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European Union

New regulation streamlines intra-EU trade

A new regulation brings more clarity to the flow of goods inside the European Union, according to **Mia Declercq**, **Geert Bovy** and **Natasja De Splenter**.

Since May 13, 2009, the Regulation on Mutual Recognition of Goods has applied in all the EU Member States.

This lays down a number of new rules and procedures to be followed by the Competent Authorities of a Member State wishing to make a decision which would hinder the free movement of a product which is not subject to harmonized community legislation and which is already lawfully marketed in another Member State.

In intra-EU trade in goods, mutual recognition is the principle under which a product lawfully marketed in one Member State and not subject to community harmonization should be allowed to be marketed in any other Member State, even when the product does not fully comply with the technical rules of the Member States of destination. It maintains that a product that complies with the laws of one Member State should be allowed to move freely to other Member States within the EU.

There is one exception to this principle: the Member States of destination may refuse the marketing of such products where they can show that this is strictly necessary for the protection of certain higher standards, e.g., public safety, health and life of humans, animals and plants or the environment.

The Member State of destination must also demonstrate that the measures it wishes to take against the marketing of such products are the least trade-restrictive, i.e., proportionate to the aim pursued.

The principle of mutual recognition derives from Article 28 of the EC Treaty, as interpreted by the European Court of Justice (ECJ), which provides that the Member States may not introduce quantitative import restrictions or measures having equivalent effect. The principle of mutual recognition was recognized and established by the ECJ in 1979 in the famous Cassis de Dijon case.

Many problems, however, continued to exist with respect to the correct application of the principle of mutual recognition. Competent Authorities lacked appropriate procedures for the application of their technical rules to specific products lawfully marketed in another Member State. Also, the marketplace was not sufficiently aware of the principle and its operational consequences.

Due to the legal uncertainty about the products covered by the principle and the burden of proof, national Competent Authorities as well as the businesses involved often took a very cautious attitude. Businesses complained that it was very difficult for them to know if, how and when mutual recognition would be applied. Also, there seemed to be a lack of dialogue between the Competent Authorities of the different Member States.

The new Regulation on mutual recognition is intended to give a fresh impetus to the free movement of goods by strengthening mutual recognition while guaranteeing a high level of safety and consumer protection. It introduces a uniform procedure for all Member States regarding the burden of proof, consultation rights and justification when dealing with the recognition of a product which is not subject to community legislation that is lawfully marketed in another Member State.

What's affected?

The Regulation basically applies to all cases where an authority intends to adopt an administrative decision to an economic operator based on a so-called technical rule about prohibiting or restricting the marketing of a product (including agricultural and fish products) which is not subject to harmonization at EU level and which is lawfully marketed in another EU Member State.

[A technical rule is any provision of a law, regulation or other administrative provision which is not the subject of harmonization at the community level, and which prohibits the marketing of a product or type of product in the territory of that Member State or compliance which is compulsory when a product or type of product is marketed in the territory of that Member State, and which lays down either:

- the characteristics required of that product or type of product, such as levels of quality, performance or safety, or dimensions, including the requirements applicable to the product or product type as regards the name under which it is sold, terminology, symbols, testing, and test methods, packaging, marketing or labeling;
- or any other requirement which is imposed on the product or type of product for the purposes of protecting consumers or the environment, and which affects the life cycle of the product after it has been placed on the market, such as conditions of use, recycling, reuse or disposal, where such conditions can significantly influence the composition, nature or marketing of the product or type of product.)

The Regulation applies only to products or particular features of products which are not subject to Community harmonization. The provisions of such harmonization measures are often exhaustive, in which case Member States may not prohibit, restrict or impede the marketing in their territories of products complying with those measures. Some community harmonization measures, however, permit Member States to impose additional technical conditions which should conform with Articles 28 and 30 of the Treaty and with the new rules in the Regulation.

The Commission is drawing up a detailed list of products for which the Regulation applies although the list will only be indicative, not exhaustive, and will be regularly updated. The list of products will follow the customs code for import-export.

What's not?

There are a number of products or situations that fall outside the scope of the Regulation.

These include:

- most railway equipment;
- the withdrawal and recall measures of dangerous products under the General Product Safety Directive;
- the withdrawal and recall measures of food and feed in order to protect human health and requiring rapid action;
- emergency measures for food and feed (Rapid Alert System for food and feed); and
- measures regarding noncompliance with EU food and feed law (official control measures, including feed and food labeling and other types of consumer information).

A national authorization scheme established in any provision of a law or administrative provision is not considered a technical rule covered by the Regulation. Should a national legislation establish a mandatory authorization scheme for a product, the authority is then entitled to immediately remove the product from the market if the product is marketed without the statutory authorization. When, however, application for such mandatory prior authorization of a product is made, any intended decision to reject the application on the basis of a technical rule should be taken in accordance with the Regulation, so that the applicant could benefit from the procedural protection which the Regulation provides.

Procedure required

A possible denial of mutual recognition by a Member State obliges national authorities to start a dialogue with the economic operator and to follow procedures established by the Regulation.

If the Member State intends to adopt a decision to deny mutual recognition, then the competent authority must send the economic operator a written notice of that intention and the technical rule (legal basis) on which the intended decision is based will be specified. It must also provide technical or scientific evidence that the expected decision is justified on one of the grounds of public interest, that the decision complies with the principle of proportionality; and base its decision on the characteristics or type of product in question.

The economic operator can then submit comments within the time limit set out in the written notice (20 days).

The national authorities assess the comments of the economic operator (if any) and make a decision within 20 working days from the expiry of the time limit for the receipt of comments from the economic operator.

The decision must state the grounds on which it is based, including the reasons for rejecting of the operator's comments (if any) and the technical or scientific evidence on the grounds of Article 30 EC Treaty or mandatory requirements recognized by the ECJ.

The economic operator shall immediately be informed. If the authority fails to inform the economic operator of its decision within the specified period, the product shall be deemed to be lawfully marketed.

It is up to the national authority to specify the "technical or scientific evidence" justifying the decision to prohibit or restrict the marketing of a product. The authority thus has the burden of proof in order to justify a marketing prohibition of a product lawfully marketed in another Member State.

The decision first has to be justified on one of the grounds of public interest of Article 30 EC Treaty or based on ECJ case law, such as public order, public security, protection of life and health of humans and animals, environment or consumer protection.

Further the decision must be proportional. The national authority will have to explain why no other less burdensome measure is available for the purpose sought.

Finally the authority must produce the technical and scientific evidence for the intended product prohibition. Evidence should not be understood as legal proof. The authorities are not obliged to justify the technical rule itself. However, they should justify the possible application of the technical rule to a product lawfully marketed in another Member State.

Contact points

In order to address the lack of dialogue between the Competent Authorities of the different Member States that has been witnessed in the past, the Regulation now provides that the Member States must designate at least one Product Contact Point and inform the European Commission and the Member States.

The task of the contact point is to provide certain information to an economic operator or to another Member State free of charge and in theory within 15 working days.

This information concerns:

- the specification of the technical rules applicable to a specific type of product in that Member State;
- the advice whether the product is subject to prior authorization;
- the contact details of the Competent Authorities; and
- the remedies available in the national territory in the event of a dispute between Competent Authorities and economic operators.

How often and in which cases the Regulation will be invoked remain to be seen. Only then will its success be assessed.

Many issues remain undiscussed on a case-by-base basis: what is a technical rule and what action involves a decision with legal effects?

Member States may have different views on these issues.

The Commission intends to publish guidelines for the use of the Regulation. Especially interesting will be the guidelines on the relationship between the General Product Safety Directive and the guidelines on the application of the Regulation to food supplements.

At least on paper, the Regulation seems to be a great step forward that offers a framework for operators and Member States to enter into a dialogue about decisions that may hamper the free circulation of goods within the EU.

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Austria

Government steps in to limit economic impact on jobs

Dr. Philipp Maier examines how the raft of measures implemented in order to ease tensions in the labor market will impact employers and employees.

In August 2009, new legislation was passed implementing a package of measures to stabilize the employment market, mitigate the negative implications of unemployment, and prevent a further rise in the unemployment rate. Most of the Labour Market Package measures came into force on September 1, 2009, and should, to some degree and in the medium term, lead to some relaxation of the relatively tense labor market situation.

In response to the demands of certain industries, the maximum period during which short-time work subsidized by the Austrian Labor Exchange Office (AMS) can be implemented by the employer has been extended from 18 months to 24 months. Further, from the seventh month of short-time work, the subsidy paid to employers is increased as parts of the social security contributions owed by the employer to short-time workers will be paid by the AMS. These measures run until the end of 2012 and are retrospective to July 1, 2009.

Educational leave, during which the employee is entitled to receive a subsidy from the AMS, could previously only be agreed on between the employer and the employee when the employment relationship had already lasted for at least one year. Since August 1, 2009, such educational leave can be agreed on after six months of continuous employment and the minimum period of educational leave has been reduced from three to two months.

Older employees

The opportunities for older employees to take advantage of the publicly subsidized old-age part-time work have been increased considerably by the Labour Market Package. First, old-age part-time work subsidized by state aid is now also available for employees whose normal working time in the last 12 months of employment totals at least 60% (previously 80%) of their normal working time.

Further, in the case of the so-called "block model" (where the employee performs within a certain time frame, i.e., performs first full-time work and then enjoys continuous time-off), the employer is no longer obliged to employ a substitute employee in place of another performing old-age part-time work in order to receive state aid.

With respect to the amount of state aid received by the employer, an old-age part-time model providing for a constant reduction of working time becomes more attractive than the block model under the new legislation. Also, the entry age (58 years for men and 53 years for women) permitting employees to perform old-age part-time work has been frozen for one year, i.e., until 2010.

Eventually, old-age part-time work can now be applied pending compliance with legal requirements for a so-called "corridor pension" (a specific form of early retirement pension given to employees reaching 62 years of age). This kind of retirement scheme, in practice, is applicable only to male employees. Old-age part-time work can now be agreed on with an employee who has reached 63 years of age.

The employment benefits for certain unemployed persons will be slightly increased. This is achieved by an inflation-based value adjustment of the assessment basis for employment benefits.

Older employees who have been unemployed in the last 15 months for at least 52 weeks are generally entitled to a so-called "transitory aid" (which exceeds the normal unemployment benefits) until they reach retirement age. This option has been extended to the end of 2010.

Younger employees

A working foundation has been laid for young employees. It particularly focuses on training and improving the skills of young unemployed persons necessary for changing careers or seeking new areas of work.

In the Solidarity Premium Model, the working time of some employees is generally reduced in order to hire unemployed persons. For such purposes, a state subsidy is granted to the employer. In the future, this subsidy will be granted when hiring not only unemployed persons, but also apprentices.

Previously, employers were exempted from paying contributions to the unemployment insurance for employees who reached 57 years of age (or 56 years of age prior to July 7, 2008). In order to finance the current employment market measures, the age limitation for the exemption from such contributions has been postponed to one year. Thus, the exemption from such contribution applies only to employees who have reached 58 years of age (or 57 years of age prior to September 1, 2009). Further, the so-called "bonus-malus-system" (which provides financial privileges to employers who hire persons over 60 years of age and a financial contribution to be made by the employer if he or she terminates the services of such employees) no longer applies.

The Labour Market Package now in place in Austria is a first and promising step to improving the employment market situation for employers, employees, and unemployed persons. However, there are significant concerns that if the economic situation does not stabilize in the foreseeable future, the current employment market measures may not be sufficient, requiring even more drastic steps.

In view of the ongoing discussions among politicians and social partners regarding additional measures in order to improve the employment market situation, the implementation of additional employment market packages can, in any case, be expected.

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Belgium

International contracts win clarity on hardship issue

In a landmark case dealing with the legal consequences of an increase in raw material prices, the Belgian Supreme Court has ruled that under the CISG, in case of hardship, parties are obliged to renegotiate their contract. **Geert Bovy** and **Michaël de Potter de ten Broeck** report.

On June 19, 2009, the Belgian Supreme Court rendered its judgment in a landmark case dealing with the legal consequences of a hardship situation in a contract for the sale of steel pipes governed by the United Nations Convention on the International Sale of Goods (CISG). The Court ruled that when the performance of contractual obligations becomes more burdensome, although not absolutely impossible, due to an unforeseeable and unavoidable event beyond the control of the disadvantaged party (in the case before the court, a 70% increase in steel prices), the contracting parties are obliged to renegotiate the contract.

In its judgment, the Belgian Supreme Court tackled the long debated question of whether hardship is regulated by the CISG. It referred to the Unidroit Principles and stated that these must be regarded as the general principles on which the CISG is based and which must be used to fill gaps in the CISG. Therefore, in the opinion of the court, since hardship situations are not expressly regulated by the CISG, the Unidroit Principles must be applied. These provide for an obligation to renegotiate.

Similar solutions for hardship situations are not available under common Belgian commercial law, where the concept of hardship has so far been generally rejected.

Long debated question

The question of whether hardship is regulated by the CISG has been long debated. At issue is whether a change of circumstances that could not reasonably be expected, rendering the performance of the contractual obligation(s) more burdensome, but not entirely impossible, qualifies as an “impediment beyond control of the obligor” within the meaning of Article 79 of the CISG.

This Article provides that “a party is not liable for a failure to perform any of his obligations if he proves that the failure was due to an impediment beyond his control and that he could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences.”

Legal doctrine and case law generally accept that Article 79 only deals with situations of *force majeure* – when performance becomes impossible – and not with hardship situations where performance becomes more burdensome but not impossible. This is supported by the “*travaux préparatoires*” to the CISG: different proposals to include hardship in the draft of the CISG were rejected, and by using the word “impediment” in Article 79, the drafters arguably intended to exclude hardship. This view has also been applied in case law. Several court decisions of different national courts have rejected the idea that hardship is regulated by Article 79 of the CISG.

The CISG Advisory Council, however, has advised that “a change of circumstances that could not reasonably be expected to have been taken into account, rendering performance excessively onerous (‘hardship’), may qualify as an ‘impediment’ under Article 79(1). The language of Article 79 does not expressly equate the term ‘impediment’ with an event that makes performance absolutely impossible. Therefore, a party that finds itself in a situation of hardship may invoke hardship as an exemption from liability under Article 79.”

Belgian judgement

The Belgian Supreme Court decided that the word “impediment” could include certain situations of hardship. It also decided that even if a hardship situation does not qualify as an impediment, it does not mean that the party

suffering from hardship could not find any relief under the CISG. The Court refers to Article 7 of the CISG which states that questions concerning matters governed by the CISG which are not expressly settled in it are to be settled in conformity with the general principles on which the CISG is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law.

Instead of immediately reaching for the applicable national legislation, as is often done in similar cases, the Belgian Supreme Court solves the case within the four corners of the CISG. The Supreme Court went in search of the general principles of international commercial law on which the CISG is based and found the Unidroit Principles on International Commercial Contracts (hereinafter, the “Unidroit Principles”).

The Unidroit Principles are a private codification based on universal comparative law, principally used as a reflection of the fundamental principles of international commercial law. They are generally regarded as containing only “soft law,” mere guidelines.

