)(1)(B). In contrast, assets that are held in a corporation are not easily removed without tax consequences. A distribution of property from a corporation would be treated as if the corporation sold the property and then distributed the proceeds in a taxable dividend. See IRC §§301, 311.

## CAPITALIZATION AND CONTRIBUTIONS

The parties to a joint venture must decide on their initial and subsequent contributions to the joint venture. In determining their contributions—whether in

cash, services, or property—the parties must identify those resources that the venture will need to succeed. The contribution of assets to a joint venture raises a number of important tax issues. Some countries impose a capital tax on contributions to a local company or the issuance of securities. Minimization strategies for such taxes may exist, such as issuing debt in lieu of some equity to the venturers, although care must be taken not to violate minimum capital requirements, and excessive debt-to-equity ratios may raise other problems as well.

The contribution of assets by U.S. persons to a foreign joint venture also raises the U.S. income tax issues discussed above. As noted previously, many of the tax complications can be mitigated if the contribution is made to a fiscally transparent vehicle. However, a contribution of services in exchange for equity interests in the joint venture will normally be taxable to the service provider, whether or not the service recipient is a corporation or partnership.

Of course, a joint venture may also gain access to assets of the counterparties through other means. For instance, intangible assets may be licensed to the joint venture, or purchased by the joint venture using capital obtained through equity or debt financing. In either case, the parties may need to ensure that their transactions pass muster under applicable transfer pricing rules (including IRC §482 and corresponding non-U.S. rules), which generally require commercial transactions to be consistent with an arm's-length dealing between unrelated persons. The application of transfer pricing rules in the joint venture context is somewhat uncertain when there are equal co-venturers, although in practice joint venture counterparties are seldom true 50-50 partners.

The parties also must be mindful that the venture may not be financially self-sufficient for some time. To that end, the parties should decide among themselves how and in what proportions they will respond to capital calls from the joint venture, and whether external equity finance should be pursued at some point. The parties also should consider the extent to which the joint venture will be financed with debt, and whether that debt financing will be related-party or third-party debt. A guarantee or pledge is often necessary to secure the latter.

Capitalizing a joint venture with related-party debt can serve a number of purposes. Debt can provide a means to extract earnings from the enterprise in addition to whatever profits may be reaped by the owners. Subject to thin capitalization or other limitations, a company paying interest would usually be allowed an income tax deduction to reduce its exposure to local country taxation. Such “interest-stripping” measures

are particularly useful when a joint venture operates in a high-tax jurisdiction, because the removal of earnings to a lower-tax jurisdiction can help the enterprise manage its overall effective tax rate. However, the payment of interest is often subject to local withholding taxes, and the related-party lender should therefore consider carefully whether there is domestic law or tax-treaty relief from withholding tax. Moreover, to fully benefit from an interest-stripping strategy, the lender's interest income ideally would be subject to low (or no) income taxation in its country of formation or operation.

### OPERATIONS AND CONTROL

Practitioners often hear that a joint venture will survive or fail depending on the execution of the venturers' business plan. Because many joint ventures are conceived as partnerships of "equals," tailoring operational control over the new enterprise to the realities of the business is critical. Initially, the venturers need to decide whether to co-manage the newly combined joint venture business themselves or to delegate responsibility to separate management. Generally speaking, co-venturers tend to engage separate management (usually comprised of persons from within their own ranks) if the joint venture has complex operational needs. If, on the other hand, operational needs are minimal, separate management is often not required and the joint venture can lean heavily on the institutional operational capabilities and know-how of each venturer.

As in the case of closely held U.S. businesses, the venturers may want to restrict management from entering into transactions or operational actions that would fundamentally affect the joint venture, its finances, or its operational independence. Depending on the composition of the governing board, this would in most instances entail imposing substantial operational restrictions on the management of the joint venture. Often, the following matters require prior approval of the co-venturers:

- Material changes or cessation of the business of the joint venture;
- Any sale of all or substantially all the joint venture's assets;
- Any authorization of a new class of securities, issuance of new securities, granting of rights to acquire new securities, reclassification of existing securities, or changes in the rights attaching to any issued securities, which results in additional securities ranking senior to or in parity with securities held by the co-venturers;
- Any redemption or repurchase of any equity securities, or payment of any dividends or distribution on any equity securities of the joint venture;
- Any amendment, waiver, or deletion of any provision of the joint venture agreement or any other document to which the joint venturer is a party that adversely impacts the equity holdings of a co-venturer;
- Any change in the size, term, or manner of election of the governing board of the joint venture;
- The creation or disposal of any subsidiaries, the purchase or disposal of equity in companies, or the merger or amalgamation of the joint venture entity or any subsidiary with any other entity; and
- Any transfer of shares held by the joint venture entity other than to a wholly owned subsidiary.

These restrictions are typically imposed through super-majority voting provisions, even in circumstances where one of the venturers has less than 50-percent voting control in the joint venture. In situations where deadlock is possible, as discussed below, mechanisms should be implemented that would prevent a complete standstill of the joint venture's operations.

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**[S]tructuring decision-making in such a way as to avoid deadlock, or providing appropriate mechanisms for resolving deadlock (e.g., mandatory mediation and binding arbitration), are critical.**

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### TERMINATION AND EXIT

Few joint venturers have failure in mind when starting out. In fact, counsel is often admonished not to focus too much on the downside risks of the transaction, but rather to view the upside potential of a successful venture. Recognizing the potential of a successful collaboration, yet being mindful of risks, are not mutually exclusive propositions, although balancing them appropriately may be difficult in practice. In many instances, it may be appropriate for counsel to approach the matter of a possible termination in such a way that the parties do not view the conclusion of the venture as a failure.

Particularly in joint ventures of purported equals, the parties may be inclined to require equal input on many matters and unanimity before certain decisions are taken. This can often be a mistake because the unanimity requirement can risk paralyzing the enterprise through deadlock if the parties disagree on an

important issue. Therefore, structuring decision-making in such a way as to avoid deadlock, or providing appropriate mechanisms for resolving deadlock (*e.g.*, mandatory mediation and binding arbitration), are critical. Buy-sell mechanisms often employed in closely held or family-held businesses or mandatory dissolution procedures may be also used and should be agreed to in advance. Further, the joint venturers may explore implementing simple (or, if appropriate, elaborate) put or call rights if certain predetermined events occur. Put and call rights are often used in situations where a competitor of one of the co-venturers takes control of the other co-venturer. These mechanisms must, of course, pass anti-competition or antitrust scrutiny and will require careful consideration at the time of formation of the joint venture.

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**Joint ventures are wonderfully flexible devices that can be used to achieve a number of business goals, but that flexibility comes at the expense of complexity.**

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In situations where an exit is contemplated from the beginning of the venture, the co-venturers may consider implementing typical venture capital and private equity mechanisms to allow them to benefit from a successful exit. These mechanisms include registration rights, standard drag-along and tag-along rights, as well as redemption rights. Registration rights provide liquidity to joint venturers by allowing them to require the joint venture entity to register the venturers' equity securities for sale to the public, either as part of an offering already contemplated by the joint venture entity (*i.e.*, piggyback rights) or in a separate offering initiated at a joint venturer's request (*i.e.*, demand rights). A drag-along right in the joint venture context generally requires one of the joint venturers to vote their equity securities in favor of a

certain transaction or action. A co-sale right in the joint venture context provides some protection against a co-venturer selling its interest in the joint venture entity to a third party by giving the other co-venturer the right to sell a portion of its own stock as part of any such sale. In certain circumstances, co-venturers may find it appropriate to implement redemption rights. A co-venturer's equity holdings may be redeemable, either at the option of the joint venture entity or the co-venturer or mandatorily on a certain date, perhaps at some premium over the initial purchase price of the equity in the joint venture entity.

### CONCLUSION

This article has highlighted the rationales for pursuing an international joint venture and explored some of the legal and tax issues affecting their formation, operation, and termination. Joint ventures are wonderfully flexible devices that can be used to achieve a number of business goals, but that flexibility comes at the expense of complexity. Joint ventures are famously difficult to negotiate, conclude, and implement successfully. One size does not fit all, and advisors who expect to follow a cookie-cutter formula in drafting a joint venture agreement will be disappointed. To be sure, joint venture templates exist, but counsel must be prepared to deviate significantly from "standard" forms in light of the innumerable variables that can dictate business and legal choices.

Moreover, it is imperative that the parties and their advisors recognize that a joint venture has no "closing," and that the execution of the definitive agreement is only the beginning of the parties' association. A joint venture is really about building a lasting business relationship and, like any good relationship, a successful joint venture requires consistent effort, flexibility, and understanding. An early realization of these requirements should promote a sense of cooperation and respect between the parties as they negotiate their business deal and then execute on their shared vision.

# International Commercial Arbitration

**Jeff Dasteel**



**Jeff Dasteel** became a full-time neutral following his 2008 retirement from Skadden, Arps, Slate, Meagher & Flom, where he was a litigation and international arbitration partner and member of the franchise law group. He conducts mediations and arbitrations of cross-border commercial transactions, franchise and distribution cases, employment-related actions, complex business/commercial multi-party disputes, and personal injury and premises liability matters. Mr. Dasteel teaches a course in international commercial arbitration at UCLA Law School and courses in franchise law and trial advocacy at Loyola Law School of Los Angeles. He has published articles on international arbitration, franchise law, and class action law. Mr. Dasteel received his undergraduate degree from the University of California, Davis, and his law degree from Loyola Law School, Los Angeles.

## INTRODUCTION

Attorneys who care whether they can obtain an enforceable judgment in a cross-border case should also care about international commercial arbitration. Imagine a world where there are no international treaties mandating that one signatory country enforce a judgment obtained in another signatory's domestic courts. In fact, the world today is that world. Although many countries have statutes and procedures codifying the Uniform Foreign-Country Money Judgment Recognition Act (available at <http://www.law.upenn.edu/bll/archives/ulc/ufmjra/2005final.htm>), which permits the enforcement of a foreign judgment in another country's domestic courts, there are no international treaties mandating enforcement of foreign judgments. For example, assume that after 4 years of hard work and great expense, an attorney manages to obtain a jury verdict against a defendant in the United States, but the defendant's assets are outside the United States. Will a jurisdiction outside the United States enforce that hard-won judgment? The answer is: Maybe so, maybe not.

How can an attorney protect against that sort of uncertainty? What if, instead of litigation in a United States court, there was an arbitration agreement between the parties? Could an arbitration award obtained in the United States be enforced in a jurisdiction outside the United States? Or, could an arbitration award obtained outside the United States be enforced in United States courts? The answer to both

questions is very likely yes. In most cases, it is in fact easier to enforce an international arbitration award than a foreign judgment.