The Unidroit Principles define hardship as the situation “where the occurrence of events fundamentally alters the equilibrium of the contract either because the cost of a party’s performance has increased or because the value of the performance a party receives has diminished, and (a) the events occur or become known to the disadvantaged party after the conclusion of the contract; (b) the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract; (c) the events are beyond the control of the disadvantaged party; and (d) the risk of the events was not assumed by the disadvantaged party.”

According to the Belgian Supreme Court, the situation at hand complied with these conditions and constituted a situation of hardship.

The Unidroit Principles provide that in case of hardship, the disadvantaged party is entitled to request negotiations, provided that such request is made in due time. If renegotiating the contract fails, either party may resort to court, which may then terminate or adapt the contract when it finds that a situation of hardship indeed exists.

With reference to the Unidroit Principles, the Belgian Supreme Court decided that unpredictable increases in price, causing a serious imbalance and rendering the performance of the contract under the contractually agreed conditions extremely disadvantageous, give the disadvantaged party the right to request negotiations. Refusing to enter into such negotiations could be regarded as a violation of the obligation to perform contracts in good faith by the refusing party and therefore as a breach of contract.

International implications

The Judgment is revolutionary in two ways: First, the Belgian Supreme Court has breached the classic point of view that hardship is not regulated by the CISG. It states the contrary but does this in a moderate fashion. In addition, the status of the Unidroit Principles has been boosted from soft law as such to soft law that must be taken into account when interpreting the CISG.

The Judgment may have an impact on case law in other jurisdictions. Article 7 of the CISG states that in the interpretation of the CISG, regard must be given to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade. Consequently, the application of the CISG in Belgian case law is a factor which must arguably be taken into account also by courts of other signatory states to the CISG.

The CISG applies only to international contracts. Hardship situations in purely Belgian contracts, as well as contracts subject to Belgian law from which the applicability of the CISG has been expressly excluded, will need to be evaluated in view of default, common Belgian law.

Under common Belgian law, the concept of hardship is generally not accepted. When the equilibrium in the contract has been fundamentally, unpredictably and unavoidably altered and no relevant clause is inserted in the contract (such as a *force majeure* clause or a hardship clause), only certain concepts, such as *force majeure*, the principle of good faith and the concept of abuse of right may be invoked to be exempted from liability or to be allowed to request an adoption of the contract. None of these concepts, however, completely embodies the concept of hardship.

To avoid any uncertainties and surprises, it is advisable to insert a hardship clause in a contract if this is what parties want. This is indeed the safest way to ensure that hardship is, or is expressly not, included in the contract, and to ensure that it is clear what the conditions are for a situation to qualify as hardship (e.g., increases in raw material prices over a certain threshold) and what the consequences are of such qualification (renegotiation, right to dissolve, automatic price increase, etc.).

It is better to be safe than to be a landmark case.

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Treaty with India streamlines social security issues

Annick Van Hoorebeke examines how a new treaty between Belgium and India should streamline interactions between the two nations.

An Agreement between the Republic of India and the Kingdom of Belgium on Social Security which came into force in September should facilitate transfers between the countries.

The Treaty applies to Belgian and Indian citizens, and also more generally to persons (employee or self-employed) “who are or have been subject to the legislation” of Belgium or of India. Moreover, because the respective test is that the person should be working in Belgium or India, the employer need not be an entity established in Belgium or India (except for secondment purposes).

The provisions of the Treaty determining the applicable legislation are limited to employees. They do not extend to self-employed persons.

As a general principle, a person working in Belgium is subject to the Belgian social security regime and a person working in India is subject to the Indian social security regime. As an exception to this rule, a person may, however, be seconded to the other country while remaining covered by the social security regime of the country of origin for a maximum period of five years. This period may be extended by a common agreement between Belgian and Indian authorities. By way of a transitional rule, periods of secondment before the entry into force of the Treaty will be disregarded for purposes of determining the maximum five-year period.

From a Belgian perspective, employees who have been seconded to India tend to be covered by the Belgian Overseas Social Security Regime (OSSR). This OSSR coverage may remain applicable or the employer and/or employee may want to invoke the secondment provisions under the Treaty. However, as the OSSR is an optional regime, submission to the OSSR is not tantamount to being considered “subject to the Belgian social security regime prior to being seconded to India.” As a result, a Belgian certificate of coverage may be issued only after such employee has returned to Belgium and has been affiliated with the regular Belgian social security regime (DIMONA registration), even if such registration covers only one day.

Per Belgian domestic law, persons employed in India (and subject to the Indian social security regime for employees) who are appointed as a remunerated director of a Belgian company have to register with a Belgian social security fund for the self-employed and claim affiliation and pay contributions as “ancillary” self-employed persons. However, to the extent that their Belgian mandate is not (or only minimally) remunerated and that they contribute to the Indian social security regime, no Belgian social security contributions will be due. While this is not explicitly confirmed in the Treaty, this may be achieved by invoking the equality of treatment clause provided for in the Treaty.

For purposes of determining entitlement to benefits per Belgian and/or Indian domestic law, the totalization principle applies, meaning, Belgian and Indian authorities are, as a matter of principle, obliged to take into consideration periods of contribution performed under the legislation of both countries (including periods prior to the entry into force of the Treaty).

Generally speaking, persons are entitled to receive Indian or Belgian benefits regardless of their place of residence. The most important exception to this rule covers old age or survivors' benefits due to persons residing in a third country. According to the Treaty, actual payment will, for these purposes, take place only if the person concerned is a Belgian or an Indian citizen. Taking into consideration the nondiscrimination principle provided for in the EU treaty, this requirement should have no impact on EU citizens residing in country other than Belgium or India who are entitled to receive Belgian pension. However, if such EU citizens are to receive Indian pension as well, India may suspend the payment thereof. In the latter circumstance, it remains to be seen whether the situation may be remedied by invoking a possible social security treaty entered into between India and the country of which the retired person is a citizen.

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Companies prepare for swine flu pandemic

François Gabriel, Jozef Sloomans and Nancy Luyten outline the steps that companies may take to protect their employees and their business from the effects of the swine flu pandemic.

As winter looms in Europe, a new wave of swine flu may sensibly be anticipated.

Based on the analyses of the World Health Organization (WHO), in a pessimistic scenario, up to 30% of the working population may become work-incapacitated for at least one week, as people battle infections, take care of ill relatives or face closure of schools/child-care facilities and the like.

This may cause serious constraints and difficulties to any company. Advance planning may therefore help.

While there are steps that companies may consider for reducing the likelihood of infection among employees, these and any business continuity measures need to comply with applicable laws.

Both the 1978 Employment Contracts Act and the 1996 Well-Being Act require employers to take necessary measures to ensure that employees can perform their duties in safe and healthy circumstances. The employer must therefore take measures to prevent the swine flu virus from spreading at work.

This must be done in cooperation with the External Service for Prevention and Protection and the internal Committee for Prevention and Protection (or Trade Union Delegation).

It is equally important to keep employees duly informed.

Based on its employer's prerogatives, the company has the right to impose on its employees certain prevention measures related to working conditions and should refer to the WHO's recommendations detailing standard precautions.

In the event of a general swine flu outbreak, the authorities may decide to impose certain quarantine measures or oblige people to avoid any unnecessary travel. Employers may decide to limit or prohibit temporarily external lunches and/or business travel. These measures as such do not pose any legal problems, except to employees whose compensation may be affected by such measures (e.g., sales representatives whose income partially consists of commissions). To overcome this, companies may need to develop a compensation package.

Frequently asked questions

May I demand a medical “no swine flu” certificate from my employees?

No. The WHO recommends avoiding contact with people who are ill, and more importantly, recommends that ill employees keep distance from other people in order to prevent the spread of the disease (e.g., stay at home, not go to work or school and avoid going to public places). From a strict legal point of view, companies have no legitimate means to check on their employees' health condition. An employee who reports to work is deemed fit to work. Companies are obliged to supply work to any employee who reports to work by virtue of the law.

There is no legal basis that allows an employer to require its employees to submit a medical certificate confirming that the employee is in good health and is not affected by swine flu. Such a requirement conflicts with privacy laws.

Even if a company has strong indications that an employee is ill, the employer may not impose a medical examination of the employee by the company physician unless the employee holds a safety or a risky position or comes in contact with food. Even for these specific categories of employees, there are strict controls governing such medical examinations.

As a general rule, employers may advise employees to stay home only if the employees feel ill (i.e., if they exhibit typical flu symptoms, such as fever exceeding 38°C, aching joints and/or muscles, fatigue and coughing or trouble breathing); and may attempt to convince employees who may be ill to go home and visit their family physician.

May I impose a medical examination of employees returning to work?

Medical examinations may be imposed only on specific categories of employees.

May I suggest other working terms and conditions to employees returning to work?

In principle, employees should resume their normal work duties after a period of leave of absence due to illness. However, by mutual consent (preferably in writing), working conditions could be altered temporarily in order to reduce the spread of swine flu.

May I impose a vaccination obligation on my employees?

No. Companies may, however, encourage employees to get vaccinated by offering (free) vaccinations against swine flu at the work place.

May I demand that my employees wear a surgical mask?

Yes, under certain circumstances.

Business continuity

If swine flu seriously affects Belgium, it will become necessary to implement additional measures to ensure business continuity.

Belgian employment law provides a number of flexible solutions, although certain obligations must be met.

The Works Council has the right to advance advice on any intended measures that may affect the work organization. In the absence of a Works Council, the TUD has the same prerogative.

The Belgian Influenza Advisory Board advises employers to establish a Business Continuity Plan.

This should contain the policy of the company with respect to the manner in which it would handle work-related consequences of a possible swine flu outbreak.

The Plan typically consists of a prevention part and a “curative” part. It should provide a response to the following main questions:

- How can we reduce the impact of an outbreak on our business?
- How can we reduce the impact of an outbreak on the work floor?
- How can we best protect the employees' health?

Frequently asked questions

May I require that employees temporarily work at a different work place?

Yes, but subject to some cautions.

In the event of a swine flu outbreak, certain key activities may be transferred temporarily to another location with limited accessibility in order to reduce the risk of contamination and hence guarantee that essential functions will remain operational.

The question evidently arises as to whether an employer is entitled to change the work place of one or more employees unilaterally (assuming that they will not be willing to agree on the temporary change of their work place).

Generally, a unilateral change in one or more essential working terms or conditions (the work place is generally deemed an essential working term, depending on the employee's position) may trigger a constructive dismissal or claim for judicial dissolution, with both scenarios exposing the company to a financial liability equal to the normal termination indemnity.

Whether a change of work place may trigger a constructive dismissal practically depends mainly on the adverse impact of the change on the employee.

However, taking into account the temporary nature of the change as well as its business necessity in case of a swine flu outbreak, the risk of triggering any such adverse scenarios by unilaterally compelling employees to perform their services at another place of work seems rather remote.

That being said, it is advisable to try initially to obtain the employee's consent (e.g., by e-mail) and limit any possible adverse impact on the employee.

May I introduce (temporary) home work arrangements?

Yes. Generally, it is advisable to secure the employees' consent when introducing a (temporary) home work arrangement (also in view of the fact that a home work annex to the employment contract must be executed).

May I modify the working schedules and/or introduce shift systems?

Temporarily implementing modifications to the individual working schedules and/or introducing rotating shifts may allow the company to both manage business continuity issues due to the reduced workforce and limit the risk of additional employees becoming infected.

That being said, both measures require that certain procedures be complied with.

May I impose a mandatory leave of absence and/or a temporary collective closure?

In the case of a swine flu outbreak, an employer may consider temporarily suspending the employment contracts of non-ill employees because of *force majeure*.

In a suspension related to *force majeure*, in principle, no (guaranteed) salary is due to the employees. However, there is a risk that a Labor Court will not accept a swine flu outbreak as an event of *force majeure*, in which case salary in arrears will be due.

Any mandatory vacations must be agreed upon in advance between the employer and the individual employees.

With regard to leave of absence for compelling reasons, any employee has the right to remain absent from work for compelling reasons, e.g., to take care of a family member with swine flu, to take care of children in case of school closure because of the swine flu.

The number of days of leave of absence for compelling reasons is generally limited to ten per year. No (guaranteed) salary is due for such days of absence.

The employee must inform the employer of his or her absence as soon as practically possible.

May I demand that employees stay at home?

Although often ignored, the duty of an employer, in addition to paying salary, is to provide the employees with work.

Therefore, from a strict legal point of view, it is not possible to oblige employees to stay at home even if their salary is continued.

That being said, the risk of any employee invoking constructive dismissal if they are paid to stay home appears remote in practice.

What obligations do ill employees have?

An employee affected by swine flu (and/or their physician) is not legally obliged to inform the company of the nature of his or her illness.

Indeed, the employee must only inform the company of his or her absence and submit a medical certificate. The medical certificate will, however, not indicate the nature of the illness, but only the fact of illness, the duration of the leave of absence due to the illness and whether or not the employee may leave home.

The control physician, who the company may send to examine the employee, may neither disclose the nature of the illness.

That being said, in case of a general swine flu outbreak, most employees will probably communicate the nature of their illness spontaneously to their employer, or at least do so when requested.

May I mobilize healthy employees for additional hours and/or recall employees on leave?

If business continuity will become at risk due to a substantial reduction of the workforce, the question that expectedly arises is whether the employer has the right to “mobilize” healthy employees to perform additional hours, or to “recall” employees who are on leave for a reason other than illness.

From a legal point of view, such “mobilization” is not permissible.

What about follow-up of e-mails during periods of leave of absence?

In case a substantial number of employees will be affected, business continuity will further require the follow-up to incoming messages addressed to absent employees. Careful consideration needs to be given as regards privacy in this regard.

Further information is available from the Influenza Call Center at 0800 99 777, or www.influenza.be.

This article is an abridged version of a more comprehensive report detailing issues organizations need to be aware of when preparing for a swine flu outbreak. The entire article is available on request.

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Belgian dividend receiving deduction regime incompatible with EU law

The treatment of company dividends in Belgium has been a focus of late of both the European Court of Justice and Belgian tax authorities. [Alain Huyghe](#) examines the implications.

Two recent decisions by the European Court of Justice have significant implications for Belgian companies distributing dividends among parents and subsidiaries.

On February 12, 2009, the ECJ found that Belgian dividend received deduction (DRD) for intra-EU dividends regime, contrary to the Parent-Subsidiary Directive in the Cobelfret case, which was handled by Baker & McKenzie. In a new decision of June 4, 2009, the ECJ leaves the referring Belgian court to decide whether the scope of the Cobelfret judgment should be extended to domestic (Belgian) dividends and to dividends received from companies residing in non-EU countries.

In the meantime, Belgian tax authorities have stated that the Cobelfret doctrine also applies to dividends distributed between Belgian companies, but that they will not grant the more favorable “Cobelfret treatment” to dividends received from non-EU countries.

Belgium has implemented the Parent-Subsidiary Directive by first including qualifying dividends received in the taxable profits of a Belgian parent company and, subsequently, granting the Belgian parent company a DRD of 95% of the qualifying dividends. In order to qualify for the DRD regime, the participation must, as a general rule, represent at least 10% of the subsidiary’s share capital or, alternatively, have an acquisition value of at least EUR 1.2 million (provided that it has been held for at least one year and that the participation qualifies as a fixed financial asset).

However, the DRD is limited to net operating profits, meaning, any “excess” DRD may not be used and does not increase the tax losses of the Belgian parent company. In other words, the net operating losses of a Belgian parent company are set off against income from dividends received and the DRD subsequently granted may only reduce the taxable income to zero. Thus, any excess DRD may not be used nor carried forward. The overall effect of the limitation of DRD is that the net operating losses of the parent company may not be offset against future taxable profits.

In the earlier Cobelfret judgment, the ECJ confirmed that such inability to carry forward excess DRDs, as provided for by Belgian tax law, was not a proper implementation of the Parent-Subsidiary Directive.

In June, the ECJ delivered its decision in a joint case that also dealt with the Belgian “excess” DRD issue. The first case asked whether the same principles apply to dividends received from companies established in non-EU countries on the basis of the free movement of capital (Article 56, EC Treaty). The second case asked whether infringement of the Parent-Subsidiary Directive was also relevant to dividends distributed between Belgian companies.

The ECJ reiterated its decision in the Cobelfret case, concluding that Belgium failed to implement the Parent-Subsidiary Directive correctly because it does not effectively restrict taxing qualifying dividend income in all situations.

Dividend treatment

Because the ECJ is competent only in interpreting European Community law, it does not take a position with respect to domestic dividends. Instead, the Court refers to Belgian courts the question of whether domestic dividends must be treated in the same manner as intra-EU dividends.

The ECJ decided that, if dividends from third countries are treated less favorably than domestic dividends, it is up to the national courts to determine whether the free movement of capital is applicable and whether this principle precludes the difference in the treatment of the dividend distributions. According to the ECJ, it may be possible to justify a restriction of the free movement of capital with respect to non-EU countries, even though such a restriction may not be justified with respect to EU member states because of the extensive administrative cooperation between the tax authorities of the member states.

Following these ECJ decisions, Belgian tax authorities issued a circular letter on June 23, 2009, confirming that excess DRD derived from intra-EU and from domestic dividends could be carried forward to later tax years.

Since the circular letter explicitly includes domestic dividends, it is to be expected that domestic courts would no longer be required to decide on this issue. It would be necessary, however, to await a decision of the national courts on the issue of dividends from non-EU countries.

The circular letter is noteworthy for three other elements.

First, the participation requirement of the Belgian DRD regime (i.e., a 10% participation or an acquisition value of EUR 1.2 million) is considerably more favorable than the participation requirement under the Parent-Subsidiary Directive (up to 25% for periods prior to January 1, 2009 and no alternative acquisition value threshold). A question was therefore raised on whether the DRD carry-forward applied only to dividends qualifying under the Parent-Subsidiary Directive or also to dividends qualifying under the less strict conditions of the Belgian DRD regime.

In the circular letter, the tax authorities indicate that they will apply the Cobelfret doctrine to all dividends qualifying under the more favorable Belgian DRD regime.

Second, Belgian tax authorities will allow taxpayers to first impute the DRD derived from non-EU dividends. This means that in situations where the amount of operational losses (before including the dividends received) is moderate, qualifying non-EU dividends may effectively be exempt because the DRD derived from such non-EU dividends may be offset first against the limited amount of taxable profits derived from dividends received.

Finally, the tax authorities confirm that the procedure of ex officio detaxation could be applied in order to reassess previous tax years in light of the Cobelfret judgment. Even if there were no tax complaints with regard to excess DRD in the past, this procedure allows Belgian taxpayers to claim DRD carry-forwards for tax assessments made after January 1, 2005 (if introduced before the end of 2009). The circular letter also allows reclaiming of excess DRD incurred in tax years prior to 2005 as long as no final tax assessment has intervened since the tax year in which the excess DRD was incurred. Usually, no final tax assessment is made when the result of the tax year is negative. In practice, this means taxpayers could still reclaim excess DRD with regard to tax years prior to 2005 as long as no taxable profits were incurred during the intermediate tax years. The tax authorities also allow carry-forward of excess DRD for tax years in which litigation is still pending, even if such litigation relates to tax years prior to 2005.

In addition to the standard tax procedures listed in the circular letter, it is also possible to recover, through a civil law procedure, damages incurred as a result of the loss of excess DRD for tax assessments that are statute-barred under normal tax procedures.

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Germany

Employers win greater security over employee inventions

Andrea Schmoll reports on recent reforms affecting ownership of employee inventions, but warns companies to keep a tight rein on the process.

On May 28, 2009, the German Parliament adopted the Patent Law Modernisation Act which tightens and accelerates the procedure of patent nullity actions and also provides for reform of the German Act on Employee Inventions.

After the failure of a comprehensive reform of the Employee Inventions Act which was intended to simplify the complex remuneration system, the new law could enhance the legal situation for small and midsize companies as regards the acquisition of ownership in employee inventions. The modifications took effect on October 1, 2009.

Today, 80% of all German inventions are made by employees. Following general principles under German patent law, the exclusive rights in an employee invention originally belong to the respective employee inventor. This exclusive right emanates from the employee's inventive act, and protects the employee inventor against the infringement of his or her inventive idea by third parties. The Employee Inventions Act stipulates the requirements to be fulfilled by the employer in order to acquire ownership in such employee inventions.

Under the current law, the employer has to actively claim the exclusive rights in an employee invention in writing within a four-month period. If the employer fails to comply with these statutory requirements, the employee remains the exclusive owner of the invention and is entitled to exploit the respective rights, e.g., by selling or licensing them to third parties. This situation is risky in particular for small and midsize companies that have no resources to establish an adequate operational scheme for claiming their employees' inventions in accordance with the legal requirements.

The new law means that the employer's obligation to actively claim the rights in an invention will be substituted by a legal presumption: if the employer does not object to claiming the rights within a period of four months after an employee invention was reported to them, the law presumes that the employer has duly claimed the rights in the employee invention and thereby becomes the owner of the exclusive rights. Practically speaking, employers now will automatically acquire the rights in employee inventions. They only have to react to the invention report if they do not want to become the owner of the respective inventions.

Employers are still well advised to carefully screen any invention reported by their employees as the Employee Invention Act explicitly obliges employers to file patent applications and to pay adequate remuneration for any employee invention acquired by them in accordance with the Act. Without careful screening, employers might be obliged to pursue patent applications and make remuneration payments for inventions which are worthless for the company.

Companies should continue to maintain or establish operational structures allowing the timely evaluation of reported employee inventions. Companies should also be prepared to rapidly assess the value of an invention to business and to possibly object to a useless invention.

The revised Employee Inventions Act also tackles the sale of an employee invention in the insolvency of the employer. Previously the employee inventor had a right of preemption if, and to the extent, the insolvency administrator decides to sell the respective invention to a third party. The right of preemption is replaced by an obligation to offer the invention to the employee at the latest one year after the insolvency proceeding is initiated. The employee is then entitled to decide within a two-month period whether or not to reacquire the rights to the respective invention.

The modifications to the Employee Inventions Act are a step in the right direction. However, especially with respect to the pressing need of a simplification of the remuneration scheme for employee inventors, the German legislator has work ahead in order to build a modern and internationally competitive law on employee inventions.

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Privacy law shapes the development of employee ranking lists

Michael Schmidl explains why companies wishing to create employee ranking lists need to ensure that they comply with applicable privacy laws.

One possible consequence of the current economic crisis is that more companies will wish to introduce mechanisms of measuring the performance of their employees. They may want to count the hours an employee is present at work, the number of calls made by a call center agent, the number of pieces of work produced by an industry worker or the number of new clients and turnover produced by a sales employee.

Measuring the performance of employees is the basis of comparing them. An increasingly popular method of comparison is based on a so-called "ranking list." Such lists consist of a table of employees ranked in accordance with the percentage of fulfillment of performance criteria defined by the employer. Creating and publishing a ranking list not only leads to the collection, processing and use of personal data but might also impact on the ambience within a company.

Given the fact that an employee data protection act has not yet been created, the Federal Data Protection Act (FDPA) has to be applied to the creation and publication of ranking lists containing personal data of employees.

In light of its limitations, employee consent cannot serve as justification for the creation and publication of ranking lists, so statutory permissions have to be applied. Subject to respecting a series of criteria and precautions, the employer can legitimately create and publish ranking lists.

The FDPA's purpose is to protect the individual from having his or her privacy impaired through the handling of personal data.

The creation of a ranking list that is based on more than just a few performance indicators requires a substantial amount of data. Such data might either be stored in and retrieved from a separate computer system dedicated to the use for the ranking list or be directly taken from the company's enterprise resource planning software, such as Oracle or SAP. In both cases, the data used as performance indicators are either processed or used by means of a data processing system or at least collected for such systems. The creation and publication of ranking lists therefore falls into the FDPA's scope of applicability, even if the resulting lists are available only as printouts to the employees concerned. In light of the recent reform of the employee data protection act entering into force on September 1, 2009, the FDPA would apply even if the ranking list was produced without the automatic processing of data.

The FDPA defines personal data as any information concerning the personal or material circumstances of an identified or identifiable individual, referred to as the data subject. Ranking lists contain a multitude of personal data. There is at least the name, the relevant key performance indicators and the resulting ranking. In some cases, employers use pseudonyms instead of their employees' real names. Using a pseudonym instead of a real name might in some companies lead to rendering the employee impossible to identify. This could occur, for example, with a ranking list containing a great number of employees who do not have social contacts, do not work in the same location or due to other circumstances will most likely never learn which pseudonym belongs to which employee.

In practice, employers do frequently prefer using real names and in any case using pseudonyms does not eliminate privacy laws, since data containing pseudonyms is not the same as anonymous data.

Under the law, the collection, processing and use of personal data shall be admissible only if permitted or prescribed by the FDPA or any other legal provision or if the data subject has consented. Although expressly mentioned, employee consent cannot be recommended as the basis of creating and publishing ranking lists. Statutory permissions are the better choice.

Creating and publishing a ranking list can be admissible insofar as this is necessary to safeguard justified interests of the controller of the filing system (i.e., the employer) and there is no reason to assume that the data subject has an overriding legitimate interest in his or her data being excluded from processing or use in the framework of a ranking list. However, careful analysis of the legislation suggests that employers need to step in very carefully in order to remain compliant with privacy laws.

Measures required

If the employer respects certain criteria and adopts certain measures in order to influence the outcome of the weighing of interests, then ranking lists might be admissible. The following list of criteria and measures can render the creation and publication of a ranking list admissible from a privacy law point of view:

- Choose objectively justified and comparable evaluation criteria: the criteria on which the ranking list is established must be objective and understandable. The correct selection of evaluation criteria certainly requires a case-by-case decision. It is, for example, important that none of the ranked employees are burdened with additional (i.e., more than the others) tasks, the execution of which are not taken into account for determining their rank in the list.
- Choose objectively comparable sales regions or sets of tasks: the sales regions or set of tasks of the respective employees must form a just and objectively comparable basis for fulfilling the evaluation criteria, which are decisive for the position in the ranking list. It might be required to provide for multiples for achievements, with a smaller absolute value, but which have been reached under extraordinarily difficult circumstances. Two turnover values might therefore have to be counted equally if the lower one was obtained in a tremendously difficult situation and the higher one in a relatively favorable environment.
- Neutralize factors, which cannot be influenced: factors, which cannot be influenced by the ranked employees (e.g., part-time work) must not be taken into account or must be neutralized for the process of placing the employees in the ranking list.
- Limit the percentage of employees listed: the ranking list should be limited to the three best employees (i.e., 33.3% of the sales force eligible for a place in the ranking list) of the analyzed employees. This number was mentioned by the Bavarian data protection authority when consulted with regard to the criteria for a permissible setup of a ranking list.
- Make known the ranking list only within the sales force concerned: the ranking list must not be made accessible to the entire company or to employees from other group companies. The publication must be limited to those employees who are to be placed in direct comparison with each other by means of the ranking list. Additionally, the respective employees must receive the binding order not to distribute the ranking list outside the concerned group of employees.
- Grant the right to object to being put on the ranking list: employees must participate voluntarily in the comparative evaluation of their performance. (The initial participation is decided by the employer but the decision to stay in the process must be a voluntary one.) They should be granted the right to object at any time, without giving reasons and with effect for the future to the initial inclusion in the ranking list and to the future listing.
- An objection should not be questioned: the respective superiors should receive the binding instruction not to question the employees for the reason for the objection. Should there be a practice of scrutinizing the employees' decision to object to the initial inclusion in the ranking list and to the future listing, their remaining in the ranking list could hardly be regarded as voluntary. The employees concerned should be informed about this binding instruction to their superiors, in order to underline that taking part (to be understood as the decision to be part of the process) in the ranking list scheme is entirely voluntary.
- An objection should not be sanctioned: the respective superiors should receive the binding instruction not to treat the objecting employee any differently from other employees. The employee who decided to object to the initial inclusion in the ranking list and to the future listing must not be sanctioned. The employees concerned should also be informed about this binding instruction, in order to underline that taking part (to be understood as the decision to be part of the process) in the ranking list scheme is entirely voluntary.
- Transparent information: prior to the first creation and publication of a ranking list, the employees concerned have to be informed in a transparent manner about the planned measure, to implement a ranking list, by means of which the employees enter into a voluntary competition with one another. Employees also need to understand the process, the scope of the data being collected and their rights.

- Shop agreement with the works council: the creation and publication of a ranking list will most likely require the agreement of the works council (if any).

It will also be necessary to consult the company's data protection officer since the creation and publication of a ranking list is subject to the data protection officer's prior control under the FDPA. Prior control is not required if a statutory obligation applies, the data subject's consent has been obtained or the collection, processing or use serves the purpose of a contract or a quasi-contractual fiduciary relationship with the data subject. These exceptions usually do not apply. Prior control is not necessary. In a company, however, where the creation and publication of a ranking list has been made a contract purpose, the collection, processing or use of personal data required for the ranking list would serve the purposes of a contract. Such scenarios are rare, however.

While there are hurdles to clear, creating and publishing a ranking list is possible based on a justified interest of the employer (e.g., increasing economic success) and the taking into consideration of the contrary interests of the employees (e.g., avoiding discrimination and making underperformance known by peers) by weighing interests.

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Hungary

Liquidation rules overhaul boosts creditor prospects

Recent changes to the rules of liquidation proceedings could create a more favorable environment for creditors. **Gábor Hollós** reports.

As a result of the economic crisis, the rules of liquidation proceedings have been amended to create a more favorable milieu for the creditors of Hungarian business associations. The purpose of the amendment is to simplify and accelerate the liquidation proceedings as well as to create a more sensible regulation.

The amendments to the liquidation proceedings entered into force on September 1, 2009.