This article distinguishes between U.S. domestic arbitrations and international arbitrations subject to the New York Convention (discussed below). It also highlights some key features of international arbitrations as well as the enforcement mechanisms in United States federal courts and California state courts. This article briefly covers the important doctrines of separability and "competence-competence," and includes a brief discussion of pre-hearing discovery and hearing procedures in international arbitration.

## THE NEW YORK CONVENTION

Unlike enforcement of foreign judgments, there are treaties that mandate enforcement of covered arbitration awards in signatory countries. There are regional treaties concerning the recognition and enforcement of arbitration, such as the European Convention on International Commercial Arbitration (1961) (<http://www.jurisint.org/en/ins/153.html>) and the Inter-American Convention on International Commercial Arbitration (1975) (<http://www.adr.org/sp.asp?id=31620>). There also are more specialized treaties, such as the Washington Convention on the Settlement of Investment Disputes Between States and Nationals of Other States (ICSID) (1965) ([http://icsid.worldbank.org/ICSID/StaticFiles/basicdoc/CRR\\_English-final.pdf](http://icsid.worldbank.org/ICSID/StaticFiles/basicdoc/CRR_English-final.pdf)) and bilateral investment treaties between

various nations. However, the most significant treaty in the world of international arbitration is the 1958 Convention On the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention) ([http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/NYConvention.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention.html)). The New York Convention has 145 signatory nations, all of which have agreed to require their domestic courts to enforce foreign arbitration awards covered by its terms. The New York Convention has been implemented in the United States as part of the Federal Arbitration Act (FAA) (9 USC §§201–208). California also has its own statutes covering the recognition and enforcement of international arbitrations. See CCP §§1297.11–1297.432.

### Domestic and Non-Domestic Arbitrations

What distinguishes an international arbitration from a garden-variety domestic arbitration? The answer to this question indicates whether the arbitration award will benefit from the privileges and protections of the New York Convention. The question amounts to whether the country where enforcement is sought considers the arbitration agreement (and any award rendered based on that agreement) to be non-domestic under that country's implementation of the New York Convention. The starting point for this analysis is the language of the treaty itself.

The terms of the New York Convention expressly apply to (1) "awards made in the territory of a State of other than the State where the recognition and enforcement of such awards are sought," and (2) "arbitral awards not considered as domestic awards in the State where their recognition and enforcement are sought." New York Convention, art I(1). The first proviso is reasonably clear: If the arbitration award has been rendered outside the territory of the country where enforcement is sought, the terms of the New York Convention apply.

There is a general exception for arbitral awards rendered in a country that is not one of the 145 signatory countries to the New York Convention when a signatory country has made a reservation for reciprocity. See New York Convention, art I(3). Signatory countries have the right to exempt from the provisions of treaty enforcement any award entered in a country that is not a party to the New York Convention. The United States has exercised that right. See New York Convention Status at [http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/NYConvention\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status.html).

The second proviso of the New York Convention, which refers to arbitrations not considered "domestic"

in the country where enforcement is sought, leaves open the possibility that an award may be considered subject to the Convention's terms even if the award is rendered in the country where enforcement is sought. For example, consider an arbitration in the United States when the client corporation is a foreign corporation and the opponent is a U.S. domestic corporation. Not only will the arbitration take place in the United States, counsel may intend to enforce any award in the United States. Under those circumstances, the New York Convention looks to the law of the country where the award was rendered to determine whether the award is or is not considered domestic.

### Implementing Statutes

Although the language of the New York Convention is the starting point, it does not entirely answer the jurisdictional question because the treaty, which is not self-executing, depends on the language of implementing statutes in the signatory countries. In the United States, the New York Convention has been implemented by the Federal Arbitration Act (FAA) (Title 9 of the USC). Chapter 1 of the FAA (9 USC §§1–16) applies to domestic arbitrations; Chapter 2 (9 USC §§201–208) implements the New York Convention. Under 9 USC §202,

[a]n arbitration agreement or arbitral award arising out of a legal relationship, whether contractual or not, which is considered as commercial, including a transaction, contract, or agreement described in section 2 of this title, falls under the Convention. An agreement or award arising out of such a relationship which is entirely between citizens of the United States shall be deemed not to fall under the Convention unless that relationship involves property located abroad, envisages performance or enforcement abroad, or has some other reasonable relation with one or more foreign states. For the purpose of this section a corporation is a citizen of the United States if it is incorporated or has its principal place of business in the United States.

Section 202 therefore sets forth two principal limitations on the kinds of awards covered by the New York Convention in the United States: (1) The nature of the relationship leading to the arbitration award must be commercial, and (2) there must be a significant "foreign" element to the subject matter or to the parties to the arbitration. Note that §202 states the citizenship requirement in the negative. The New York Convention's terms do not apply if the agreement or award arising out of the relationship is *entirely* between citizens of the United States. Accordingly, complete diversity of citizenship is not required to gain jurisdiction under the New York Convention.

Note also that there is no express requirement that the arbitration award be rendered outside the United States. As long as there is a sufficient “foreign” element to the arbitration, it will be covered by the New York Convention as implemented by the FAA, even if the arbitration was held and the award rendered in the United States. See *Yusuf Ahmed Alghanim & Sons v Toys R Us, Inc.* (2d Cir 1997) 126 F3d 15 (dispute involving two non-domestic corporations and one U.S. corporation regarding conduct and performance in Middle East falls under terms of Convention even though arbitration held in United States); *Jain v de Mere* (7th Cir 1995) 51 F3d 686, cert denied (1995) 516 US 914 (federal district court has power to compel arbitration under FAA Chapter 2 because, even though arbitration to take place in Illinois, New York Convention applies because neither party to arbitration agreement is a United States citizen); *Bergesen v Joseph Muller Corp.* (2d Cir 1983) 710 F2d 928 (New York Convention and Chapter 2 of FAA apply to arbitration award rendered in United States between two foreign parties).

Under the United States’ implementation of the New York Convention, territoriality (*i.e.*, where the award was rendered) is not dispositive of the question of whether an award is covered by the Convention. Even the citizenship of the parties is not dispositive as long as there is a sufficient foreign element to the subject matter. Thus, even if the litigation is entirely between citizens of the United States and the award is rendered in the United States, the award may still be considered non-domestic if, *e.g.*, the property or the performance that is the subject of the dispute is located abroad. See generally *Fuller v Compagnie Des Bauxites De Guinee* (WD Pa 1976) 421 F Supp 938 (arbitration to be held in United States between two citizens of United States fell under terms of New York Convention when substantial performance under subject contract was to take place in Guinea).

### Reservations to the Convention

Counsel also should be aware of two “out” clauses associated with the New York Convention. Article I, §3 of the New York Convention gives signatory nations the right to make two kinds of reservations. First, signatory nations can restrict application of the Convention to arbitrations seated in other signatory states. This “reciprocity” reservation does not apply to a party from a nonsignatory state as long as the seat of the arbitration was in the territory of a signatory state. The United States has made the reciprocity reservation. See New York Convention Status at [http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/NYConvention\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status.html).

Second, signatory nations can restrict application of the Convention to “commercial” matters. Nations that adopt this reservation typically intend to exclude criminal matters, family law matters, and noncommercial torts. The United States has also made this reservation. See New York Convention Status at [http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/NYConvention\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status.html).

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**[E]ven if the litigation is entirely between citizens of the United States and the award is rendered in the United States, the award may still be considered non-domestic if, *e.g.*, the property or the performance that is the subject of the dispute is located abroad.**

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If counsel believes that it will be necessary to enforce an arbitration award in a jurisdiction outside the United States, it will be important to determine whether the jurisdiction of enforcement has any reservations to the New York Convention, and further, whether the subject matter of the arbitration is capable of being settled by arbitration in the country of enforcement. For example, Norway’s reservation provides, in part, that “[t]his State will not apply the Convention to differences where the subject matter of the proceedings is immovable property situated in the State, or a right in or to such property.” See footnote (i) at [http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/NYConvention\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status.html).

## INTERNATIONAL ARBITRATIONS UNDER FAA CHAPTER 2

### Advantages

Comparing domestic to international arbitration, there are two key advantages to falling under the United States’ implementation of the New York Convention in Chapter 2 of the Federal Arbitration Act (9 USC §§201–208): (1) original jurisdiction in the federal courts, and (2) more certain confirmation of an arbitration award. As with everything else in litigation, the question of most importance to litigants is whether the outcome is binding and enforceable. In this regard, there are two important practical reasons to care whether the arbitration award is considered non-domestic under the FAA. First, unlike Chapter 1 (applicable to domestic arbitrations), Chapter 2 of the FAA (applicable to non-domestic arbitration awards) provides original subject matter jurisdiction in the

federal courts, including the right to remove the matter from a state court. See 9 USC §203. This jurisdictional benefit means that, unlike domestic arbitrations, there is no need to find an independent basis for jurisdiction to get into federal court. Compare 9 USC §203 with *Vaden v Discover Bank* (2009) \_\_\_ US \_\_\_, 173 L Ed 2d 206, 129 S Ct 1262, 1271 (“As for jurisdiction over controversies touching arbitration,’ however, [Chapter 1 of] the Act is ‘something of an anomaly’ in the realm of federal legislation: It ‘bestow[s] no federal jurisdiction but rather requir[es] [for access to a federal forum] an independent jurisdictional basis’ over the parties’ dispute.” (quoting *Hall Street Assocs., LLC v Mattel, Inc.* (2008) 552 US 576, 581, 170 L Ed 2d 254, 128 S Ct 1396)).

Second, under 9 USC §207, a court *must* confirm an international arbitration award as long as it does not find “one of the grounds for refusal or deferral of recognition or enforcement of the award specified in the said [New York] Convention.” This language generally limits the grounds on which a court may refuse enforcement to the seven specified in Article V of the New York Convention:

- (1) Party incapacity or invalidity of the agreement of arbitration;
- (2) Lack of due process in the appointment of arbitrators or conduct of the arbitration hearings;
- (3) The award covers matters outside the scope of the arbitration clause;
- (4) Improper constitution of the arbitration tribunal;
- (5) The award has not yet become binding or is set aside in the country or under the law under which the award was made;
- (6) The subject matter of the dispute is not capable of settlement by arbitration in the country where enforcement is sought; and
- (7) Enforcement would violate public policy of the country where enforcement is sought.

#### New York Convention, Article V

Note that Article V of the New York Convention provides that a signatory “may” refuse enforcement of an award on the enumerated grounds. That is, although enforcement of an international arbitration award is mandatory unless a ground for refusal is present, refusal to enforce an international arbitration award when such a ground is present is permissive. For example, suppose an arbitration award has not yet become final and binding under the law of the country in which the award was made because, *e.g.*, a party to the arbitration has filed an appeal or application to

vacate that award. In that circumstance, a court has the discretion nonetheless to enforce the award. See *Europcar Italia v Maiellano Tours, Inc.* (2d Cir 1998) 156 F3d 310 (district court has power to decide whether to stay confirmation proceedings even if one ground to stay or reject confirmation under New York Convention was present; in this case, appeal was pending in Italy, where arbitration award was rendered).