The most important reasons for amending the rules on liquidation proceedings are: to create a closer relationship between the liquidation and the bankruptcy procedures; to set shorter deadlines for the completion of the liquidation proceedings; to further detail the liabilities of the executive officers of the companies that underwent liquidation proceedings; and to impose more severe sanctions.

Although the bankruptcy and liquidation proceedings were related to each other even before the new rules entered into force, as a result of the amendment, the relationship now became more intertwined. This is evidenced by the fact that as of September 1, 2009, courts can establish the insolvency of the company *ex officio* and may order liquidation *ex officio*, immediately after it is determined that the preceding bankruptcy procedure was unsuccessful in resolving the financial debt of a legal entity.

The court orders the liquidation of the company if the company is insolvent. The amendment to the liquidation procedure further broadens the events of insolvency. From now on, a company shall be deemed insolvent (in addition to the current rules) if its debts exceed its assets or if the available evidence shows that the company will more than likely not be able to satisfy its outstanding debts when such debts become due and the quota holders of the company are unable or decide not to guarantee the satisfaction of the outstanding debts.

The amendment also changed the appointment procedure of the liquidator. The liquidator is appointed by the court. According to the new rules, a liquidator must be appointed randomly via an electronic system. The following factors must be taken into consideration when appointing a liquidator: the liquidator's professional experience, expertise and capability, and the geographical location. If the judge wishes to deviate from these selection criteria, then the judge's decision to deviate must be explained in a well-detailed reasoning. The appointment of the liquidator falls within the competence of a judge other than the presiding judge.

Shorter deadlines

The amendment introduced shorter deadlines with respect to many aspects of the liquidation procedure. The executive officer of a company must fulfill his or her obligations to cooperate with the liquidator in a shorter period of time. The creditors must announce their respective claims to the liquidator within a 180-day forfeit deadline. The previous legislation prescribed a one-year deadline. However, practical experience showed that the creditors generally announce their claims within about 90-100 days. The liquidator must convene the creditors to establish the creditors committee within 75 days (instead of 90 days) from the date of the publication of the court order in relation to the commencement of the liquidation procedure.

The amendment introduced secondary liability of quota holders acting as surety. This secondary liability of the quota holders exists in relation to a fine or supplementary costs. Fines may be imposed on the executive officers as a result of their failure to fulfill their obligations arising from the nature of their executive positions. If the executive officers fail to cooperate with the liquidator or fail to fulfill their obligations, they may be obliged to pay supplementary costs incurred by the liquidator's performance of the duties of the

executive officers and may be fined. If the executive officers fail to fulfill their payment obligations resulting from the above, the secondary liability of the sole quota holder of the company or the quota holder having at least majority control over the company (having at least 50% of the votes plus one vote) shall become a primary issue and the quota holder will become liable as guarantor to fulfill the payment obligations.

The amendment provides more details in relation to the existing rules applicable to the liquidator in relation to the liquidator's obligation to provide information to the creditors. The liquidator must regularly inform the creditors about the liquidator's activities, the status of the liquidation procedure and the costs.

One of the most important changes is that the liquidation procedure may be terminated if the debtor fully pays any and all of its recognized and undisputed claims registered by the liquidator and provides a guarantee for the disputed claims and the fee of the liquidator. This is a conceptual change. Before the amendment entered into effect, if the court ordered the liquidation by a final and binding court decision, the liquidation procedure could only be concluded by the termination of the company without a legal successor and the de-registration of the company from the trade registry even if the debtor was able to settle all outstanding claims.

Ultimately the amendment to the liquidation procedure creates rules more favorable to the creditors by accelerating the procedure, providing a more complex statutory protection and introducing stricter liability rules in relation to the executive officers of the debtor and the liquidator. However, the true impact of the new rules will be determined only after it has been tested.

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Employers seek to cut costs by overhauling work patterns

Evgeny Reyzman and **Anna Ivanova** examine the opportunities for reduction of working time during the economic downturn.

The current global economic downturn is forcing many companies to review personnel costs. Russian labor law offers various ways to modify working patterns but their flexibility and ease of implementation are questionable.

The Labour Code provides the opportunity to reduce the length of working time (and hence reduce salaries) with or without an employee's written consent. Needless to say, companies prefer to modify the work environment unilaterally because in most cases, such modifications result in higher labor capacity for less expense.

As the financial instability of many companies may result in mass dismissals and violation of employees' labor rights, Russian state authorities have responded accordingly. As of January 2, 2009, all employers must notify their district employment centers about a shortened working week.

The reduction of the working week is specifically regulated by the Russian Labour Code. It can be introduced only to avoid mass dismissal, and only for a period of up to six months. An employer is advised to prepare a technical and economic justification setting out the current condition of the company and the necessity to reduce production while avoiding dismissal of employees. Subsequently this document can be used to demonstrate the need for the reduction in working time to the state authorities and a court if necessary.

Reduction of working time requires two months' prior notification and the reasoned opinion of the trade union (if any). Companies need to pay special attention to the statutory requirements because disregarding them may result in collective and individual labor disputes. A change in working conditions can bring claims from employees for reinstatement with compensation, payment of moral damages, and payment for forced absence.

An employee can decline to work in the new environment, in which case the employer must offer another vacant position or, if no such position exists, has the right to dismiss him or her. Employees have two months within which to agree to the new conditions or refuse to work under the new conditions. In practice, employees sometimes prefer not to respond at all and wait for the reaction of the employer. In this situation, the employer can inform the employees that failure to respond is seen as consent. That will minimize the negative consequences for the employer in the case of a dispute.

Sometimes an employee tries to change his or her decision when the threat of dismissal becomes real. On one hand, the employer can accept the belated consent of the employee and keep him or her at work, but sometimes a business plan for the new working conditions is drafted based on the initial responses of employees. Currently, there is no available court practice explaining whether an employer can refuse to accept an employee's changed decision. In order to avoid conflicts with employees, it makes sense for employers to tell personnel in advance that only initial responses will be taken into account.

If employees refuse to work under the new working conditions, the employment agreement with them should be terminated as if they had been dismissed due to staff redundancy. This entails a redundancy payment equal to one month's average salary and possible payment for the second and third months after dismissal if no new job is found. However, normal staff redundancy means that there is an excess of staff employees and positions must be reduced in the staff schedule. For the dismissal of employees due to their refusal to continue working, the employer is not obliged to amend the staff schedule and has the right to take in other people to fill the vacant positions with shortened working hours.

Employers should note that Russian labor laws do not allow the period of reduced working time to be prolonged. Repeated implementation of the reduced working time means going through the full procedure as outlined. If the employer's business allows employees to return to full-time work earlier than expected, the motivated opinion of the primary trade union organization must be sought.

Today, many manufacturing companies are trying to survive during the economic instability by decreasing production and reducing working time. Usually employees accept such changes with understanding because any such reduction is better than unemployment or being on leave without pay.

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Legislators wield scalpel to deliver competition reforms

Marat Mouradov and **Ivan Smirnov** examine recent changes to Russian competition legislation and their likely impact.

Numerous changes to Russian competition legislation came into effect in August 2009.

The changes significantly expand the application of the Law and clarify the competence of the Russian Federal Antimonopoly Service (FAS). They also alter the dominant position rules, tackle the concept of “monopolistically high” and “monopolistically low” prices, introduce significant changes to the provisions dealing with vertical agreements, raise the thresholds that trigger the requirement for clearance of acquisition transactions through FAS, set the period for institution and consideration of cases on violation of antimonopoly legislation, and augment and clarify various legislative acts in the area of antimonopoly regulation.

The Law now covers not only the agreements, but also the actions of Russian and foreign entities, if such agreements or actions are executed or performed with regard to fixed assets located in the Russian Federation, intangible assets, shares (participatory interest) of Russian companies or rights to them, or, importantly, they affect the state of competition in Russia. Thus, any agreements and actions, executed or performed by or between foreign organizations (including those governed by foreign law) that are either executed with regard to Russian assets, shares, and rights, or otherwise affect competition in Russia, will formally come under the effect of the Law.

The concept of a “group of persons” is redefined to include individuals and/or legal entities that are included in one group which holds more than 50% of voting shares in the charter capital of the company.

There is also clarification of the concepts of “monopolistically high” and “monopolistically low” price of goods, which are defined using both the cost plus method (estimation of required expenditure for production of goods) and the comparable markets method (comparison with price established in market conditions in Russia or, importantly, elsewhere).

The legislative amendments also set criteria when the raising, maintenance, or lowering of the price of goods may lead to the establishment of a monopolistically low or monopolistically high price. Such criteria include, among other things, the expenses of an enterprise, changes in the composition of sellers or buyers of goods, and changes in the conditions of the sale of goods connected with changes in state tax or tariff regulation. A monopolistically high price of goods does not apply to goods resulting from innovative activity.

The amendments have practically removed the previously existing 35% threshold for recognizing the position of an economic entity as dominant. If certain conditions established by the Law are met, the FAS may, based on an analysis of the state of competition in the relevant market, recognize the position of an economic entity as dominant, even if its share of the market in question is below 35%.

For purposes of countering abuse of a dominant position by an economic entity, for the first time, the Law requires the Government to develop rules for non-discriminatory access to commodities markets and/or goods produced or sold by natural monopolists.

Vertical agreements

Amendments to the Law substantially rework the regulation of so-called vertical agreements between entities that do not compete with each other, but where one organization provides and the other acquires goods, works, or services.. Previously the law included a prohibition on the division of a commodities market on territorial principles, scope, or assortment of sales or purchase of goods, composition of sellers and buyers, etc. Now conditions on exclusivity in any form are not expressly prohibited in vertical agreements, including distribution agreements. The Law now grants sellers and buyers the opportunity to include more flexible provisions into their agreements.

There are just two direct prohibitions for vertical agreements remaining. First, the parties may not agree on a price for the resale of goods, and second, the seller may not require the buyer not to permit the sale of competing goods, with the exception of agreements on the organization of sale of goods under a trademark or company name of the seller.

Apart from previously envisaged rules on permissibility in accordance with the rules of reasonableness established in the legislation, all limitations relating to commercial concession agreements and agreements in which the share of their parties does not exceed 20% on any market, have been lifted.

Furthermore, certain instances when vertical agreements are allowed (the so-called “general exceptions”) are established. For example, agreements between sellers and buyers of goods (with observance of specific conditions) and agreements on joint scientific research and joint use of its results are permitted. Sellers and buyers will be allowed to conclude agreements if their share of the market is less than 35%, and they do not compete with each other (with the exception of the market for the goods that are the subject of the agreement), and if the buyer does not produce interchangeable goods. The legislation sets out a number of mandatory conditions for such agreements.

However, certain limitations have been introduced. For instance, conditions preventing buyers from independently setting the resale price of goods, preventing the buyer from reselling goods to a certain category of customers, inhibiting the sale of spare parts to retail purchasers or specialized repair and servicing organizations, prohibiting resale in a subsequent sale agreement, and others, are not allowed. Certain conditions are permissible only in the existence of other specific conditions or may be introduced for a specific period.

In particular, agreement conditions that forbid a wholesale buyer from reselling goods on a specified territory are permissible – provided that the sale of goods in that territory is not conducted by another (exclusive) buyer or the seller itself.

Amendments to the Law increase the threshold values of the aggregate amount of assets of the acquirer and company (including their groups of persons), the shares (participatory interest), assets, and rights of which are acquired before triggering the need for preliminary consent of the FAS. The threshold for aggregate amount of assets has been increased from RUB 3 to 7 billion, and for revenue from RUB 6 to 10 billion.

Moreover, the aggregate amount of assets according to the latest balance sheet of entities (and their groups), whose shares (participatory interest), assets, or rights to which are acquired, is increased from RUB 150 to 250 million. Threshold values are also doubled for assets above which the FAS must be notified about the execution of a transaction: from RUB 200 to 400 million for the aggregate amount of assets of the acquirer of shares (participatory interest), assets, or rights relating to the company and the company itself (and their groups of persons), and from RUB 30 to 60 million for the aggregate amount of assets of the company and its group of persons.

Preliminary approval of transactions performed within one group of persons has been revoked. From now on the execution of transactions within one group by persons united on the basis of ownership of more than 50% of voting shares (participatory interest) in the charter capital is subject only to the notification procedure.

The amendments clarify the list of persons bearing responsibility for obtaining approval for a transaction from the FAS. The Law establishes the obligation of the acquirer of shares (participatory interest), assets, and rights of companies to obtain the preliminary approval of the FAS for such transactions. This obligation cannot be transferred to the seller.

The FAS can now also reject an incomplete application.

The possibilities for the FAS to investigate compliance with antimonopoly legislation have been broadened and clarified. The FAS is empowered with the authority to conduct scheduled and unscheduled investigations of bodies of executive power at various levels, state non-budgetary funds, local government bodies, commercial and non-commercial organizations, and private individuals, including individual entrepreneurs.

The basis for a scheduled investigation is the expiry of three years from the date of incorporation of a legal entity or organization, state registration of an individual entrepreneur, or the conclusion of the last scheduled FAS investigation. Thus, scheduled investigations should not be conducted more than once every three years.

The grounds for an unscheduled investigation are materials and information indicating violations of antimonopoly legislation. An additional cause is the expiry of the period for fulfillment of an order-issued FAS review of an antimonopoly violation.

The subject of both a scheduled and an unscheduled investigation is quite broadly defined – observance of the requirements of antimonopoly legislation. The subject of an unscheduled investigation may also be a check on the fulfillment of an order issued earlier.

Limitation period

For the first time, the limitation period for actions regarding violation of antimonopoly legislation has been established at the legislative level.

This period is three years from the date of a violation of antimonopoly legislation, and in the case of a continued violation, from the date of cessation of the violation or its discovery. If a case of violation of antimonopoly legislation is instituted after the indicated period it is subject to dismissal.

The commencement of the period of limitations has been established for administrative violations, including unlawful limitation of freedom of trade; abuse of dominant position; abuse of dominant position with a share of less than 35%; prohibition of agreement, concerted actions, coordination; and unfair competition. The indicated period is calculated from the effective date of the decision of the FAS committee that establishes the fact of violation of antimonopoly legislation.

Changes in the Law envisage a considerable amplification of the list of grounds allowing the transfer of state or municipal property without tenders or auctions. Among other things, there are now several grounds concerning special entities with which such an agreement may be executed. These include legal entities that provide educational and medical services, legal entities owning engineering and technical supply networks (e.g. companies rendering communications services), and most forms of non-commercial organizations, including associations, unions, and employers' groups.

At the same time, control is strengthened over the setting of rules for the conduct of competitions and auctions for the execution of agreements concerning state and municipal property. Now the body responsible for such rules is the FAS (previously it was the Government), which, in all likelihood, will result in quicker decisions regarding the approval of such rules.

There is also a practical prohibition on subleasing state and municipal real estate, insofar as no more than 10% of the total area of leased property and not more than 20 square meters may be subleased.

The chapter of the Law pertaining to state or municipal preferences is similar to the chapter it replaces concerning the granting of state and municipal aid. However, the concept of "state and municipal preferences" is broader than the previously effective concept of "state and municipal aid" as it includes not only the transfer of property or objects of civil rights, but also the granting of property concessions (e.g., the establishment of a concessionary rate of rental payments).

That said, the granting of preferences is permitted only in connection with the attainment of publicly significant and social aims, such as protection of public health, development of education and science, ensuring the defense capability and security of the country, and support for small and medium businesses.

Competition penalties

The abuse of a dominant position on the commodities market continues to incur a “turnover” administrative fine of 1- 15% of the revenue of the violator from sale of the goods (works, services) concerned. However, if the revenue of the violator exceeds 75% of its total revenue from all sales, the fine is established at 0.3-3% of the revenue from the sale of the relevant goods. The fine levied for such violations cannot be less than RUB 100,000.

A minimum fine of RUB 100,000 is also envisaged for a “turnover” fine on a legal entity for the execution of an agreement limiting competition (performance of actions limiting competition), and also for the coordination of economic activity. The levying of a “turnover” fine is introduced for the first time.

There is also a tightening of the “leniency program” that envisages the possibility of release from administrative liability for certain violations of the law. Release from administrative liability applies to the entity that was first to perform all the requirements envisaged by the Code of Administrative Violations of the Russian Federation. An application submitted simultaneously on behalf of several entities is not subject to consideration. Furthermore, the changes do not envisage the application of the “leniency program” to the coordination of economic activity.

For the first time, administrative liability of officials and legal entities is introduced for abuse of the dominant position of an economic entity whose share of a specific market is less than 35%, in an amount of up to RUB 20,000 and RUB 1,000,000, respectively.

Changes to the Criminal Code envisage criminal liability in the form of a fine or imprisonment for a period of up to three years, and revocation of the right to occupy certain positions (engage in certain activity) for up to one year or without the same for the non-admission, limitation, or elimination of competition through the execution of agreements or performance of concerted actions or continued abuse of a dominant position, if such actions have caused large-scale damage (exceeding RUB 1,000,000) to individual citizens, to organizations, to the state, or, for the first time, have resulted in the receipt of large-scale revenue (exceeding RUB 5,000,000). In the event of the infliction of particularly large-scale damage (RUB 3,000,000) or gaining particularly large-scale revenue (exceeding RUB 25,000,000), criminal liability becomes more rigorous in the form of imprisonment for a term of up to six years.

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Authorities gear up to phase in social contributions system

Baker & McKenzie’s taxation specialists reveal that the introduction of the social contributions scheme will deliver tax benefits to highly paid employees.

The law replacing the Unified Social Tax with social contributions will come into effect on January 1, 2010.

The Unified Social Tax will completely disappear from the Russian Tax Code and be replaced by social contributions payable to the State Pension Fund, Social Security Fund, Federal Medical Insurance Fund and Territorial Medical Insurance Fund. According to the Russian Parliament, these amendments tie in with changes in legislation on pensions and social benefits.

The Law introduces a new model of administrative control over calculation and payment of social contributions to the various social funds which is similar to the model that operated in Russia prior to 2001. Control over payment of social contributions will be transferred from the Russian tax authorities to the social funds. The Law also governs audits and the imposition of penalties for late payment of social contributions. However, social contributions, as well as the exemptions available, will be calculated in much the same way as the Unified Social Tax. The Law gives the state agency nominated by the Russian Government authority to clarify the provisions of the Law.

Currently, the Unified Social Tax is payable on a regressive tax scale, from 26% down to 2%, with the lowest rate applicable to that part of an employee's annual salary in excess of 600,000 rubles (approximately US\$20,270).

Under the new regulations, social contributions will be paid at a flat tax rate.

From January 1, 2010, social contributions will be paid at 26% of an employee's salary, with 20% paid to the Pension Fund; 2.9% to the Social Insurance Fund; 1.1% to the Federal Medical Insurance Fund; and 2% to the Territorial Medical Insurance Fund.

From January 1, 2011, social contributions will be paid at 34% of an employee's salary, with 26% going to the Pension Fund; 2.9% to the Social Insurance Fund; 2.1% to the Federal Medical Insurance Fund; and 3% to the Territorial Medical Insurance Fund.

Importantly, social contributions payment will be capped. Payers will make social contributions at rates depending on their total salary until it reaches 415,000 rubles (approximately US\$14,020) per calendar year. No social contributions will be required for salary in excess of this threshold. Thus, the maximum amount of social contributions per employee for 2010 will be capped at 107,900 rubles (approximately US\$3,645). As a result, the Law gives tax advantages to companies with highly paid employees. However, this threshold may be adjusted by the Russian Government from January 1, 2011 and later if average salaries increase.

Payers of social contributions will be required to submit reporting documentation to the respective funds, including calculation of contributions to the Pension and Medical Insurance Funds, by the first day of the second month following the reporting quarter; and calculation of contributions to the Social Insurance Fund, by the 15th of the month following the reporting quarter.

By March 30, 2010, payers will be required to submit a declaration on payment of pension contributions to the tax authorities. After a documentary audit, the results will be turned over to the Pension Fund.

The Law sets out a list of payers to which reduced rates of social contributions apply (e.g., companies using the unified agricultural tax, residents of high-tech special economic zones, organizations applying the simplified system of taxation).

The Law also establishes a list of expenses not taken into account when calculating the base of social contributions for certain types of payers (i.e., artists and musicians). These require documentary support, and if it is not possible to provide proper supporting documents, the Law sets a fixed rate of expenses that may be deducted based on the amount of accrued income.

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Emissions scheme clips wings of unprepared aircraft operators

Max Gutbrod and **Sergei Sitnikov** outline the new rules governing aircraft operators making flights to EC member states.

The European Community has established a cap-and-trade scheme designed to limit emissions of greenhouse gases into the atmosphere. Under the Scheme, aircraft operators conducting aviation activities – operating air flights – may perform flights to or from the EC only if they possess the allowances for emitting the carbon dioxide equivalent during a specified year.

The key enactments governing the Scheme are Directive 2008/101/EC (“the Directive”) of the European Parliament and the Council, which amends Directive 2003/87/EC to include aviation activities in the scheme for greenhouse gas emission allowance trading within the EC; and the amendments to Decision 2007/589/EC as regards the inclusion of monitoring and reporting guidelines for emissions and ton/kilometer data from aviation activities.

Subject to a few exemptions, the Scheme applies to all aircraft operators conducting aviation activities – operating air flights – within the EC. A flight will be subject to the provisions of the Directive if it departs from, or arrives in, an aerodrome located within the EC. Certain aircraft operators (for example, commercial air transport operators operating for three consecutive four-month periods fewer than 243 flights per period; the so-called “small emitters”) and certain flights (training flights, test flights, etc.) are exempt from the scope of the Directive.

In the event that an aircraft operator fails to comply with the requirements of the Scheme and where other enforcement measures have failed to ensure compliance, an operating ban may be imposed on the aircraft operator concerned.

From January 1, 2012 aircraft operators may perform flights to and from the EC in the relevant year only if they possess allowances for them. The volume of emissions from the aviation activities of an aircraft operator conducted within the EC may not exceed the number of allowances the project operator has obtained for the relevant year. Under the Scheme, allowances may be obtained in two principal ways: first, free of charge – from EC member states authorized with respect to each particular aircraft operator (the so-called “Administering States”); or second, by purchasing them from either Administering States at auctions or third parties.

The total quantity of allowances for all aircraft operators for 2012 will be determined by the Commission based on historical emissions data. Such data will be taken from verified reports to be provided by the aircraft operators to the Administering States for the monitoring year (2010). To apply for allowances for 2012, aircraft operators need to submit a monitoring plan to the competent authority of the Administering State no later than August 31, 2009 (unless this timeframe is changed by the Administering State) and submit verified reports on emissions to their Administering States by March 31, 2011.

By September 30, 2011, the Commission will, among other things, calculate the total quantity of allowances and the allowances to be allocated free of charge, auctioned, and placed in the special reserve. The Administering States will then allocate the allowances free of charge to the relevant aircraft operators based on their historical emissions and on the data mentioned above.

To ensure compliance, on a year-by-year basis, aircraft operators will be obliged to surrender no later than April 30 to their Administering States allowances equal to their total emissions for the preceding year. If the emissions for the relevant year exceed the allowances held by an aircraft operator, it will be obliged to obtain additional allowances equal to the amount of excess emissions and pay a fine of EUR 100 per ton of excess emissions.

Aircraft operators covered by the scheme should consider its implications for their activities, and prepare and submit monitoring plans to the authorized bodies of the Administering States as soon as possible.

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New rules announced for JI projects under the Kyoto Protocol

Max Gutbrod and **Sergei Sitnikov** examine recent changes to the rules surrounding joint implementation projects under the Kyoto protocol and their likely impact.

On October 28, 2009, the Russian Government adopted two new enactments relating to the development of joint implementation (JI) projects under the Kyoto Protocol to the United Nations Framework Convention on Climate Change in the Russian Federation.

The two changes are Russian Government Resolution No. 843 "On Measures to Implement Article 6 of the Kyoto Protocol to the United Nations Framework Convention on Climate Change" (the Resolution); and Regulations "On Implementation of Article 6 of the Kyoto Protocol to the United Nations Framework Convention on Climate Change" (the New JI Rules).

These two enactments have replaced two previous documents adopted by the Russian Government on May 28, 2007 (namely the Russian Government Resolution No. 332 "On the Procedure for Adopting, and Checking the Development of Projects Implemented Under Article 6 of the Kyoto Protocol to the United Nations Framework Convention on Climate Change" and the Regulations "On Adopting, and Checking the Development of Projects Implemented Under Article 6 of the Kyoto Protocol to the United Nations Framework Convention on Climate Change," jointly known as Resolution No. 332).

The New JI Rules finally complete the basis for JI projects in Russia. They differ from Resolution No. 332 in major aspects (such as the procedure for adoption of JI projects, the parties involved, responsibilities of the parties, etc.). This will have ramifications for project documentation prepared on the basis of the Resolution No. 332.

The New JI Rules foresee the interaction of state bodies and private entities in the various activities required under the New JI Rules (such as approval of a JI project, issuance and transfer of Emission Reduction Units (ERUs), etc.).

These include the Russian Ministry of Economic Development (the MED) performing the functions of a focal point pursuant to the Resolution; the OAO Sberbank of Russia performing the functions of an "operator of carbon units"; an Expert Council formed by Sberbank with the consent of the Focal Point; and the investor in a project.

The New JI Rules grant Sberbank important powers relating to the implementation of JI projects in Russia. Sberbank not only participates in approval of the projects or transfer of ERUs as described below, but is also authorized to give its consent to the agreements between the project participants governing the transfer of ERUs between them. However, the procedure for giving such consent and the consequences of not obtaining such consent has not yet been defined.

Additionally, according to clause 28 of the New JI Rules, the procedure for determining the maximum fees under agreements governing the operations with carbon units is to be established by the MED. This clause, however, does not clearly state whether MED is authorized to establish a limit for Sberbank fees for the services it will be providing to the project participants in connection with operations with carbon units (such as storage of ERUs, transfer of ERUs, etc.); or to establish a maximum price for ERUs. We believe that the first option should apply, but only practice can show the real impact of this rule.

According to the New JI Rules, only a Russian legal entity may be a project applicant which is defined as being the investor in the JI project (the project investor) from the date of approving the project as JI project.

To be eligible for a JI project, as of the date of submitting the project application the project applicant must meet the following criteria:

- no bankruptcy or liquidation procedure has been initiated against the applicant;
- the applicant's activity must not be suspended pursuant to the Russian Code on Administrative Offenses;
- the applicant must not have outstanding debts on taxes, duties and other obligatory payments to budgets of any level or state non-budget funds for the previous calendar year; and
- the applicant must have the right of ownership over, or other proprietary rights in, the facilities at which the project is to be implemented.

The first and third criteria do not apply to entities included in the list that might be adopted by the Governmental Commission on Increasing the Stability of the Russian Economy.

JI implementation

According to the New JI Rules, implementation of a JI project consists of the following major stages:

- selection of the project applications and approval of a project;
- implementation of a JI project; and
- issuance and transfer of carbon units.

The project applications are to be selected on the basis of tenders arranged by Sberbank pursuant to the rules to be adopted by the Focal Point. Such rules should, among other things, provide for the limit of emission reduction (absorption) units which may be issued based on the results of the implementation of projects approved (the so-called tender limit); and criteria for selection of the project applications (including the criteria of energy and ecological efficiency of the anticipated results of the investment activities under the project, as well as criteria of applicant's technical and financial potential for achieving the declared project results and the anticipated economical and social effect from the project's implementation).

The project applications submitted to Sberbank should include, among other things: the project documentation developed in accordance with the legislation on investments, and international rules; a positive determination report prepared by an independent entity (determinator) chosen by the applicant; and materials confirming the applicant's compliance with the requirements of the New JI Rules (including those relating to the applicant's technical and financial potential to achieve the declared project results and the anticipated economical and social effect from the project's implementation). Within five business days from the date of receipt of a project application, Sberbank decides on its compliance with the tender rules and notifies the applicant on acceptance of the project application or a motivated rejection.

Tenders in fact constitute an expert evaluation of the project applications by Sberbank and the Expert Council. The results of evaluation as well as recommendations of the Expert Council are recorded in a protocol which is to be submitted to the Focal Point for approval within three business days from the date of the meeting of the Expert Council.

Within 10 business days from the date of receiving the protocol, the Focal Point makes a decision on approval of the projects, or sends a motivated refusal to Sberbank. The basis for refusal may only be violation by Sberbank of either the tender rules (affecting the tender results) or the New JI Rules.

Approved projects are to be registered in the register of projects maintained by the Focal Point. The register of projects includes, among other things, information on the planned volume of greenhouse gases emission reductions (absorption).

The project is to be implemented in accordance with the project documentation approved.

Any deviations from the project terms or stages set forth in the project documentation are to be reported by the Project Investor to Sberbank. Subject to agreement with the Focal Point, the Project Investor may introduce changes in the project that do not impair the project's energy and ecological efficiency.

Before September 30 of each year, the Project Investor submits a report on the project's implementation to both the Focal Point and Sberbank, which report should, among other things, contain an expert opinion on the project's implementation including a verification report prepared by an independent entity chosen by the Project Investor (the Expert Opinion).

During the year, the Project Investor may also submit interim reports on the project's implementation.

Carbon units

Upon the project's approval, the Focal Point decides on transfer of Assigned Amount Units (AAUs) in the amount corresponding to the Tender Limit to the account of Sberbank in the Russian register of carbon units.

Subject to a positive Expert Opinion and a request from the Project Investor, within five business days from the date of the request, the Focal Point decides on issuance of ERUs (by transforming corresponding AAUs reserved on the account of Sberbank) in the amount corresponding to the projected volume of emission reductions but no more than the volume indicated in the project documentation. Such ERUs are to be credited to the Sberbank account in the Russian register of carbon units.

Sberbank transfers ERUs relating to a JI project to the account of a third party based on: a request from the Project Investor; a report on the project implementation; and an agreement between the Project Investor and the third party, to which agreement Sberbank's consent has been obtained.