The fact that a court may enforce an international arbitration award even if grounds for refusal are present reflects the pro-arbitration bias of the New York Convention as implemented in Chapter 2 of the FAA.

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**It is generally, although not universally, accepted that the location where an international arbitration takes place gives the courts of that location exclusive jurisdiction over the supervision of the arbitration.**

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#### IMPORTANCE OF THE LOCATION (SEAT) OF THE ARBITRATION

In United States domestic arbitrations, there often are fights over where the arbitration should take place. Most of the fights have more to do with the convenience of the venue to one of the parties than with any material distinction in substantive rights. In most cases, the procedural law of the particular state where the domestic arbitration occurs is not nearly as outcome-determinative as the substantive law to be applied to the parties’ transaction. Because substantive law is usually independent of venue, the venue battle has more to do with the issue of which party gets dragged the farthest distance and is subjected to the most inconvenience.

In international arbitrations, however, the “seat” of the arbitration is of critical importance to the arbitration itself. The location (or seat) also determines how readily domestic courts will interfere in an arbitration proceeding and how easily an award may be vacated. It is generally, although not universally, accepted that the location where an international arbitration takes place gives the courts of that location exclusive jurisdiction over the supervision of the arbitration. As a result, the parties are generally limited in their ability to forum shop for a court more likely to interfere in pending arbitration proceedings. See *URS Corp. v The Lebanese Co. for the Development & Reconstruction of Beirut Cent. Dist. SAL* (D Del 2007) 512 F Supp 2d

199 (United States district court refused to exercise supervisory jurisdiction over arbitration when seat was in France).

### Consequences of the Location

There are two key issues arising out of the seat of the arbitration. First, the arbitration becomes subject to the so-called mandatory arbitration laws of the host country. Those laws are the laws applicable to the conduct of arbitrations in the country of the seat, including laws concerning the procedures that must be followed, regardless of what may appear in the parties' arbitration agreement. Those laws therefore constitute venue-driven limits on the parties' autonomy. For example, for arbitration agreements governed by the FAA, the parties cannot design procedures that permit substantive post-arbitration appeals to the United States appellate courts. *Hall Street Assocs. LLC v Mattell* (2008) 552 US 576, 170 L Ed 2d 254, 128 S Ct 1396 (parties are not permitted to expand grounds for review under FAA by agreement, even if expanded right of review was with district court's approval). But see *Cable Connection, Inc. v Directv, Inc.* (2008) 44 C4th 1334, 82 CR 229 (even after *Hall Street Assocs.*, California state law permits parties to obtain judicial review of merits of arbitration awards in California state courts by express agreement).

The second key issue concerns host country court supervision of the arbitral proceedings. International arbitrations having their seat in the United States will be subject to domestic laws regarding vacating or setting aside arbitration awards (*i.e.*, Chapter 1 of the FAA (9 USC §§1–16)), even though they may meet the requirements to be considered “non-domestic” under the FAA. The procedures under Chapter 1 of the FAA to vacate or set aside an award are applicable to both domestic and international arbitrations sited in the United States. See *Yusuf Ahmed Alghanim & Sons v Toys R Us, Inc.* (2d Cir 1997) 126 F3d 15.

The rationale for permitting courts at the location of the arbitration to apply domestic law to vacate or set aside an international arbitration award is grounded in Article V(1)(e) of the New York Convention. As noted above, that clause permits a court to refuse enforcement if the award “has been set aside or suspended by a competent authority of the country in which, or under the law of which, that award was made.” The consequence of this supervisorial authority is that, for international arbitrations held in the United States, the grounds to set aside, modify, or vacate the award set forth in 9 USC §§10–11 may be applied in addition to the grounds for setting aside an award under Article V of the New York Convention. These grounds arise (9 USC §§10–11):

- (1) When the award was procured by corruption, fraud or undue means;
- (2) When there was evident partiality or corruption in the arbitrators;
- (3) When the arbitrators are guilty of misconduct in refusing to postpone the hearing or hear relevant evidence;
- (4) When the arbitrators exceeded their powers or failed to make a final and definite award;
- (5) When there is an evident material miscalculation in the award;
- (6) When the arbitrators awarded on a matter not submitted to them; and
- (7) When the award is otherwise imperfect in a matter of form not affecting the merits and may be modified or corrected.

These grounds to vacate an award may or may not exist in other countries. The location of the seat of the arbitration therefore can be dispositive of whether an unhappy litigant will be successful in vacating an award. If the award cannot be vacated at the seat under the procedural law of that country, then the unhappy litigant is left with only the grounds available under the New York Convention for refusing enforcement at the location of enforcement, even if the domestic law of the enforcing country might have permitted the award to be vacated.

### COMPELLING ARBITRATION UNDER THE NEW YORK CONVENTION

As noted above, there are significant benefits to enforcement of an arbitration award if it is covered under the FAA's implementation of the New York Convention. There is also a benefit to having the New York Convention apply to a matter if it becomes necessary to compel a reluctant party to arbitrate or to prevent concurrent litigation in domestic courts. In that regard, the New York Convention, Article II(3) provides:

The court of a Contracting State, when seized of an action in a matter in respect of which the parties have made an agreement within the meaning of this article, shall, at the request of one of the parties, refer the parties to arbitration, unless it finds that the said agreement is null and void, inoperative or incapable of being performed.

This provision requires courts in signatory states to stay or dismiss legal proceedings in favor of arbitration. Moreover, under the FAA, a federal court has the power to order arbitration “whether that place is within or without the United States.” 9 USC §206. See also 9 USC §3 (stay of proceedings), which is incorporated into Chapter 2 of the FAA by 9 USC



§208 (residual application). There is no discretion under the New York Convention to allow a domestic court action to proceed to trial instead of arbitration. Because federal courts have original jurisdiction with respect to international arbitrations, a party to an arbitration agreement can go directly to federal court to seek an order to compel arbitration and to stay or dismiss federal or state actions that fall within the scope of the arbitration clause.

Note that the provisions of the New York Convention and Chapter 2 of the FAA are inconsistent with the provisions of California state law (discussed below) regarding domestic arbitrations. Under California law, California state courts have the power to stay arbitration pending the outcome of related litigation if any of parties in the related litigation are not subject to an agreement to arbitrate. See CCP §1281.2(c). However, these provisions by their terms apply to domestic arbitrations and not to international arbitrations.

The California International Arbitration and Conciliation Act (CCP §§1297.11–1297.432) addresses international arbitrations. Code of Civil Procedure §1297.81 provides that

when a party to an international commercial arbitration agreement as defined in this title commences judicial proceedings seeking relief with respect to a matter covered by the agreement to arbitrate, any other party to the agreement may apply to the superior court for an order to stay the proceedings and to compel arbitration.

This provision does not clearly *mandate* a stay; moreover, it does not give the court express authority to stay arbitration pending the outcome of litigation, as does the California domestic arbitration statute (CCP §§1280–1294.2). There is an easy way around this problem, however. Under the FAA, a party to a state court action has the right to remove the action to federal court, where the federal court will apply federal arbitration law to stay pending litigation and order the parties to arbitration. See 9 USC §§205, 206.

### CALIFORNIA STATUTES REGARDING INTERNATIONAL ARBITRATION

The Federal Arbitration Act does not generally preempt the field of arbitration law. Instead, there is concurrent jurisdiction for state courts and state law, even with respect to non-domestic arbitrations, so long as state law does not actually conflict with federal law promoting arbitration of disputes. *Volt Inf. Sciences v Stanford Univ.* (1989) 489 US 468, 103 L Ed 2d 488, 109 S Ct 1248. In that regard, the Supreme Court recently held in *AT&T Mobility LLC v*

*Concepcion* (2011) 563 US \_\_\_, 179 L Ed 2d 742, that a state law that “stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress’ [internal citation omitted] is preempted by the FAA.” 179 L Ed 2d at 759 (FAA preempts state law that barred arbitration clauses that did not permit class-wide arbitration).

In California, as under federal law, there is one statute governing domestic arbitrations (CCP §§1280–1294.2) and one governing non-domestic arbitrations (the California International Arbitration and Conciliation Act (CCP §§1297.11–1297.432)). California law makes clear that, except as otherwise provided, the provisions for domestic arbitration and international arbitration are mutually exclusive. See CCP §1297.17.

California’s international arbitration statutes define an international arbitration to be one in which (CCP §1297.13):

- The parties, at the time of the conclusion of the agreement to arbitrate, had “their places of businesses in different states [*i.e.*, countries]”; or
- One of the following is “outside the state [country] in which the parties have their places of business”: (a) the place of arbitration; (b) the place “where a substantial part of the obligations of the commercial relationship is to be performed”; or (c) “the place with which the subject matter of the dispute is most closely connected”; or
- The parties “have expressly agreed that the subject matter of the arbitration . . . relates to commercial interests in more than one state [country]”; or
- “[T]he subject matter of the arbitration . . . is otherwise related to commercial interests in more than one state [country].”

Note that California law has defined international arbitrations very broadly. Indeed, California law even allows the parties to stipulate that the subject matter of the arbitration is international in nature (something the parties cannot do under federal law).

With two exceptions, California’s international arbitration statutes apply only if the place (seat) of arbitration is in the State of California. See CCP §1297.12. One exception (Article 2 of Chapter 2) is when a party seeks to compel arbitration and the associated power to stay pending California state litigation. See CCP §§1297.81–1297.82. The second exception (Article 3 of Chapter 2) applies if the parties have not vested exclusive jurisdiction in the arbitrators to rule on requests for interim or emergency relief. In that circumstance, California state courts may take such jurisdiction without the moving party being

deemed to have waived jurisdiction by recourse to the courts. See CCP §§1297.91–1297.95.

### Consequences for Arbitrations in California

Aside from these two exceptions, there are two important consequences to the application of California's international arbitration statutes only to arbitrations held in California. First, as a matter of jurisdiction, it is doubtful that a California statute could extend to arbitrations in which the seat is located, and enforcement is sought, outside the state. Although it is conceivable that parties could specify that the California International Arbitration and Conciliation Act procedures would apply to an arbitration with a seat outside the state, courts with supervisory authority at the seat of the arbitration would in all likelihood treat California's statutory provisions like any other set of international arbitration rules. In effect, those rules would be subject to the mandatory laws of the jurisdiction at the seat of the arbitration.