The Focal Point may exclude a project from the register of projects in the following cases:

- repeated (i.e., more than twice) missing of deadlines for submitting reports on project implementation;
- a negative Expert Opinion on the report on project implementation; and
- liquidation of the legal entity being the Project Investor.

The New JI Rules like Resolution No. 332 do not contain any specific provisions on taxation of operations performed under agreements covering a JI project. Therefore, the general rules of Russian law should apply, depending on the particular agreements governing the relationship of the parties to a JI project.

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Financial crisis sparks interest in fresh investment approaches

Protecting and preserving financial wealth has never been a more acute concern. High net worth individuals are increasingly interested in alternative investment structures which may offer more security, writes **Sergei Zhestkov**.

Life assurance is often used as a tool for asset protection especially as the laws of many countries give preferential treatment to life insurance proceeds. It may further serve as an investment vehicle where the life insurance policy is linked to an investment portfolio. Also because the insurance policy has been created to pay out a lump sum after death, it provides a degree of certainty and protection for the beneficiaries chosen by the policyholder.

Due to the global economic downturn, asset protection in general and the security of personal wealth in particular have become even more important than before. The current trend is for asset security to be considered more important today for high net worth nationals than the actual performance of their own portfolio. Both corporate insiders and independent directors require additional protection to protect them in the event of financial crisis litigation since even the best liability insurance may not offer complete protection.

In the case of investment through life assurance, the insurance company becomes the only legal and economical owner of the underlying assets of the life assurance contract. The creditors of the policyholder have therefore no claim on these assets. Only the policyholder has the right to withdraw and to surrender. Therefore, the assets in a life assurance are protected against third-party seizure.

Independent advisers to high net worth nationals are constantly having to reorientate themselves in order to give the best possible financial planning advice. Private bankers and wealth managers need stability in the assets they manage in order to be able to continue to provide services over the longer term. This may be partly solved through life assurance, but the only certain way for investors to achieve security in times of crisis is from a State-controlled investor protection regime.

In Russia, the matter of safekeeping personal wealth is still a concern due to a number of issues, such as pressure from the State, in particular from tax and law enforcement authorities, or raider attacks from business rivals. Further concerns may be associated with the acquisition of high value property, when the intention is to transfer the property to a certain number of people who are not necessarily relatives or descendants or with the need for asset protection during a divorce. Current Russian laws do not provide the level of security needed in these cases. Russian wealthy families therefore often seek protection of their assets outside Russia. Luxembourg is one of the prime jurisdictions chosen by Russian high net worth individuals.

Luxembourg law, as set out in its investor protection regime, requires that all clients' assets must be held by an independent custodian bank approved by the Luxembourg state regulator, the Commissariat aux Assurances (CAA). The regime is known as the Triangle of Security due to its three-cornered structure: CAA – insurance company – custodian bank. Under this regime, the Insurance Company deposits all policyholder assets with an independent Custodian Bank approved by the CAA and maintains a register of these assets. Policyholders' assets are held entirely separate from the other assets of the Insurance Company. The Custodian Bank, being entirely independent from the Insurance Company, holds clients' securities (e.g., investment funds, shares and bonds) segregated from its own assets and off its balance sheet. Thus, the clients' assets are separated from the insurance company, its shareholders and creditors. Furthermore the clients' securities are segregated from the custodian bank assets and therefore protected in the event of failure of the custodian bank. Such a regime provides a degree of security for the policyholder who has opted for a private placement life assurance solution.

Private placement life assurance solutions for high net worth individuals are not widely offered by Russian insurers.

The Russian Law on Organisation of Insurance Business regulates insurance companies. Insurers must be legal entities incorporated in Russia and insurance activities are subject to licensing under Russian laws.

Thus, a foreign insurer may enter the Russian market only through a registered and licensed local subsidiary. There are also some specific restrictions with respect to foreign investments in the Russian market, including:

- subsidiaries of foreign companies and companies with more than 49% participation of foreign investments are not allowed to carry out life insurance, mandatory insurance and insurance related to state needs in Russia;
- there is a quota on foreign capital in insurance companies (the quota is calculated annually on foreign investors and their subsidiaries in the aggregate charter capital of Russian insurers); and
- only foreign insurance companies established for at least 15 years and with no less than two years of participation in Russian companies, may have subsidiaries in Russia.

The above restrictions (except for the quota) do not apply to subsidiaries of companies incorporated within the member states of the European Communities and to companies with more than 49% of foreign investments if such foreign investors come from the member states of the European Communities.

The law also forbids foreign insurers from conducting insurance activities or insuring Russian residents in Russian territory. Policies contravening this rule would be invalid if Russian law were to apply to them. There is an argument that this rule should not be violated when Russian residents go abroad to conclude life insurance agreements outside Russia. Thus, once a Russian resident is outside Russia, a restriction on entering into insurance contracts with foreign insurers should generally not apply to such an individual. Currently, no relevant court practice exists to confirm or reject this argument.

Tax implications

Under the Russian Tax Code, payments made by insurance companies are divided into two groups. First Russian-sourced insurance payments, which are insurance payments effected upon the occurrence of the insured event, including periodic insurance payments (annuities etc.) and/or payments associated with the participation of the policyholder in the investment income of the insurer, as well as the cash surrender values received from Russian insurers and/or from foreign insurers in connection with activities of their separate subdivisions in Russia. The second group comprises non-Russian-sourced payments by foreign insurers in all other cases.

Russian tax residents are eligible to pay individual income tax on their worldwide income, including Russian-sourced income and income from sources outside Russia, while nonresidents are taxed only on their Russian-

sourced income. Hence, payments under foreign life assurance policies are subject to Russian individual income tax only for Russian tax residents, if received from foreign companies, which have no tax registration in Russia.

An individual is considered a Russian tax resident if he or she has resided in Russia for at least 183 calendar days during 12 consecutive months. If an individual residing in Russia for tax purposes is also simultaneously regarded as a tax resident of another jurisdiction, such residency conflict has to be resolved according to the tie-breaker rules of the relevant double tax treaties concluded and ratified by Russia. Under the model treaty rule, an individual is generally treated as a tax resident in the state where his or her permanent residence or center of vital interests is located.

Payments made under insurance contracts by Russian as well as foreign insurers to individuals residing in Russia are subject to Individual Income Tax. However, some insurance payments are tax-exempt. These include payments effected under Russian mandatory insurance contracts; agreements which provide compensation for damage to life and health and which reimburse medical expenses (excluding payments for health resort stays); voluntary pension insurance agreements which are concluded with individuals insurers, if such payments are made upon the onset of pensionable circumstances under Russian laws; and voluntary life insurance contracts.

However, payments effected under voluntary life insurance contracts entered into with Russian insurers and effective until a fixed date, e.g., until the policyholder reaches a certain age or linked to any other event, may be exempt from individual income tax if: the amount of the insurance premium is paid to the Russian insurer by the individual themselves; or the amount of the proceeds received from the insurer does not exceed the amount of the payment to the Russian insurer multiplied by the average annual re-finance rate of the Russian Central Bank (currently 13%) for each year the life insurance policy is in force.

Otherwise, the excess payment is subject to 13% individual income tax for Russian tax residents, and to 30% tax for non-Russian tax residents receiving income from Russian insurers, unless tax treaty agreements apply.

Where a voluntary life insurance policy is surrendered earlier (except under force majeure circumstances) and, if as a result of such surrender the policyholder receives payments (return of premiums, surrender value), the individual would be subject to individual income tax at a rate of 13% on the difference between any income received and the amount of premiums already paid to the Russian insurer.

Payments to resident individuals made by foreign insurers under voluntary life insurance contracts in the case of death of the policyholder and/or in case of partial or full policy surrender are subject to individual income tax at the ordinary rate of 13%. An individual, in this case, would not be allowed to reduce the amount of proceeds received from the foreign insurer by the amount of premium and contributions paid to such insurer. This may be disputed by the Russian tax authorities, but may not be directly prohibited by tax legislation.

If payments under a life insurance policy are made directly to a Russian resident by a foreign insurer that has no tax presence in Russia, the foreign insurer would not have any withholding or tax reporting obligations. Accordingly, the tax reporting obligation would apply only to the insured persons or their beneficiaries, depending on their tax residency status in Russia.

Optimal approach

Russian high net worth families require a specific approach to satisfy their financial needs. This approach is not limited to tax optimisation issues but also concerns the best way to protect their assets. One of the decisive criteria for Russian high net worth nationals when choosing their wealth management structure is better asset protection whereby a simple, transparent and secure structure is chosen. It is often the case that Russia's wealthy families are relatively young and may not possess the sufficient level of experience to manage their own wealth.

Assets are more secure if they are held off balance sheet and, thus, protected from the creditors of the bank, in case of the bank's insolvency. There may be alternatives for off balance sheet structures that Russian high net worth nationals may opt for, and such alternatives offer different levels of asset protection.

Security accounts were previously very popular, being easily set up with the same bank or within the same financial holdings. However, they may now face problems from customers who no longer fully trust financial

institutions. Notwithstanding the protection principle proclaimed, reality shows that when a bank becomes insolvent, the client has to approach the liquidator regarding his or her assets. This can make off balance sheet structures less interesting.

Under Luxembourg Investment Assurance structures, the insurance company, the custodian bank and the investment manager are usually part of the same financial holding, which may result in specific in-house products of the same holding for the client's portfolio, although no legal obligation to invest in collective investment funds formally exists. Clearly, there is a different degree of countervailing power – and therefore peace of mind – if all parties belong to the same financial holding.

Alternatively, Luxembourg Private Placement Life Assurance structures provide total independency between the insurance company, the approved custodian bank and the investment manager. In optimal circumstances, the insurance company should not execute any in-house traded investment funds or investment management responsibilities. Moreover, it is not required to cancel the policy if the client wants to change the custodian bank and/or the appointed investment manager; therefore continuity is provided in this financial planning structure. Economic risks associated with other insurance activities of the insurance company do not really exist. The assets in the policy are legally protected against bankruptcy of the insurance company, which is controlled by the Luxembourg State regulator, the CAA.

During an economic downturn, keeping securities on a security account off balance sheet in one's own name is a first layer of protection against a possible bankruptcy. Should a higher level of security and protection be needed, then the same assets may be kept on a security account off balance sheet held through the structure of a Luxembourg Life Assurance. Additionally, Private Placement Life Assurance may be used, which constitutes a sophisticated use of life insurance as a financial planning tool. Private Placement Life Assurance provides an exceptionally high level of investor protection, has tax-favored status and offers investor confidentiality according to Luxembourg law. Moreover, being autonomous, Private Placement Life Assurance guarantees maximum protection against bankruptcy of the custodian bank or of the insurance company. It assures both investment flexibility for the client and the continuity of the structure in case the client decides to replace the custodian bank and/or the investment manager.

The best possible D&O (Directors & Officers) and IDL (Independent Directors Liability) assurances are strongly recommended for corporate and individual directors but even these assurances have limits. On the other hand, the client's assets invested through Luxembourg Private Placement Life Assurance legally belong to the insurance company and cannot be seized by the client's creditors.

Finally, current trends show an ever-increasing interest in life assurance on the Russian market and there are some working products which Russian insurance companies are not able to offer to Russian clients due to the lack of appropriate legislation, including the lack of tax incentives and restrictions for foreign insurers. Such products may be offered outside Russia, where tax incentives under foreign local laws may apply. Ultimately it is the client and his or her advisers who will have to decide whether the discomfort of change outweighs the advantages of Luxembourg Private Placement Life Assurance.

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Why companies should sign up for electronic signatures

Jordi Masdevall explains how the Administration and autonomous communities are encouraging the use of electronic invoices among companies, professionals, and other economic agents.

For whatever reason, companies are not generally implementing the electronic signature, and even when they do, rarely to its full potential. They use it on a limited number of occasions and for only a limited number of its applications.

Yet there are many occasions when using electronic signatures makes sense.

The first application is for filing tax forms via the Internet (e-Tax). Since October 1, 2008, companies (both corporations or SAs and limited liability companies or SRLs) are required to file their voluntary tax declarations via the Internet.

This declaration through data transmission requires the user to have a user's certificate installed in its browser. Users may get a certificate issued by the National Mint, or any other electronic certificate permitted by the State Tax Agency (AEAT). The AEAT will no longer admit voluntary tax declarations on paper.

The second application where electronic signatures make sense is the electronic invoice – e-invoice. Organizations save money and space by using electronic invoicing and also secure economic aid offered under Plan Avanza 2006-2010. Importantly also, electronic invoices are increasingly required for organizations contracting with the public sector. Obligatory use will be extended progressively following the approval of the Ministry Order implementing the regulations on the use of the electronic invoice in contracts with the public sector. Initially, companies which cannot submit an abbreviated profit and loss account must use the electronic invoice. This requirement will be gradually extended to individuals and legal entities depending on their nature and business volumes by November 2010.

At the same time, the Administration and the autonomous communities will foment the use of the electronic invoice among companies, professionals, and other economic agents in the market, especially among small and medium-sized enterprises and micro-companies to promote the development of electronic commerce.

Finally, electronic signatures are helpful for electronic communications between companies and their stockholders, where the security afforded by electronic signatures can be useful. Limited liability companies (SRLs) have more flexible regulations than corporations (SAs), though both types of companies may include the use of electronic communications in their bylaws.

Limited liability companies can, for example, have an agreement requiring or allowing (as the case may be) that: the company or its directors have an e-mail address for communication with the stockholders; the stockholders' call to a General Stockholders Meeting be made by e-mail instead of announcements (Official Gazette of the Commercial Registry, newspaper); the Board of Directors Meeting be called by e-mail; resolutions be adopted via videoconference and/or the resolutions adopted by the Board of Directors be validated by electronic vote without holding a session; or electronic voting or representation be done by e-mail.

The two areas where electronic signatures should be used are contracting with the Administration through technology platforms (G2B) and the use of electronic arbitration to resolve consumer disputes.

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Non compete clauses face key interest test

Sara Luján examines how a recent Court case might impact the implementation and longevity of non compete arrangements.

Within the employment relationship framework, while working, employees may not engage in any disloyal behavior towards their employer – so the biggest risk of damage from professional disloyalty comes when the employee leaves the organization.

Knowledge acquired by the employee – business know-how – about a company’s confidential data, the relationships between the employee and clients and suppliers, and so on, is suddenly at risk. However, Article 21 of the Workers’ Statute allows a post-contractual non-competition clause to be established to defend corporate interests and guard against monetary losses resulting from an employee’s disloyal performance.

Such post-contractual non-competition agreements are commonly used by most employers who have strong competitors. In order to establish such an agreement there must be a commercial or industrial interest held by the employer and payment of proper economic compensation to the employee.

The commercial or industrial interest is represented by the risk the company runs that the employee will use insider knowledge to unfairly take advantage of the company when they leave. The non-competition clause prohibits the employee from working for his or her former employer’s competitors. Obviously, this prohibition affects the right to work and the obligation to work, and so applies for only two years for qualified technicians and six months for other employees. The employer is also obliged to pay compensation to the employee as a result of the professional limitation, plus an additional sum of money for damages if either party breaches the obligations established in the agreement.

Unilateral termination of the covenant by either party is not set forth by law. Accordingly, the Higher Courts of Justice, in many decisions, have pointed out that for the non-competition agreement to be valid and lawful, besides its being limited in time, these two requirements must be met, namely, the employer’s commercial or industrial interest and the establishment of an economic compensation. This creates reciprocal obligations between the contracting parties, the fulfillment of which cannot, under the general rules of the Spanish Civil Code, be left to the will of only one of them.

Recent case

In January 2009, the Higher Court of Justice of Cataluña, tackled a case in which the parties included a non-competition clause in the employment contract to be effective from the termination of the employment relationship. When the employer dismissed the employee, the employer stated in the dismissal letter that, since the company had no effective industrial or business interest in keeping the non-competition clause included in the employment agreement, the Company canceled all obligations arising from the covenant, therefore releasing the employee from the restriction on his or her professional activity.

As a consequence of the employer’s terminating the non-competition clause, the employee filed suit seeking the payment of an amount equal to six months’ salary and a “bonus” for income, to be paid within six months of the termination date of the employment agreement, plus 10 percent interest for delay pursuant to the non-competition clause.

It is clear that if the interest remains, the non-competition agreement will become effective for both parties. However, if the interest disappears, it will not become effective, and there will be no obligations for the parties. Therefore, if the business or industrial interest ceases to exist, the employer is under no obligation to compensate the employee financially, since he or she may freely exercise his or her right to work and choose a profession.

The employee argued that complying or not complying with the non-competition clause cannot be left to the company’s will and that, for the term covered by the non-competition clause, his or her right to consider job offers within his or her professional field was interfered with. In this recent decision, the Higher Court of Justice of Cataluña ruled in favor of the employer and declared that for the non-competition clause to be valid and lawful after the termination of the employment agreement, the employer must, as we said before, have a business or

industrial interest and that, if that interest does not exist from the outset, the clause becomes invalid for lack of content. Furthermore, agreeing to such a clause presupposes that there is such a business or industrial interest, even though the clause would not be effective until the termination of the employment agreement.

The Court holds that it is obvious that under no circumstances can it be considered unlawful for the employer to decide whether or not the clause should be effective depending on whether or not the interest exists. In this way, the Court decided that the non-competition agreement is subject to a condition precedent, which is that the covenant shall become effective if, after the termination of the employment agreement, the business interest subsists. Otherwise, the clause shall not become effective. The clause has no effect on the employment agreement and will only become effective on the termination of the employment agreement and not during its term. At that time, the employer may decide whether or not the business or industrial interest which was being protected continues to exist.

This suggests that if the employer proves that it has no business or industrial interest, whether because it has absorbed its competitors or simply because the interests it tried to protect initially under the non-competition agreement no longer exist, it may, in principle, freely terminate the obligations agreed upon.

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Inquiry recommends steps to simplify life for SMEs in Sweden

Inquiry chair **Carl Svernlöv** and **Azalia Moradi** outline the key proposals and recommendations which are expected to streamline and simplify life for SMEs.

A new Inquiry regarding changes in the Swedish Companies Act and the Companies Ordinance was completed in April 2009. The Inquiry focused particularly on the needs of small and medium enterprises (SMEs) for simpler regulations in the area of company law. In addition to proposing simplifications, the Inquiry has also been tasked with considering the need for a new type of company, reviewing the provisions on remuneration for senior management of listed companies and considering whether a special time-bar rule should be added to the Partnership and Non-registered Partnership Act.

The proposals made in the report aim to reduce the administrative burden on limited companies as far as possible without neglecting other important interests such as protection for the limited company's creditors, tax control and the fight against economic crime. One proposal is to abolish the paper-based system of share certificates, dividend coupons and interim certificates. This means that the share register will contain more information and its contents will have greater legal importance.

In the area of governance, the report proposes that the requirement for at least one alternate board member in cases where the board of directors has fewer than three members be altered to apply only where the board has only one member. Another simplification proposal is to abolish the mandatory requirement to adopt rules of procedure whose removal has been recommended for private limited companies. The same would apply to the requirement for written instructions on the allocation of work between company organs.

The report further proposes that it will no longer be necessary to attach general meeting minutes to a notification to the Swedish Companies Registration Office of a member or alternate member of the board of directors, an auditor or alternate auditor and a general examiner or alternate general examiner. Instead, a solemn declaration will be made in the notification to the effect that the information in the notification agrees with the decisions on which it is based. This will reduce the quantity of documents that companies have to file with the Swedish Companies Registration Office in various notification matters.

Of interest to international investors in Sweden is that the report proposes the abolition of the residency requirement in the Companies Act for founders, members and alternate members of the board of directors, the managing director, deputy managing director, company signatories and liquidators. The reasons for the proposal include the principle that company law should not set too many practical obstacles to the establishment of a company.

Several other proposals include giving private limited companies greater possibilities of acquiring their own shares. The same applies to making loans to connected persons and loans for the acquisition of shares. The period for a summons to unknown creditors in connection with liquidation will be reduced from six months to two months. Moreover, a procedure will be introduced to dissolve the company through deregistration as an alternative to voluntary liquidation or winding up.

As regards the need for a new type of company, the Inquiry has concluded that there are, at present, no reasons for adding a new type of company without personal liability to Swedish law, not at least in view of the anticipated creation of the new European Private company (SPE). The prime focus of the Inquiry has instead been on simplifying the existing body of regulations.

With respect to the provisions in the Companies Act and certain procedures governing remuneration to senior management of listed companies and in annual accounts acts on disclosure of such remuneration, the report proposes that these cease to apply. Instead, the issues would be dealt with through self-regulation, an appropriate vehicle being the Swedish Code of Corporate Governance.

Finally, the Inquiry proposes that a time-bar rule be added to the Partnership and Non-registered Partnership Act to the effect that a partner's responsibility for the partnership's obligations will be time-barred 10 years after the partner's resignation has been registered in the Partnership Registry unless the time-bar applicable to the partner is interrupted before then.

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Switzerland

Door opens to EEA parallel imports

Michael Widmer and **Manuel Annasohn** explore the impact of the new principle of regional exhaustion under Swiss Patent Law.

Exhaustion of patent rights is concerned with the relationship between a patent owner's right to prohibit use (also known as exclusivity) and the right to use a patent-protected product based on its acquisition. According to the principle of exhaustion, a patent owner's right to prohibit use of a patent-protected product, as granted by the patent, is deemed used up (exhausted) if the product has been put into circulation with the patent owner's permission. Hence, the rightful owner of the patent can no longer prohibit commercial use and resale of such product by a third party. Thus, the question of exhaustion of patent rights affects the relation between the patent owner's right to prohibit use and the purchaser's right to use the patent-protected goods in accordance with his or her (tangible) property rights.

Previously, patent rights have kept Switzerland's doors closed to certain parallel imports. However, changes introduced to Swiss Patent Law in July 2009 effectively opened up the market to parallel imports of patented goods from EEA countries.

There are three variants of exhaustion. First, according to the principle of national exhaustion, the exclusive rights of the patent owner granted domestically expire when the product is put into circulation domestically with his or her permission. However, if a protected product is brought into circulation abroad, domestic rights are not exhausted. Therefore, under the regime of national exhaustion, importing into Switzerland a patent-protected product that was put into circulation abroad would require the permission of the patent owner.

On the other hand, under the principle of international exhaustion, exclusive rights to a product expire irrespective of whether the protected goods are put into circulation domestically or abroad. Thus, parallel import of protected goods purchased abroad may not be prevented under the regime of international exhaustion.

Finally, under the principle of regional exhaustion, exclusive rights expire when the product is brought into circulation with the permission of the patent owner in any of the countries belonging to a certain region (e.g., EU, European Economic Area [EEA]). As a result, the patent owner may not prohibit the resale of such products within the region as well as parallel imports from other countries within the region. However, the patent owner's rights are retained if the protected products are brought into circulation outside the region.

Therefore, determination of whether national, regional or international exhaustion applies has a substantial impact on whether parallel imports of patent-protected goods into Switzerland are permitted.

In a decision in 1999, the Swiss Federal Court set up the principle of national exhaustion for Swiss Patent Law. This is in contrast to Swiss trademark and copyright laws, which are governed by the principle of international exhaustion. As a result of this decision, the patent owner is now able to prevent parallel import of patent-protected products that he or she, or a third party with the patent owner's approval, has placed in a foreign market.

Since then, this controversial decision and the principle of national exhaustion under the patent law have been much debated. During the recent revision of the patent law, the Swiss Federal Council held steadfast to the principle of national exhaustion, but suggested measures to prevent abuse of the patent law. In December 2007, it presented to the Swiss Parliament an amendment to the Swiss Patent Act. Eventually, in December 2008, the Swiss Parliament turned on the principle of national exhaustion and made the categorical decision that the principle of unilateral (i.e., without establishing a reciprocal agreement) regional exhaustion in relation to EEA member states shall apply. This means the principle of regional exhaustion with the EEA applies in Switzerland but there are no bilateral treaties which would ensure that this principle also applies in other countries of the EEA for goods placed on the market in Switzerland.

Changed approach

The new Article 9a of the Swiss Patent Act, which stipulates the principle of unilateral regional exhaustion, came into effect on July 1, 2009. It states that patent-protected products which are placed on the market within the EEA, either by the patent owner or by a third party with the patent owner's consent, may be imported and used or

resold in Switzerland without the patent owner's consent. Hence, parallel imports of patented goods from EEA countries are generally permitted.

Also, if an apparatus in which a patent-protected procedure may be applied has been placed on the market within the EEA, either by the patent owner or by a third party with the patent owner's consent, the first and any future purchaser of such apparatus may apply this procedure.

Furthermore, the import of products is permitted even if they have been placed on the market outside the EEA by the patent owner or by a third party with the patent owner's consent if patent protection is only of subordinate importance to the functional characteristics of the product.

Finally, the patent owner's consent to importing patent-protected products is still required if the product's price is fixed by the government in Switzerland or abroad. National exhaustion therefore remains applicable to this extent. This provision applies primarily, but not exclusively, to pharmaceuticals.

Due to the newly introduced principle of unilateral regional exhaustion under Swiss Patent Law, the patent owner's exclusive rights to a specific patent-protected product expire when the product is placed on the market in any of the member states of the EEA with the consent of the patent owner. Therefore, parallel imports of products from such countries into Switzerland, generally, may no longer be prevented.

The effects on the Swiss Economy of the change from national to regional exhaustion under the patent law remain to be seen. The extent of parallel imports of patent-protected products under the new regime of regional exhaustion and its influence on prices in Switzerland depend on several factors, such as market entry barriers, transaction costs, possibility of coexistence of markets with high and low prices, and price elasticity of demand, and therefore could not be easily determined. Also, it is not yet clear what impact the new regime would have on research and development activities. During the revision of the relevant legal provisions, it was feared, in particular, that the introduction of the regional exhaustion principle would have a negative impact on the pharmaceutical industry. As a result, the Swiss Parliament decided to adhere to the principle of national exhaustion when it comes to goods with prices fixed by the government. Finally, based on a study conducted in 2002, it is anticipated that regional exhaustion would result in a modest, if any, welfare increase of 0–0.1% of the gross domestic product. Whether these predictions are true remains to be seen.

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New rule impacts allocation of jurisdiction for contractual claims

Prisca Schleiffer explains that the way of tackling contractual disputes will change significantly starting in 2011.

On January 1, 2011, the revised Convention on Jurisdiction and the Enforcement of Judgments in Civil and Commercial Matters, known as the Lugano Convention, will come into force in Switzerland. The Lugano Convention is part of the so-called Brussels Regime, a set of rules regulating the allocation of jurisdiction in international legal disputes on civil and commercial matters between or among parties domiciled in the European Community.

Apart from rules assigning jurisdiction, the Brussels Regime governs the recognition and enforcement of foreign judgments and consists of the Brussels Convention, binding member states of the European Community; the Lugano Convention agreed by then members of the European Free Trade Association (EFTA), including Switzerland; and Brussels I Regulation 44/2001, replacing the Brussels Convention. All three legal instruments are broadly similar in content.

When the Brussels I Regulation came into force on March 1, 2002, it triggered the revision of the Lugano Convention in order to maintain consistency in the allocation of jurisdiction and enforcement of judgments on civil and commercial matters in the European Community and the contracting states of the Lugano Convention.

The changes introduced by the revised Lugano Convention are many and include changes relating to jurisdiction for claims based on contractual obligations, domicile of legal persons, jurisdiction for related actions, and procedure for the recognition and enforcement of judgments in another contracting state.

The current Lugano Convention (Article 5(1)) provides that a person domiciled in a contracting state may be sued in another contracting state in matters relating to a contract – in the courts for the place of performance of the obligation in question. Specific rules, however, apply to claims arising from employment contracts, consumer contracts, insurance contracts, and lease contracts. The place of performance must be determined separately for each obligation so the courts must refer to the specific obligation forming the subject of the dispute. For the specific obligation, the place of performance is determined according to the private law referred to by the choice of law rules of the court dealing with the dispute. With regard to contracts involving different obligations (e.g., purchase agreement or contract for services), the current version of the Convention could result in a split of competence, meaning, claims arising out of the same contract might have to be filed with different courts. In a contract of sale, for example, there is, on the one hand, the seller's obligation to deliver the goods and, on the other hand, the buyer's payment obligation. Therefore, where goods are to be delivered in Vienna but the purchase price is to be paid in Zurich, the jurisdiction for the obligation to deliver is in Vienna whereas the jurisdiction for the obligation to pay is in Switzerland, being the buyer's domicile.

Determining jurisdictions

The new version of Article 5(1) of the Lugano Convention reads as follows:

"A person domiciled in a Contracting State may, in another Contracting State, be sued:

(a) in matters relating to a contract, in the courts for the place of performance of the obligation in question;

(b) for the purpose of this provision and unless otherwise agreed, the place of performance of the obligation in question shall be:

- in the case of the sale of goods, the place in a Contracting State where, under the contract, the goods were delivered or should have been delivered,
- in the case of the provision of services, the place in a Contracting State where, under the contract, the services were provided or should have been provided,

(c) if subparagraph (b) does not apply then subparagraph (a) applies."

The revised rule distinguishes between, on the one hand, contracts for the sale of goods and the provision of services and, on the other hand, other contracts (excluding employment, consumer, insurance and lease contracts, which are subject to specific rules). The scope of the provision of services is broad and includes all contracts where one party provides remunerated services, in particular, ordinary mandates, agency contracts, distribution contracts, work contracts, and contracts of carriage.

The new rule is intended to improve the weaknesses regarding the possible split of jurisdiction, the rather complicated system where the jurisdictional question is determined based on the applicable law, and the fact that the place of payment may result in a forum for the plaintiff. While the revised rule may not be able to remedy all of these weaknesses, it may improve the legal situation for contractual claims based on the sale of goods or the provision of services.