Second, California's international arbitration statutes were intended to make California an "arbitration-friendly" venue to hold international arbitrations. Unlike the FAA, the California international arbitration statutes set forth detailed default procedures for the conduct of international arbitrations. See CCP §§1297.11–1297.432. Parties are generally free to deviate from the statutory default procedures. Further, as a part of California's statutory scheme, the procedures mandate that "no court shall intervene [in a pending arbitration] except where so provided in this title, or applicable federal law." CCP §1297.51. This arbitration-friendly provision is designed to give maximum authority to the arbitrators to resolve the disputes before them (see "Competence-Competence" discussion below)—a prerequisite for any jurisdiction attempting to gain market share in international arbitrations.

### Absence of Pro Hac Vice Provisions

There is, however, one difficulty. Since 1998, it has been the law in California that attorneys who participate in arbitrations as advocates are engaged in the practice of law. *Birbower, Montalbano, Condon & Frank v Superior Court* (1998) 17 C4th 119, 70 CR2d 304. Under CCP §1282.4, out-of-state attorneys are allowed to participate in domestic arbitrations in California if they follow a pro hac vice procedure set forth in the statute. However, there is no equivalent procedure for international arbitrations. Because, under CCP §1297.17, California's international arbitration statutes supersede California law related to domestic arbitrations, including CCP §1282.4, there is no

mechanism for an out-of-state lawyer to legally participate in an international arbitration seated in California.

Moreover, even if the pro hac vice provisions of CCP §1282.4 could be applied to international arbitrations, those provisions apply only to attorneys licensed to practice in another state, not in a foreign country. Accordingly, the law as it now stands makes it much more difficult for California to become a center for international arbitration. Although California attorneys can and do represent clients in international arbitrations seated in, e.g., London, Paris, Hong Kong, Switzerland, and elsewhere, there is no reciprocity for attorneys licensed in those jurisdictions to represent clients in international arbitrations here. Proponents of California as a center for international arbitration are currently working with the state legislature to provide a means for out-of-state and foreign attorneys to participate in international arbitrations seated in California. See, e.g., Caron & Harhay, *A Call to Action: Turning the Golden State into a Golden Opportunity for International Arbitration*, 28:2 Berkeley J Int'l Law 497 (2010).

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### DOCTRINE OF SEPARABILITY

Separability is an important doctrine in both domestic and international arbitration. The doctrine of separability is based on the concept that the agreement to arbitrate is separate and apart, and thus severable, from the remainder of the commercial relationship of the parties. Even if an agreement to arbitrate is included as one clause in a single integrated contract, the doctrine of separability holds that the agreement to arbitrate is considered to be an agreement independent of the remaining terms of the contract, as if it had been entered into in a completely separate document. The United States Supreme Court has accepted the doctrine of separability for arbitrations held in the United States: "[A]s a matter of substantive federal arbitration law, an arbitration provision is severable from the remainder of the contract." *Rent-A-Center, West, Inc. v Jackson* (2010) \_\_\_ US \_\_\_, 177 L Ed 2d 403, 412, 130 S Ct 2772 (quoting *Buckeye Check Cashing, Inc. v Cardegna* (2006) 546 US 440, 445).

The major sets of international arbitration rules have incorporated the doctrine of separability into their terms. Rule 6(4) of the International Chamber of Commerce (ICC) Rules of Arbitration (see <http://www.iccwbo.org/court/arbitration/id4199/index.html>) provides that

[u]nless otherwise agreed, the Arbitral Tribunal shall not cease to have jurisdiction by reason of any claim that the contract is null and void or allegation that it is non-existent, provided that the Arbitral Tribunal upholds the validity of the arbitration agreement. The Arbitral Tribunal shall continue to have jurisdiction to determine the respective rights of the parties and to adjudicate their claims and pleas even though the contract itself may be non-existent or null and void.

The International Center for Dispute Resolution (ICDR) Rules ([http://www.adr.org/sp.asp?id=33994#INTERNATIONAL\\_ARBITRATION\\_RULES](http://www.adr.org/sp.asp?id=33994#INTERNATIONAL_ARBITRATION_RULES)) have a similar provision (ICDR Rule 15(2)):

The tribunal shall have the power to determine the existence or validity of a contract of which an arbitration clause forms a part. Such an arbitration clause shall be treated as an agreement independent of the other terms of the contract. A decision by the tribunal that the contract is null and void shall not for that reason alone render invalid the arbitration clause.

The London Court of International Arbitration (LCIA), Rule 23.1 ([http://www.lcia.org/Dispute\\_Resolution\\_Services/LCIA\\_Arbitration\\_Rules.aspx](http://www.lcia.org/Dispute_Resolution_Services/LCIA_Arbitration_Rules.aspx)) similarly provides that:

[a]n arbitration clause which forms or was intended to form part of another agreement shall be treated as an arbitration agreement independent of that other agreement. A decision by the Arbitral Tribunal that such other agreement is non-existent, invalid or ineffective shall not entail ipso jure the non-existence, invalidity or ineffectiveness of the arbitration clause.

Finally, the United Nations Commission on International Trade Law (UNCITRAL) Arbitration Rule 23.1 ([http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/1976Arbitration\\_rules.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/1976Arbitration_rules.html)) provides that:

[a]n arbitration clause that forms part of a contract shall be treated as an agreement independent of the other terms of the contract. A decision by the arbitral tribunal that the contract is null shall not entail automatically the invalidity of the arbitration clause.

### Separability Doctrine in Practice

The separability doctrine allows a party to challenge another provision of the contract or the contract as a whole without preventing the court from ordering the party to arbitrate the dispute, unless the challenge

goes specifically to the validity of the arbitration agreement. The United States Supreme Court's decision in *Rent-A-Center* holds that even if the parties have challenged the validity of an agreement to arbitrate, the court may still order the parties to arbitrate the dispute if the parties have agreed to arbitrate "gateway" disputes of arbitrability. See *Rent-A-Center, West, Inc. v Jackson* (2010) \_\_\_ US \_\_\_, 177 L Ed 2d 403, 130 S Ct 2772.

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### **Absent an express statement in the choice-of-law clause that its terms also apply to the arbitration agreement, it is generally assumed that the parties intended for the arbitration agreement to be governed by the law of the seat.**

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The doctrine of severability or separability as enunciated by the United States Supreme Court is the same for both domestic and international arbitrations. It prevents parties who resist arbitration from landing every arbitration agreement in court by the simple expediency of challenging the validity of the underlying contract as a whole. Indeed, the doctrine of separability applies when a party asserts that the contract containing an arbitration clause is fraudulent or void ab initio. Unless those claims go separately to the existence of the arbitration agreement, courts will require the dispute to be arbitrated. Thus, although something of a fiction, the doctrine of separability is very much pro-arbitration and is key to the efficient operation of both domestic and international arbitrations.

The doctrine of separability also comes into play in international arbitration with respect to choice of law. Because the agreement to arbitrate is considered an agreement separate and apart from the remainder of the contract governing the commercial relationship between the parties, the substantive choice-of-law provision governing the remainder of the contract does not necessarily apply to the arbitration agreement. Absent an express statement in the choice-of-law clause that its terms also apply to the arbitration agreement, it is generally assumed that the parties intended for the arbitration agreement to be governed by the law of the seat. Thus, if the contract declares that it is to be interpreted according to the laws of one country, but the arbitration clause requires the arbitration to take place in another country, the arbitration law of the seat will govern the agreement to arbitrate (instead of the law chosen to govern the substance of the parties' commercial relationship), unless the parties have expressly agreed otherwise.

### Consequence of the Doctrine

The consequence of the separability doctrine is felt most strongly in international arbitration because it is very common for the seat of the arbitration to be unrelated to the parties or the commercial transaction. The reason is that parties often select a neutral location to arbitrate disputes where neither party can claim a home field advantage. Thus, a French company and an English company may choose to have their contract governed by English law but agree to hold any arbitration in New York. Unless English law is expressly made applicable to the “separate” agreement to arbitrate, New York state and United States federal arbitration law will apply to the terms of the arbitration clause. United States policies on court interference in an arbitration proceeding will therefore apply to the matter, even if an English court might have taken a different approach under its arbitration laws.

### DOCTRINE OF “COMPETENCE-COMPETENCE”

For practitioners accustomed to handling domestic arbitrations in the United States, perhaps the most surprising difference between arbitrations seated in the United States and those seated virtually anywhere else in the world is the allocation of jurisdiction between courts and arbitration tribunals under the doctrine of “competence-competence.” The doctrine of competence-competence, which is closely related to the doctrine of separability, holds that arbitration tribunals in the first instance have jurisdiction to determine their own jurisdiction over the subject matter or the parties to the arbitration—including the existence of the relationship giving rise to the arbitration. Taking the two most common jurisdictional issues, under the doctrine of competence-competence, arbitration tribunals thus have jurisdiction to consider (1) whether a matter in dispute falls within the scope of a particular arbitration agreement, and (2) whether a particular party is subject to an arbitration agreement.

The rule in United States federal courts has been very different. Under U.S. federal law, unless the parties have expressly allocated the power to determine the scope of an arbitration clause to the arbitrators, it is for a court to determine whether a particular matter falls within the terms of an arbitration agreement or whether parties in fact entered into an agreement to arbitrate. See *First Options of Chicago, Inc. v Kaplan* (1995) 514 US 938, 944, 131 L Ed 2d 985, 115 S Ct 1920. Indeed, a party may even get an injunction against a pending arbitration until the court determines whether the party has obligated itself to arbitrate the matter, on the theory that being required to

proceed to arbitration when not obligated to do is per se irreparable harm. *Masefield AG v Colonial Oil Indus., Inc.*, (SD NY 2005) 2005 US Dist Lexis 6737 (citing *Maryland Cas. Co. v Realty Advisory Bd. on Labor Relations* (2d Cir 1997) 107 F3d 979, 985).

### Impact of *Rent-A-Center* Decision

The recent United States Supreme Court decision in *Rent-A-Center* appears to chip away at what had been a peculiarly American allocation of jurisdiction through an extension of the separability doctrine. In a 5–4 decision, the *Rent-A-Center* court held that the issue of unconscionability of an arbitration agreement is for the arbitrator, not the court, to decide. *Rent-A-Center, West, Inc. v Jackson* (2010) \_\_\_ US \_\_\_, 177 L Ed 2d 403, 130 S Ct 2772. In *Rent-A-Center*, the claim of unconscionability was isolated to the parties’ arbitration agreement rather than the terms of their overall employment relationship. The Supreme Court nonetheless held that, because the unconscionability claim challenged the arbitration agreement as a whole instead of that part of the arbitration agreement that delegated authority to the arbitrator to resolve gateway disputes, the jurisdictional dispute had to be resolved by the arbitrator. 177 L Ed 2d at 419.

The *Rent-A-Center* majority ruled that the clause in the arbitration agreement dealing with the scope of the arbitrator’s authority was severable from the rest of the arbitration agreement. In that way, the majority could assert that it was following *Buckeye Check Cashing, Inc. v Cardegna* (2006) 546 US 440, 163 L Ed 2d 1038, 126 S Ct 1204, in which the arbitration agreement was severable from the underlying contract: “In this case, the underlying contract is itself an arbitration agreement. But that makes no difference. Application of the severability rule does not depend on the substance of the remainder of the contract.” *Rent-A-Center*, 177 L Ed 2d at 413. Accordingly, unless the challenge is specifically to the scope of the arbitration agreement, it is for the arbitrator, not the court, to decide the issue of unconscionability in the first instance.

The *Rent-A-Center* majority’s extension of the doctrine of separability has gone a long way toward adoption of the international view of competence-competence with respect to the arbitrators’ jurisdiction. Unless the parties have a specific challenge to the scope of the arbitrator’s jurisdiction under the arbitration agreement, it will be up to the arbitrators to decide the issue of validity of the arbitration agreement, *i.e.*, to determine their own jurisdiction. Under an arbitration agreement that expressly grants to the arbitrators the jurisdiction to determine whether the

agreement is valid, the arbitrators will have competence to make that decision in the first instance.

The doctrine of competence-competence has been enshrined in many of the sets of international arbitration rules. See, e.g., ICC Rules of Arbitration, Rule 6(2) (<http://www.iccwbo.org/court/arbitration/id4199/index.html>):

[I]f any party raises one or more pleas concerning the existence, validity or scope of the arbitration agreement, the Court may decide, without prejudice to the admissibility or merits of the plea or pleas, that the arbitration shall proceed if it is prima facie satisfied that an arbitration agreement under the Rules may exist. In such a case, any decision as to the jurisdiction of the Arbitral Tribunal shall be taken by the Arbitral Tribunal itself.

See also ICDR Rules of International Arbitration Rule 15(1) ([http://www.adr.org/sp.asp?id=33994#INTERNATIONAL\\_ARBITRATION\\_RULES](http://www.adr.org/sp.asp?id=33994#INTERNATIONAL_ARBITRATION_RULES)); LCIA Rule 23.1 ([http://www.lcia.org/Dispute\\_Resolution\\_Services/LCIA\\_Arbitration\\_Rules.aspx](http://www.lcia.org/Dispute_Resolution_Services/LCIA_Arbitration_Rules.aspx)); UNCITRAL Rule 23.1 ([http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/1976Arbitration\\_rules.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/1976Arbitration_rules.html)).

The California International Arbitration and Conciliation Act also expressly adopts the rule of competence-competence. It provides that (CCP §1297.161):

The arbitral tribunal may rule on its own jurisdiction, including ruling on any objections with respect to the existence or validity of the arbitration agreement, and for that purpose, an arbitration clause which forms part of a contract shall be treated as an agreement independent of the other terms of the contract, and a decision by the arbitral tribunal that the contract is null and void shall not entail ipso jure the invalidity of the arbitration clause.

After *Rent-A-Center*, the old U.S. federal common law rule of arbitration that a court, not an arbitrator, decides threshold challenges to arbitration agreements will largely be a thing of the past. Most agreements to arbitrate either have a broad arbitration clause or incorporate by reference arbitration rules that expressly allocate to arbitrators the gateway jurisdictional issues. The doctrine of competence-competence found outside the United States has therefore finally taken root here.

## DISCOVERY IN INTERNATIONAL ARBITRATION

In U.S. domestic arbitrations, the parties often engage in typical forms of litigation-style discovery, including depositions, broad-ranging document demands, and even interrogatories and requests for admission. Domestic arbitrators typically have subpoena power to require third parties to produce documents

or to appear at depositions or arbitration hearings. In that respect, U.S. domestic arbitrations have come to resemble domestic litigation.

International arbitration has a different philosophy. International arbitration has grown out of an attempt to meld the different legal systems that exist internationally, including the civil law system (in which pre-trial discovery is generally not permitted) and common law procedural methods. Even in common law systems outside the United States, document discovery is much more limited than under the broad U.S. standard of discoverability, and depositions are unheard of. Although not prohibited by the New York Convention or the FAA, U.S.-style discovery is almost universally not permitted in international arbitrations when the seat is outside the United States. Even if the seat of the arbitration is in the United States, discovery is generally much more restricted.

Under the principle of party autonomy, the scope of pre-hearing discovery is a procedural issue, largely left to the rules agreed to by the parties. One of the most common sets of rules used in the discovery and evidentiary stages of international arbitration is the IBA Rules on the Taking of Evidence in International Arbitration (IBA Rules) ([http://www.ibanet.org/Publications/publications\\_IBA\\_guides\\_and\\_free\\_materials.aspx](http://www.ibanet.org/Publications/publications_IBA_guides_and_free_materials.aspx)). The IBA Rules are designed to be used in conjunction with both institutional rules (e.g., the arbitration rules of the ICC, the ICDR, or the LCIA) and ad hoc rules (e.g., the arbitration rules of UNCITRAL or of the International Institute for Conflict Prevention and Resolution (CPR Institute)) for conducting international arbitrations.

There is no provision in the IBA Rules for the taking of depositions, even testimonial depositions of witnesses outside the subpoena power of the arbitral tribunal. Further, with regard to production of documents, the IBA Rules set forth limitations on scope such that with the permission of the arbitral tribunal a party may only request (1) specifically identified documents, or (2) “a description in sufficient detail (including subject matter) of a narrow and specific requested category of Documents that are reasonably believed to exist.” IBA Rule 3(a)(ii). In addition, the requesting party must state why the requested documents are “relevant to the case and material to its outcome.” IBA Rule 3(a)(ii). Finally, the requesting party must state (1) that it does not already have the requested documents in its possession, or why it would be unreasonably burdensome to produce them, and (2) why the requesting party believes the responding party has the documents. IBA Rule 3(a)(ii). Although the IBA Rules are not used in all international

arbitrations, they give a good flavor of the limitations on pre-hearing discovery available in this context.

### Discovery Under the FAA and California Law

The FAA is silent regarding the details of pre-hearing procedures. However, for international arbitrations seated in the United States, 9 USC §7 applies to permit courts to order third parties to produce documents and appear as witnesses at arbitrations. There is, however, a conflict among the courts regarding whether the subpoena power included in §7 permits tribunals to order pre-hearing discovery. Compare *Security Life Ins. v Duncanson & Holt, Inc.* (8th Cir 2000) 228 F3d 865, 870, with *Life Receivables Trust v Syndicate 102* (2d Cir 2008) 549 F3d 210. When the seat of the arbitration is in a “no pre-hearing discovery” jurisdiction, some practitioners try to avoid the “no pre-hearing discovery” restriction by requesting the arbitration tribunal to convene a hearing specifically for the purpose of preserving testimony or subpoenaing documents. It is an open question whether “no pre-hearing discovery” jurisdictions will countenance this artifice.

Like the FAA, the California International Arbitration and Conciliation Act provides little guidance to tribunals on how much pre-hearing discovery is available to litigants. Although California’s statute does not specifically mention document production or depositions, it does provide for subpoenas to obtain evidence. See CCP §1297.271. In contrast, California’s domestic arbitration rules do mention the right to discovery and, indeed, make that right nonwaivable in certain contexts. See CCP §§1283, 1283.05.

### E-Discovery in International Arbitration

The restricted approach to pre-hearing discovery in international arbitration turns into active aversion when it comes to production of electronically maintained documents. Although e-discovery is relatively common in both U.S. courts and in domestic arbitration proceedings, it is very rare in international arbitrations. The international arbitration rules largely ignore the issue. By default, they leave arbitration tribunals with the power to fashion their own solutions, although without much guidance. The newly revised IBA Rules address the issue, by providing that (IBA Rules §3(3))

in the case of Documents maintained in electronic form, the requesting Party may, or the Arbitral Tribunal may order that it shall be required to, identify specific files, search terms, individuals or other means of searching for such Documents in an efficient and economical manner.

## HEARING PROCEDURES IN INTERNATIONAL ARBITRATION

Practices with respect to the conduct of arbitration hearings vary widely in the world of international arbitration. In general, as long as there is basic due process and the parties are treated with equality, the parties and the tribunals are free to design their own hearing procedures. This freedom makes it difficult to identify distinctions between hearing procedures in domestic and international arbitrations. Some generalizations can be made, however. Although domestic arbitrations in the United States more or less resemble bench trials, with heavy reliance on direct and cross-examination, international arbitrations may proceed quite a bit differently, depending on the tribunal. It is common in international arbitration for direct examination to be submitted in the form of written witness statements, with the witness sitting for cross-examination and questions by the tribunal. Local practices may be applied to the scope and manner of examination, privilege issues, and admissibility of evidence, with the result that even practitioners who share the same common legal tradition, but come from different countries, may have to make significant adjustments to their means and manner of presentation at hearings. See Jacobs & Dasteel, *American Werewolves in London*, 18(2) *Arbitration Int’l* 165 (Oct 2, 2002).

Recently, international tribunals have begun to experiment with different ways of dealing with expert evidence. The traditional model of having each expert give testimony and then stand separately for cross-examination has been challenged. Some tribunals and parties have experimented with so-called “hot tubing,” where opposing experts meet in advance of the hearing to try to isolate their differences and then appear simultaneously at the hearing to explain those differences and respond to questions. See Kao et al., *Into the Hot Tub . . . A Practical Guide to Alternative Expert Witness Procedures in International Arbitration*, 44(3) *Int’l Lawyer* 1035 (Fall 2010).

In the end, the international arbitration rules typically leave the conduct of hearings entirely in the hands of the tribunal, mandating only the most basic due process requirements, e.g., the right to be represented by counsel, an opportunity to appear and present evidence, and the right to timely notice of any hearing. Beyond these basic requirements, international tribunals are generally free to decide whether and in what manner to receive testimony or documents.

## REQUIREMENT FOR A REASONED AWARD

The last key issue in international arbitration is the concept of a reasoned award. Most attorneys who have arbitrated under the domestic American Arbitration Association rules have seen the standard form of award, which merely states who won and how much. The idea behind this short form of award was to create a slender profile for appeal. It is hard to mount a claim that an arbitrator has engaged in manifest disregard of the law (to the extent U.S. courts still have access to that ground) or has exceeded the scope of his or her authority if all that a party has is a one-sentence award. One-sentence awards are routinely upheld in domestic arbitrations. See *United Steelworks v Enterprise Wheel & Car Corp.* (1960) 363 US 593, 598, 4 L Ed 2d 1424, 80 S Ct 1358 (“Arbitrators have no obligation to the court to give their reasons for an award.”). But is the same true for international arbitrations?

First, Article IV of the New York Convention provides three formal requirements to obtain recognition and enforcement of an international arbitration award. The party applying for recognition and enforcement must supply (1) “the duly authenticated original award or a duly certified copy thereof”; (2) “the original agreement [to arbitrate] referred to in article II or a duly certified copy thereof”; and (3) “if the said award or agreement is not made in an official language of the country in which the award is relied upon . . . a translation of these documents into such language.” New York Convention, Art IV, §§1, 2. The New York Convention’s terms do not require that the award include reasons.

Similarly, the Federal Arbitration Act does not require reasons for an award. Section 207 merely refers back to the New York Convention for the grounds on which the court may refuse enforcement. The only additional ground for refusal added by the FAA is that the application for confirmation of an award must be brought within 3 years after the award was made. 9 USC §207.

Although neither the New York Convention nor the FAA expressly requires a reasoned award, international arbitration essentially requires a reasoned decision as a matter of practice. See Born, 2 International Commercial Arbitration 2451. There are two reasons: First, most countries outside the United States will not enforce an award that does not include a reasoned decision. See Born, 2 International Commercial Arbitration at 2452. Many jurisdictions consider it an

essential element of the adjudicative process to provide reasons for a decision. See Born, 2 International Commercial Arbitration at 2453. Accordingly, even though there is no technical requirement under the New York Convention or the FAA for a reasoned award, failure to require a tribunal to issue a reasoned award may mean that the award is not enforceable outside the United States.

Second, most sets of international arbitration rules require a reasoned award. See ICC Rule 25(2); LCIA Rule 26.1; UNCITRAL Rule 34(3); ICDR Rule 27(2). Indeed, the ICC arbitration rules not only require a reasoned award but also require “scrutiny” of the award by the ICC court before the award will be issued to the parties. ICC Rule 27. Thus, as a practical matter, even if a reasoned award is not technically required for enforcement under U.S. law, the rules adopted by the parties in an international arbitration will likely require one. Under the California International Arbitration and Conciliation Act, unless the parties otherwise agree, “[t]he arbitral award shall state the reasons upon which it is based.” CCP §1297.313.

## CONCLUSION

There are fundamental differences between international arbitration and domestic arbitration. There is a widely adopted international treaty, the New York Convention, which requires signatory countries to recognize and enforce covered arbitration awards. The New York Convention has been implemented in the United States by Chapter 2 of the Federal Arbitration Act, a statutory scheme different from and parallel to Chapter 1, which concerns domestic arbitrations. California has its own dual statutory scheme separating international arbitrations from domestic arbitrations.

The different statutory schemes mean that different rules govern the procedures for enforcing or setting aside an international arbitration award. These jurisdictional distinctions may provide advantages for parties seeking to enforce an arbitration clause or award.

The differences between domestic and international arbitrations do not end with recognition and enforcement, however. Arbitration procedures also reflect key differences. As noted in this article, the concepts of separability and competence-competence have special application in the realm of international arbitration. In addition, practitioners should expect more limitations on pre-hearing discovery and, in some cases, no discovery at all may be permitted. Finally, practitioners should make sure to request a “reasoned” award in any international arbitration to reduce the risk that a hard-won award will not be enforced.

# Financing Provisions in Acquisition Agreements

Linda L. Curtis  
Melissa L. Barshop



**Linda L. Curtis** is partner in the Los Angeles office of Gibson, Dunn & Crutcher LLP. Her practice focuses on all aspects of corporate finance, including leveraged financings and debt capital markets transactions. She received her A.B. in Public Affairs/Economics from Princeton University, her B.A. in Jurisprudence from Oxford University, and her J.D. and M.B.A. degrees from Stanford University.



**Melissa L. Barshop** is an associate in the Century City office of Gibson, Dunn & Crutcher LLP. Her practice focuses on corporate finance, including secured and unsecured credit transactions and debt capital markets transactions. She received her B.A. from the University of California, Berkeley, and her J.D. from Columbia University.

## INTRODUCTION

Corporate acquisition transactions can take many forms, including mergers, equity purchases, asset purchases, and recapitalizations. Regardless of form, many acquisitions are funded with a combination of equity financing from the buyer and debt financing from a lender or group of lenders identified by the buyer. Especially in public company acquisition transactions, there can be a long time-lag between execution of the acquisition agreement and consummation of the transaction, due to the need to satisfy closing conditions such as antitrust clearance and shareholder approval. Although lenders often provide financing commitments at the time of signing of the acquisition agreement, the commitments typically have some conditions to their obligation to consummate the financing. These conditions may include contingencies not reflected in the acquisition agreement, such as financial conditions applicable to the business of the target company at closing. In the wake of the 2008 financial crisis, one of the most hotly negotiated issues in leveraged acquisition transactions is the allocation between the buyer and the seller of the risk that the contemplated debt financing for the acquisition fails to materialize between signing and closing.

**NOTE:** The buyer in a corporate acquisition may be a financial sponsor or strategic purchaser, or a combination of one or more sponsors and strategic purchasers. The buyer may include one or more shell acquisition subsidiaries. The term “seller” as used in this article includes not only

the target company but also, to the extent applicable, the target’s equity holders receiving consideration in the transaction.

The allocation between buyer and seller of the risk that an acquisition financing may not be obtained is accomplished in part by provisions in the acquisition agreement. These provisions may include (1) the presence, or absence, of a financing condition to the buyer’s obligation to close (and alternative provisions, such as a reverse breakup fee), (2) the buyer’s representation to the seller concerning the terms of its committed debt financing, (3) the covenant of the buyer to obtain financing, and (4) the covenant of the seller to cooperate with the buyer in obtaining financing. The acquisition agreement also may include financing-related provisions specific to the business of the buyer or seller or to the transaction itself. In addition, in the wake of the litigation among buyers, sellers, and lenders that occurred when acquisition financing collapsed during the financial crisis, it has become customary for lenders to seek in acquisition agreements so-called “Xerox” provisions, intended to mitigate the lenders’ risk of liability to the buyer for failure to fund.

## FINANCING CONDITIONS AND REVERSE BREAKUP FEES

A financing condition is a condition to the buyer’s obligation to close the acquisition that the buyer has obtained the debt financing contemplated at the date of signing the acquisition agreement, or alternative debt financing on comparable terms. A “pure” financ-



ing condition squarely allocates the risk of a failure of the debt financing to the seller. If the debt financing fails to materialize, the buyer's obligation to consummate the acquisition is excused and the buyer has an option to walk away from the deal without penalty. The consequences to the seller of a failure of the debt financing may include material economic loss. The seller may not be able to obtain a price comparable to the original price, and there is a risk of reputational loss for a failed deal. Out-of-pocket expenses for the seller may also be significant. For this reason, sellers often resist a "pure" financing condition strongly, particularly in auction situations where sellers have many alternative suitors.

Financing conditions that allocate the financing risk completely to the seller as described above are rare in the current public market. Indeed, a number of recent public merger agreements have included language specifically disclaiming any financing condition. A compromise approach that has become common in order to allocate the risk of a failure of the debt financing between seller and buyer is the so-called "reverse breakup fee." A reverse breakup fee is an amount payable to a prospective *seller* if the buyer fails to consummate the acquisition due to conditions specified in the acquisition agreement, which may include the failure of the buyer's proposed debt financing. (In contrast, a traditional breakup fee is an amount payable to a prospective *buyer* if the seller fails to consummate the acquisition as a result of specified conditions, such as the acceptance of an alternative bid by the seller.)

In some deals, the reverse breakup fee is the sole remedy for a financing failure, but the buyer retains a potential remedy of specific performance or damages for a willful or other type of breach. In other deals, the reverse breakup fee is the sole remedy for any type of breach by the buyer. The latter type of structure is called a "pure option" reverse breakup fee, because, in essence, it gives the seller an option to walk away from the transaction for an agreed price.

The reverse breakup fee provisions need to be considered in the overall context of the other remedial provisions of the acquisition agreement. Some deals establish one level of reverse breakup fee for financing failures and another level for other types of breaches, often including a higher amount for "willful" breaches. It is important that the specific performance, damages, and reverse breakup fee provisions be drafted clearly and that their interaction consistently reflects the parties' intent. The Delaware Chancery Court has held that a specific performance remedy may be unavailable in light of conflicted contractual provisions. See *United Rentals, Inc. v RAM*

*Holdings, Inc. & RAM Acquisition Corp.* (Del Ch 2007) 937 A2d 810.

In addition, in reviewing its remedies for a potential buyer breach or financing failure, the seller will want to take into account the creditworthiness of the buyer entity. In many leveraged transactions, the buyer's merger subsidiary and its direct owner (the parties to the acquisition agreement) may be mere shell entities with no assets at the time of execution of the agreement. As a result, the seller will want to seek a guaranty or other type of recourse to a creditworthy entity.

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**A reverse breakup fee is an amount payable to a prospective *seller* if the buyer fails to consummate the acquisition due to conditions specified in the acquisition agreement, which may include the failure of the buyer's proposed debt financing.**

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## BUYER'S FINANCING REPRESENTATIONS

### Representations Concerning Financing Commitments

The buyer will be asked to make certain representations to the seller regarding its financing commitment letters. As used in this article, the phrase "financing commitment letters" includes one or more of the equity and debt commitment letters, the fee letter relating to the debt commitment, and (if applicable) any engagement letter with respect to potential debt securities to be included in the debt financing. One of these representations will be that the buyer has provided to the seller true, correct, and complete copies of the applicable financing commitment letters. (See Example 1, p 86.)

From the buyer's perspective, the seller's representation that it has provided to the buyer current copies of its financing commitment letters is essential. Whether there is a financing condition in the agreement or not, the seller needs to be able to understand how the conditions to the financing relate to the conditions to the acquisition. The conditions to the debt financing are usually the focus of most of the discussion. Both buyer and seller will be incentivized to make the conditions to the debt financing track as closely as possible the conditions to closing in the acquisition agreement. It is common, for example, for the material adverse change condition in the debt financing commitment to be conformed virtually word for word to the material adverse change condition in

**Example 1:****Sample Buyer Financing Representation  
(Availability of Commitment Letters)**

**Parent has delivered to the Company true, correct and complete copies of the executed commitment letters from Bank of America, N.A., Merrill Lynch, Pierce, Fenner & Smith Incorporated and Royal Bank of Canada, dated as of the date hereof (the “Debt Commitment Letter”), pursuant to which, and subject to the terms and conditions thereof, the lender parties thereto have committed to lend the amounts set forth therein to Parent for the purpose of funding the transactions contemplated by this Agreement (the “Debt Financing”), and (ii) the executed equity commitment letter, dated as of the date hereof (the “Equity Commitment Letter” and, together with the Debt Commitment Letter, the “Financing Commitments”) from certain funds affiliated with Apax Partners, L.P. (“Sponsor”) pursuant to which Sponsor has caused such funds to commit to invest the amounts set forth therein (the “Equity Financing” and, together with the Debt Financing, the “Financing”). The Equity Commitment Letter provides, and will continue to provide, that the Company is a third party beneficiary thereof.**

See Epicor Software Corporation, Current Report on Form 8-K, Exhibit 2.1 (Agreement and Plan of Merger dated as of April 4, 2011 between Eagle Parent, Inc., Element Merger Sub, Inc., and Epicor Software Corporation) (Epicor Merger Agreement), Section 5.8(a), filed April 6, 2011, available at <http://www.sec.gov/Archives/edgar/data/891178/000119312511090368/dex21.htm>.

the acquisition agreement. Both buyer and seller will focus on, and attempt to eliminate, conditions to the debt financing that are not conditions to the acquisition (*e.g.*, minimum EBITDA or other financial conditions). So called “SunGard” provisions (limiting conditionality in debt financing commitments with respect to representations and warranties required for closing, and with respect to certain collateral matters) are common in the current market.

One particular point of contention in the financing representation can be whether a redacted version of the fee letter between the buyer and its lenders will be disclosed to the seller, and what information will be redacted. It has become customary in preparing acquisition financing commitments to include in the fee letters not only the amount of any fees payable to the

lenders, but also other potentially confidential provisions. A key set of provisions often included in fee letters are the so-called “market flex” provisions, which give the lenders some flexibility to change provisions of the financing commitment in connection with the syndication of the debt. Because fee letters are subject to confidentiality requirements, a buyer will need to obtain its lenders’ consent for any disclosure, which the lenders may be unwilling to provide. At a minimum, they will insist on redaction of the fee amounts. They may also redact certain of the market flex provisions and other amounts. If the buyer has entered into an engagement letter with an investment bank to place a portion of the financing, the treatment of confidential economic information may be similar to that of the fee letter. (See Example 2, p 87.)

The seller, however, may request limited information relating to market flex and the maximum amount of fees payable under the commitment letter(s). The market flex provisions of the fee letter give the lenders flexibility on pricing and potentially other terms in connection with syndication of the loans, but in reviewing these provisions, the seller will want to make sure that they do not give the lenders the ability to impose new conditions to the availability of the financing at closing.

The buyer’s financing representation also normally includes the following matters relating to the financing commitments:

- A representation with respect to the enforceability of the financing commitment letters;
- A representation that, as of the date of the acquisition agreement, there has been no event that would constitute a default under the financing commitment letters;
- A statement that there are no contingencies to funding the full amount of the financing, other than as set forth in the financing commitment letters;
- A representation that, assuming the full amount of the financing is funded at closing, the buyer will have sufficient funds to pay the acquisition consideration, as well as any fees and expenses required to be paid in connection with the acquisition and the financing, and to pay amounts related to refinancing of any outstanding indebtedness of the seller contemplated by the acquisition agreement and financing commitment letters.

**Buyer’s Solvency Representation**

Separate from the representation concerning the financing commitments, it has become common in public leveraged buyouts for the buyer to represent to the

**Example 2:****Sample Buyer Financing Representations  
(Fee Letter and Engagement Letter)**

**Except for a fee letter and an engagement letter (complete copies of which have been provided to the Company with only the fee amounts and certain economic terms of the market flex (none of which would adversely affect the amount or availability of the Debt Financing if so required by the lenders party to such letters) redacted), there are no side letters or other agreements, contracts or arrangements relating to the Financing Commitments.**

See Epicor Merger Agreement, Section 5.8(b), third sentence.

**Parent has delivered to the Company true, correct and complete fully executed copies of the commitment letter, dated as of the date hereof, among Parent, Bank of America, N.A. and Merrill Lynch, Pierce, Fenner & Smith Incorporated, including all exhibits, schedules, annexes and amendments to such agreement in effect as of the date of this Agreement, and excerpts of those portions of each fee letter and engagement letter associated therewith that contain any conditions to funding or “flex” provisions (excluding provisions related solely to fees) regarding the terms and conditions of the financing to be provided thereby . . .**

See Silgan Holdings Inc., Current Report on Form 8-K, Exhibit 2.1 (Agreement and Plan of Merger dated as of April 12, 2011 between Silgan Holdings Inc. and Graham Packaging Company Inc.) (Silgan Merger Agreement), Section 3.02(s), filed April 18, 2011, available at <http://www.sec.gov/Archives/edgar/data/849869/000119312511101026/dex21.htm>.

seller that the purchased enterprise will be “solvent” after giving effect to the sale transaction and related debt financing. Solvency is usually defined in a way consistent with applicable state and federal fraudulent transfer laws and in light of case holdings that certain aspects of leveraged buyout transactions may be challenged as fraudulent transfers. The solvency definition will therefore usually include not only a balance sheet test but also tests to the effect that the entity will be able to pay debts as they become due and that the entity will not be left with unreasonably small capital. Solvency—either of the seller’s enterprise as a whole

on a consolidated basis or with respect to specific borrower and guarantor entities—may be a condition to the debt financing. The buyer may have more detailed information available to it concerning the economics of the financing than will the seller. In making the solvency representation, the buyer will usually be able to assume that the seller is in compliance with all of its representations and warranties in the acquisition agreement or at least the provisions relating to its financial condition.

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**A key set of provisions often included in fee letters are the so-called “market flex” provisions, which give the lenders some flexibility to change provisions of the financing commitment in connection with the syndication of the debt.**

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#### BUYER’S COVENANT TO OBTAIN FINANCING

The buyer’s financing covenant contains the buyer’s undertaking to use “reasonable best” efforts (or “commercially reasonable” efforts, or a similar formulation) to obtain the financing described in the financing commitment letters. The additional provisions of the covenant supplement and add detail to this general undertaking. They often include the buyer’s agreement not to permit any modification of the terms of the financing commitments without the seller’s consent, subject to certain exceptions (which often include adding or replacing lenders, but not adding any new conditions to funding or expanding the existing conditions). Further, in the additional provisions of the covenant, the buyer usually agrees to:

- Maintain the financing commitment letters in effect and comply with all obligations thereunder;
- Enter into definitive agreements for the debt financing (sometimes within a specified number of days of signing the acquisition agreement);
- Give notice to the seller if certain events (such as default) occur under the financing commitment letters; and
- Obtain alternative financing (generally, on terms not materially less favorable to the buyer) if the original financing contemplated by the financing commitment letters becomes unavailable.

One component of the covenant to obtain the financing under the financing commitment letters is that the buyer generally agrees to use reasonable ef-

forts (or a similar standard) to enforce its rights under

**Example 3:  
Sample Buyer Covenant to Enforce  
Financing Commitments  
(General Undertaking and  
Enforcement of Commitment Language)**

**Parent shall use its reasonable best efforts to take, or cause to be taken, all actions and to do, or cause to be done, all things necessary, proper or advisable to consummate and obtain the Financing on the terms and conditions described in the Commitment Letter, including using best efforts to (i) maintain in effect the Commitment Letter and, if entered into prior to the Closing, the definitive documentation with respect to the Financing contemplated by the Commitment Letter (the "Definitive Agreements"), . . . and (v) enforce its rights under the Commitment Letter and Definitive Agreements in the event of a breach by the Financing Sources that impedes or delays the Closing, including by seeking specific performance of the parties thereunder if necessary, unless Parent reasonably concludes that seeking specific performance is impracticable or not reasonably likely to succeed under such circumstances. In the event that all conditions to the Financing have been satisfied, Parent shall use its reasonable best efforts to cause the lenders and the other persons providing such Financing to fund such Financing on the Closing Date.**

See Silgan Merger Agreement, Section 5.12(a) (excerpted from first sentence).

The wording of the provision concerning the buyer's obligation to enforce its rights under the financing commitment letters can be controversial. The buyer will want the maximum flexibility in its relationship with its lenders. Accordingly, the buyer may be hesitant to be overly specific in the acquisition agreement about the actions it will take to enforce its rights under the commitment letters.

**SELLER'S FINANCING  
COOPERATION COVENANT**

In a leveraged buyout, the target's assets and revenue are used to support the acquisition financing. Indeed, in a financial sponsor acquisition, the target's business may be the sole or primary source of recourse for the acquisition lenders. Even if the buyer is

the commitment letters. (See Example 3, p 88.)

a strategic buyer, the target's business likely will provide part of the credit support for any acquisition financing. Accordingly, the buyer will seek a covenant from the seller that it will cooperate with the buyer in obtaining the buyer's financing contemplated by the financing commitment letters.

In the wake of the financial crisis, buyers have been serving up significantly more detailed and extensive requirements for the seller's assistance with the financing. This development is being driven in part by lenders' insistence on increasingly detailed syndication conditions in the financing commitment letters. It also benefits the buyer by creating more "optionality" in the acquisition agreement: If the buyer does not want to close, it will look for covenant breaches by the seller, which will allow it to terminate the acquisition agreement without paying the reverse breakup fee. On the other hand, sellers seek to streamline their cooperation covenant and define their obligations as clearly as possible. As a result, these provisions are heavily negotiated.

As in the case of the buyer's covenant to obtain the financing, the seller's cooperation covenant begins with a general statement of the seller's obligation, followed by specific agreements that supplement the general undertaking. (See Example 4, below.)

**Example 4:  
Sample Seller Covenant to Cooperate With  
Buyer in Obtaining Financing  
(General Undertaking)**

**The Company shall, and shall cause its Subsidiaries to, at the sole expense of the Parent use its and their reasonable best efforts to provide such cooperation as may be reasonably requested by Parent in connection with the financing of the Transactions, if any, including . . . .**

DPL Inc., Current Report on Form 8-K, Exhibit 2.1 (Agreement and Plan of Merger dated as of April 19, 2011 between DPL Inc., The AES Corporation, and Dolphin Sub, Inc.) (AES Merger Agreement), Section 5.13(a) (initial sentence/lead in), available at [http://www.sec.gov/Archives/edgar/data/874761/000114420411023092/v219172\\_ex2-1.htm](http://www.sec.gov/Archives/edgar/data/874761/000114420411023092/v219172_ex2-1.htm).

The list of specific seller undertakings often includes the seller's agreement to, or in certain cases to use "reasonable best" efforts (or "commercially reasonable" efforts, or a similar formulation) to:

- Participate in lender meetings, rating agency presentations, and bond offering road shows, and prepare related documents (bank book, rating agency presentation, and bond offering documents);
- Execute definitive loan documents and certificates (including a solvency certificate) for closing of the financing; and
- Obtain auditor comfort letters and legal opinions.

The seller typically requires the buyer to indemnify the seller for any actions taken in connection with buyer's financing and to reimburse the target for any fees and expenses that it incurs by its compliance with the cooperation covenant. The covenant also customarily makes clear that the seller will not be liable for any fees or expenses related to the financing unless and until the acquisition closes.

### Required Information and Marketing Period

#### Required Information

The financing cooperation covenant will often include an obligation of the seller to deliver "Required Information" (sometimes called "Required Financial Information") to start the "Marketing Period." The intent of this covenant is to give the buyer a sufficient period of time before the closing to syndicate its debt financing, including (but not necessarily limited to) any part of the debt financing consisting of a private placement or public offering of securities. These two definitions are often the most heavily negotiated of the financing-related provisions in the acquisition agreement.

In general, "Required Information" is the financial information needed by the buyer to prepare an offering document for its debt financing. There is an important distinction between "Required Information" (which must be provided before the closing of the acquisition) and the other information and assistance required by the cooperation covenant (which usually requires only "reasonable efforts" or a similar standard to satisfy). For this reason, the seller will want to move as many requirements as possible out of the "Required Information" definition and into the general provisions of the financing assistance covenant. At a minimum, "Required Information" will usually include financial statements and other financial data required by Regulation S-X (17 CFR pt 210) and Regulation S-K (17 CFR pt 239) of the Securities Act of 1933 (Securities Act) (15 USC §§77a-77aa) for registered offerings, of the type and form customarily included in private placements under Rule 144A of the Securities Act (17 CFR §230.144A). Often it will also include other information and data as necessary

to receive customary auditor comfort letters with respect to the financial statements and other financial data described above. The buyer will often request that "Required Information" include information necessary to prepare pro forma financial statements. The seller may agree to include such information as "Required Information," but will clarify that preparation of the pro forma financial statements is the buyer's responsibility. There often are deal- and party-specific carveouts and exceptions to the definition. (See Example 5, p 90.)

#### Marketing Period

The "Marketing Period" ties to the buyer's obligation to close the transaction. As usually defined, it is the minimum number of days that must elapse before closing to allow for marketing the buyer's financing. The basic length of the marketing period for many transactions in the current market is 20 calendar or business days. Many acquisition agreements will provide for a delay after execution of the agreement before the marketing period can begin, to give the buyer time to prepare the bank book, rating agency presentation, and bond offering memorandum. The time period of this delay may be tied to the expiration of the go-shop period or the mailing of the proxy statement. Depending on the time of year in which the acquisition agreement is signed, the marketing period may also have a built-in delay for the winter holiday season or other seasonal events to account for the difficulty of marketing debt during this time. For example, the acquisition agreement may provide that if the marketing period has not ended before Christmas, it will not commence until after the new year.

In addition, the Marketing Period usually can begin only after certain closing conditions in the acquisition agreement are satisfied or waived. At a minimum, these conditions include stockholder approval of the deal, a bring-down of the seller representations (including the representation that there has been no material adverse change), and the absence of any injunction or law restraining or prohibiting consummation of the acquisition. The buyer will seek to include additional conditions, such as compliance with covenants, obtaining regulatory or third party consents, and delivery of certain certificates and affidavits. The seller will often draft a notice provision in the acquisition agreement, enabling it to give notice to the buyer that it believes in good faith that it has provided the Required Information and that the Marketing Period will be deemed to have commenced unless the buyer objects in good faith within a specified time period.

**Example 5:  
Sample Definition of "Required  
Information"**

**. . . all consolidated financial statements and other pertinent information related solely to the Company and the Company Subsidiaries required by the Financing Commitments and all financial statements, financial data, audit reports and other information related solely to the Company and the Company Subsidiaries required by Regulation S-X (other than Sections 3-10 and 3-16) and Regulation S-K under the Securities Act and of type and form customarily included in an offering memorandum pursuant to Rule 144A under the Securities Act to consummate the offering(s) of debt securities contemplated by the Financing Commitments, but without the Company having to prepare separate financial statements for any Company Subsidiary or changing any fiscal period and (ii) during the period commencing on the twenty-third (23rd) Business Day immediately prior to July 13, 2011, and ending on the filing of the 2011 10-K, preliminary financial results of the Company and the Company Subsidiaries for the fiscal year ended May 31, 2011, including a preliminary consolidated balance sheet, preliminary income statement and preliminary cash flow statement (and, if available, any preliminary audit adjustments and notes thereto) (all such information in this clause (d), the "Required Financial Information"); provided, however, that Required Financial Information shall not include, and Parent shall be solely responsible for, the preparation of pro forma financial information including, pro forma cost savings, synergies, capitalization, ownership or other pro forma adjustments desired to be incorporated into any pro forma financial information; provided, further, however, that Required Financial Information shall not include any of the information required by Items 10-14 of Form 10-K;**

See Lawson Software, Inc., Current Report on Form 8-K, Exhibit 2.1 (Agreement and Plan of Merger by and among GGC Software Holdings, Inc., Atlantis Merger Sub, Inc. and Lawson Software, Inc. dated as of April 26, 2011), Section 6.7(d), filed on April 26, 2011, available at [http://www.sec.gov/Archives/edgar/data/1344632/000104746911004086/a2203658zex-2\\_1.htm](http://www.sec.gov/Archives/edgar/data/1344632/000104746911004086/a2203658zex-2_1.htm).

The Marketing Period may also include triggers for certain accounting-related events that will suspend the Marketing Period, such as withdrawal of the audit opinion with respect to any financial statements, announcement of a restatement of the seller's financials, a delay in SEC reporting, or the receipt of material SEC comments on a disclosure document. The seller should exercise caution, however, because these triggers can work as a proxy for financial-related conditions that would not otherwise cause a failure of a closing condition. Because these conditions are not typically included in the financing commitment letters, the seller will argue that these conditions should not delay or prevent the closing of the acquisition. If the buyer's debt financing includes a Rule 144A (or other securities) offering component, the buyer will often negotiate with its lenders for a committed bridge loan to be available in the event that the securities markets are unfavorable at the time of the closing. The seller will expect such a bridge commitment and will argue in the context of negotiating the Marketing Period definition that the bridge loan is intended to be a backstop to the securities offering.

The buyer also needs to ensure that the financial information provided does not go stale during the Marketing Period. As a result, the definition often incorporates a provision that the Marketing Period will not be deemed to have commenced if the financial statements included in the Required Information would be required to be updated under Regulation S-X during the 20-day period in order to permit a registration statement using those financial statements to be declared effective by the SEC.

### DEAL-SPECIFIC FINANCING PROVISIONS

In addition to the provisions discussed above, an acquisition agreement may include specific financing-related provisions concerning the particular buyer, seller, or transaction. Examples of these provisions include provisions relating to the disposition of convertible debt securities, the seller's cooperation with respect to a preclosing tender offer for debt securities of the seller, and the prepayment of the seller's bank debt. The buyer's confidentiality obligations with respect to nonpublic information of the seller will need to be tailored to take into account the possible disclosure of such information to prospective lenders as part of the debt syndication process.

### LENDER LIABILITY PROTECTION PROVISIONS

In the wake of litigation relating to financing failures during the financial crisis (see, e.g., *BT Triple Crown Merger Co., Inc. v Citigroup Global Mkts., Inc.* (NY Sup Ct 2008) 866 NYS2d 90; *Hexion Specialty Chems., Inc. v Huntsman Corp.* (Del Ch 2008) 965 A2d 715), acquisition lenders are concerned that sellers may claim that any failure to fund committed acquisition financing amounts to tortious interference with the acquisition agreement and that lenders could face potential tort liability. This liability might even exceed the amount of any reverse breakup fee or damages cap negotiated by the buyer in the acquisition agreement. The lawsuits potentially could be brought in forums favorable to the seller (e.g., before juries in the seller's home state).

In response, acquisition lenders have developed the so-called "Xerox" language to be included in the acquisition agreement. (The language is referred to as "Xerox" language because it first came to the market's attention when it was included in a 2009 merger agreement among Xerox Corporation, Boulder Acquisition Corp., and Affiliated Computer Services, Inc. See <http://www.sec.gov/Archives/edgar/data/108772/000119312509199142/dex21.htm>) The language gives the lenders the benefit of any cap on damages negotiated by the buyer. Some variant of the Xerox language is now routinely included in public acquisition agreements.

The Xerox provisions typically include the following:

- The lenders have the benefit of any cap on damages negotiated by the buyer (so that if the reverse breakup fee is the sole and exclusive remedy of the seller under the acquisition agreement as against the buyer, it is also the sole and exclusive remedy as against the lenders);
- New York is the exclusive jurisdiction for any action brought against the lenders in connection with the acquisition;
- Buyer and seller waive any right to a jury trial; and
- The lenders are express third-party beneficiaries of these provisions.

### CONCLUSION

Debt financing will continue to be an important part of corporate acquisitions for the foreseeable future. As long as debt remains an important source of funding, sellers and buyers will continue to struggle with minimizing, and allocating between themselves,

the risk of a debt financing failure between signing and closing. The outcome of this negotiation in any particular transaction will depend in part on the negotiating leverage of the parties and the nature of their particular businesses. The typical representations, warranties, and covenants that allocate the financing

risk in the acquisition agreement are complex and will continue to evolve as creative buyers and sellers (and their counsel) continue to improve and refine them.



## Raising Seed Capital from the Rest of Us: Addendum

Jennifer Kassan

The following case note, concerning the “risk capital” test for a security under California state law, amends the author’s article, *Raising Seed Capital From the Rest of Us*, 26 CEB Cal Bus L Prac 42 (Spring 2011).

In *Silver Hills Country Club v Sobieski* (1961) 55 C2d 811, 13 CR 186, some enterprising developers bought land in Marin County to develop a country club. To help pay construction costs, they sold charter memberships in the club. The members would not share in the profits or ownership of the club but would have the right to use club facilities. Under the federal definition, the memberships would not be securities because the members joined the club to get the benefits of membership, not for a financial return. However, the California Supreme Court found otherwise.

The court formulated a new test for a security under former Corp C §25008 (now Corp C §25019): the risk capital test. This test considers:

- Whether funds are being raised for a business venture or enterprise;

- Whether the transaction is offered indiscriminately to the public at large;
- Whether the investors are substantially powerless to effect the success of the enterprise; and
- Whether the investor’s money is substantially at risk because it is inadequately secured.

The risk-capital test has since been adopted in some form in more than 17 jurisdictions.

If the investment is sufficiently collateralized, however, or if the investor is actively involved in the venture, California courts will not consider the arrangement a security. If an investor has an active and substantial participation in the venture and expects to reap a profit from his or her own services, the investment generally will not be considered a security. *Fox v Ehrmantraut* (1980) 28 C3d 127, 139, 167 CR 595; *People v Graham* (1985) 163 CA3d 1159, 1168, 210 CR 318 (lack of managerial control on investor’s part is key to identifying a security under risk-capital test).

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Ms. Kassan acknowledges the assistance of Karan Dhadialla in the preparation of this Addendum.