For claims based on the sale of goods and the provision of services, the place of performance will no longer be determined based on the private law referred to by the choice of law rules of the forum. There is now an autonomous definition of the "place of performance." For the sale of goods, it is the place where the goods are delivered or should have been delivered and, in case of the provision of services, it is the place where the services are provided or should have been provided. The autonomous definition prevents a split of competence, as all claims arising out of a contract are determined based on the same place of performance (provided that a contract does not have more than one place of performance). Furthermore, the definition no longer involves determining the place of performance based on the private law referred to by the choice of law rules of the court of the forum. In the earlier example, where the goods are to be delivered in Vienna and the payment is to be made in Zurich,

there is now only one jurisdiction, in Vienna, being the place where the goods must be delivered, irrespective of whether the seller's obligation to deliver or the buyer's payment obligation is in dispute.

Beginning January 1, 2011, a different set of rules shall apply in determining the jurisdiction for disputes arising out of commercial contracts other than employment, consumer, insurance and lease contracts. With respect to contracts for the sale of goods and the provision of services, a party could be sued at the respective places where the goods were delivered and the services were provided, irrespective of the obligation in dispute. In other contracts, the legal venue is determined based on the place of performance of the obligation in question which is, in turn, established based on the private law referred to by the choice of law rules of the court of jurisdiction.

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Revision of unfair competition law tackles scammers

Miriam Kaufmann examines new remedies against unfair marketing practices.

In recent years, unfair marketing practices have been on the increase in Switzerland, with current legislation unable to provide sufficient remedies to fight against such practices. For this reason, a revision of the Swiss Federal Act against Unfair Competition (UCA) is underway. The message of the Swiss Federal Council regarding the revision of the UCA was released on September 2, 2009.

The revision of the UCA aims to provide a specific legal basis with respect to common unfair marketing practices, to improve the protection against unfair general terms and conditions in contracts and to facilitate the implementation of the provisions of the UCA.

One proposed change seeks to tackle the problem of companies and individuals becoming victims of directory or advertising scams.

Directory scams refer to the listing of companies and individuals in directories with doubtful, if any, value for the listed client. Advertising scams involve the sale of adverts on maps, information brochures or other advertising formats. These scams are initiated by means of unsolicited sales letters, telephone calls or door-to-door sales agent visits. Companies and individuals are given the impression that said services are free of charge, however accepting such an agreement often results in costly bills.

Another way to mislead companies and individuals is to imply that a service contract already exists. The companies and individuals are then asked to sign a form if they wish to terminate the service. In signing the form however, the companies and individuals unknowingly give their consent to the service and enter into a contractual relationship.

Yet another scam involves sending out invoices for trade directory listings or advertising orders which have never been solicited or actually sold.

According to the draft of the revised UCA, directory and advertising scams are specifically mentioned in the definition of unfair advertising and sales methods and other unlawful behavior. Examples of what the law considers acts of unfair competition include promoting the listing in any kind of directory or promoting advertising services through forms or similar means, or directly offering such listing and advertising services without indicating in prominent type, in a visible space, and in understandable language a range of information. This must include the nongratuitous nature and the private character of the offer; the duration of the contract; the total costs according to the duration of the contract; and the geographical limitations, the form, the minimum circulation and the latest date of the publication.

The draft act also classes as an act of unfair competition sending out invoices for the listing in directories of any kind or for advertising services without prior authorization of these services.

Pyramid schemes

Pyramid schemes, for example, chain letters, are characterized by the fact that they are connected with the payment of money or with pyramid sales or distribution systems. Pyramid schemes are also known as snowball or avalanche systems.

Pyramid schemes are currently mentioned in the Ordinance to the Swiss Federal Act on Lotteries and Commercial Bets – not in the UCA – as pyramid schemes were already regulated before the latter entered into force in 1986. As pyramid schemes are related to unfair competition, the revision of the UCA provides for the transfer of the provision on pyramid schemes into the UCA. In addition, the wording of the provision is slightly amended.

According to the wording of the revised provision, offering someone the delivery of goods, the payment of premiums or other services in such a way that the recipient mainly benefits by recruiting other persons rather than through the sale or consumption of goods or services (snowball, avalanche or pyramid systems) is considered an act of unfair competition.

Making the distinction between legitimate multi-level marketing systems and pyramid schemes might prove to be difficult. According to the message of the Swiss Federal Council, pyramid schemes focus on the recruitment of other members while legitimate network-marketing focuses on the distribution of a marketable product.

As opposed to the existing provision and pursuant to the wording of the revised provision, a pyramid scheme now exists if priority is given to the recruitment of other persons rather than to the sale or consumption of goods or services. The amendment of the wording aims at including pyramid schemes disguised as goods or services businesses.

General Terms and Conditions

In addition, the revision of the UCA aims to improve protection against abusive general terms and conditions in contracts.

Pursuant to the applicable UCA, anyone who misleadingly makes use, to the detriment of a contracting party, of pre-worded general terms and conditions which deviate considerably from the applicable statutory provisions that apply either directly or by analogy, or foresee an allocation of rights and obligations which seriously contradicts the nature of the contract is liable for an act of unfair competition.

Due to the term “misleadingly”, a court may currently only declare general terms and conditions as unfair in the event that misguidance has actually occurred. On the other hand, it may not declare general terms and conditions as unfair solely based on their unfair content.

The revision of the UCA aims to enable the courts to declare general terms and conditions as unfair based on their unfair content. For this reason, the wording of the mentioned provision is amended.

As the UCA is generally applicable, the protection against unfair general terms and conditions is not limited to consumers, but extends to companies as well.

It was held in the course of the revision of the UCA that general terms and conditions should preferably be regulated by the Swiss Code of Obligations, or that the protection against unfair general terms and conditions should be limited to consumers. However, these stipulations were not implemented into the draft of the revised UCA.

Implementation

Ultimately, the revision of the UCA is intended to facilitate the implementation of the provisions of the UCA. For this reason, the draft of the revised UCA provides for an extension of the right of action of the Swiss Confederation as well as for a basis for collaboration with foreign supervisory authorities.

According to the current version of the UCA, the Swiss Confederation is, under certain circumstances, entitled to initiate the actions provided for in the UCA. At present, this is only possible in the event that the Swiss Confederation considers the initiation of an action to be necessary to safeguard the reputation of Switzerland abroad, and that the persons entitled to bring an action are domiciled abroad.

In order to better protect Swiss companies and consumers, the draft of the revised UCA also provides the Swiss Confederation with a right of action if the interests of several persons or of a group of members of a certain industry or other collective interests are threatened or violated.

In addition, the draft of the revised UCA provides the Swiss Federal Council with the right to inform the public of unfair practices by naming the companies concerned, if this is necessary for the protection of public interest.

The basis for the collaboration with foreign supervisory authorities is established by a new chapter in the UCA. These provisions are inserted in order to combat unfair practices involving several countries. As recent experience has shown, such practices are on the increase.

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Looming VAT changes streamline administration

Michael Gusterer compares the current and future ways in which the VAT system will be administered and, in light of the changes, advises companies to review their activities before January.

The current Swiss VAT system is a very complex system due to its many exceptions, its three different tax rates, its lack of flexibility, and the strong formalism with which the tax authorities interpret the VAT Act. As a result, the reform of the VAT system has been greatly welcomed by all parties as a means for reducing the enormous administrative costs to taxpayers and authorities and for improving the stability of the law.

The reform of the VAT system is divided into two parts. Part A consists of a completely redrafted and restructured new VAT Act; and Part B introduces a single tax rate of 6.1 percent, instead of the current three different VAT rates, and intends to abolish several tax exemptions.

Part A was passed by the Swiss parliament on 12 June 2009 and would enter into force on 1 January 2010 – unless a referendum is held, although this appears unlikely. The Swiss parliament would take up the debate on the controversial Part B of the reform in autumn 2009.

Part A introduces a range of important amendments.

- The new VAT Act breaks from the past. It gives priority to the aspects of a general consumption tax over the aspects of an economic transfer tax. In other words, the VAT endeavors to tax non-corporate domestic consumption and avoid any tax burden at the level of the taxpayer. There are only two exceptions: refusal of the deduction of input tax on tax-exempt turnover; and reduction of the recovery of input tax when receiving subsidies.
- Under the new VAT Act, any person who conducts a business is a taxable person, i.e., the economic activity and not the (effective) generation of a taxable turnover is relevant. Based on this principle, start-ups may register for VAT, even if they do not yet generate any turnover, and they have the right to deduct input tax. If the turnover of a business exceeds CHF 100'000, registration for VAT is compulsory. This threshold replaces the current three turnover limits of CHF 75'000, CHF 150'000 and CHF 250'000. Volunteer organizations, such as sports clubs and charities, will continue to be exempt from VAT up to an annual turnover of CHF 150'000.
- As a basic rule, under the current VAT Act, a service is considered as provided at the place where the service provider has his or her domicile. With the reform of the VAT Act, a new definition of the place of supply has been adopted, that is, the place of supply is now deemed the domicile of the service recipient. This principle is not entirely new, as it has been used in exceptional cases under the current VAT Act. In the future, the application of the “domicile principle” will be limited to a few cases, i.e., for services that are provided to physically present persons.
- Under the old VAT Act, a company was liable for the full tax debt of the VAT group even it had left the group. The reform intends to mitigate this joint liability provision. Should a company decide to leave the VAT group, it would

be liable only for the tax debt resulting from its own business activities. With this amendment, the acquisition of a company which is part of a VAT group would be easier and the group taxation system would be more attractive.

- Several amendments relate to the object of taxation. For example, the taxation of self-supply in connection with the work carried out on own buildings has been abolished. A new definition of all non-compensatory payments has been introduced. Generally, these do not fall within the scope of VAT (e.g., subsidies, donations, dividends, indemnity payments).
- Another amendment which addresses the object of taxation is the taxation of service combinations. In the future, a taxable person may treat combinations of independent supplies and services as a unit from a tax perspective. However, there are two conditions: first, the service combination must be offered at one price for all combined services; and second, one of these services must have a value of at least 70 percent of the total price. For the subordinated services, the legal consequences are the same as those for the main service. This affects, for example, the tax rate, i.e., the tax rate of the dominant service will apply to all other services. Additionally, if the dominant service is subject to tax exemption, the subordinated services will also qualify as tax-exempt.
- The new VAT Act endeavors to extend the right to opt for voluntary taxation of “in principle” tax-exempt turnovers. For example, currently, the option for voluntary taxation of the sale and rent of real estate is possible only under the condition where the acquirer or tenant is a taxable person using the real estate for taxable purposes. Under the new VAT Act, this condition ceases to apply. The seller may opt for taxation of the income resulting from the sale or rent of real estate even if the real estate is sold or rented to a non-taxable party. The option right is subject only to the condition where the real estate is not used for private purposes. The voluntary option for taxation is also possible for other “in principle” tax-exempt turnovers (excluding insurance and financial services, as well as services relating to gambling).
- In principle, the new VAT Act allows every taxable person to fully deduct input tax incurred in connection with its business activity. This principle clarifies the previously controversial question of the extent to which input tax that may not be explicitly attributed to individual turnovers of the taxpayer, but occurs in the scope of its general business activities, may be deducted. This new principle is relevant, for example, to holding companies conducting operating business activities, as the possibility to claim input tax on dividends or other non-service-related income has been widened. Organizations that are financed through donations are now allowed to deduct the full input tax on these donations. Subsidies, however, still have a negative effect on the pro rata input tax deduction. Additionally, full input tax on expenses for food and drinks may be reclaimed, as the 50 percent limit on the recovery of VAT on such expenses has been lifted. The existence of a formal receipt is no longer required for the deduction of input tax. The reclaiming taxpayer must simply be able to provide evidence that payment has been made. The form of evidence is irrelevant.
- The new tax period is the calendar year or – on request – the business year of the taxpayer. The quarterly tax returns remain but will be summarized in an annual VAT declaration. Tax audits will have a definitive effect, and the taxpayers have the right to request a tax audit as well as binding tax rulings.

The Federal Department of Finance issued the draft of the new VAT Ordinance on 22 September 2009 for public consultation. The administrative guidelines also need to be updated, but the updated guidelines are not expected to be published before 1 January 2010.

It is noteworthy that the old VAT Act will be applied to all turnovers generated fully or partially before 1 January 2010 based on the absolute limitation period of 15 years of the old VAT Act.

Taxpayers should analyze the impact of the VAT reform on their business activities. They should review structures and transactions which could be affected by the new VAT Act, identify the required changes, and develop an action plan to implement such changes as soon as possible, i.e., by 1 January 2010. Finally, they are advised to review the validity of the existing tax rulings under the new VAT Act and – in case of doubt – to obtain new tax rulings.

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Private Equity secondary transactions: a growing trend?

James Burdett, Sarah Adams and Gabriel Boghossian examine how the current economic climate has affected private equity secondary sales.

A private equity secondary sale, in its simplest form, is the transfer of the interests held by an investor in a private equity fund or other investment fund (for example, a real estate fund) prior to the end of the fund's term, thereby providing liquidity for the selling investor. While more common in the closed-ended fund arena (where investors are generally not at liberty to redeem their interests), secondaries also occur in respect of open-ended funds, especially in the latter part of the fund's life when redemptions may be restricted.

In the current economic climate, sellers have been motivated by liquidity problems (resulting in an inability/difficulty in meeting capital calls) and the so-called 'denominator effect' (when an investor's portfolio has become overallocated to private equity (PE) as a result of a greater drop in value of its other investments, e.g., listed securities). In recent times, prices have tended to be driven down as a result of an abundance of sellers. However, while secondary transactions are currently seen as 'distressed transactions', prior to the current financial crisis they were evolving rapidly as a means of sellers actively managing their portfolios (e.g., exiting tail-end PE funds and rebalancing their portfolios at a strategic level so as to enable them to reinvest their capital elsewhere).

The buy-side is dominated by dedicated secondary funds of funds. However, other players do exist, such as standard funds of funds as well as the primary limited partner investors themselves.

In many ways, a private equity fund secondary transaction is similar to a corporate M&A deal. However, secondary transactions differ in several significant respects, principally as a result of the character of the asset being transferred - namely, a limited partnership (or other similar fund) interest.

The principle aspect of that character is illiquidity. This illiquidity is no accident: when launching a fund, general partners expect investors to be in for the life of the fund and, although transfers are possible, life is deliberately not made easy for the limited partner who chooses to exit.

There are some key considerations for limited partners (LPs) who want to exit, and while the deal is struck between the exiting LP and the buyer, general partners (GPs) play a pivotal role in facilitating the transaction while protecting the interests of other LPs and themselves.

Limited partnership agreements (LPAs) will invariably require that the seller obtain GP consent to the transfer and to the prospective buyer becoming a substitute LP. Although the GP is often required to act reasonably, in practice GPs have broad discretion in this regard. GPs will typically prefer an institutional buyer that has the potential to commit to new funds it may launch in the future, rather than a secondary fund which is unlikely to be interested in primary investments in follow-on funds. So the GP has a vested interest in maintaining an active role in the sale process, and more proactive GPs will often attempt to line up "friendly" buyers when faced with an LP that wishes to exit. The exiting LP would be well advised to engage with the GP at an early stage so as to reduce transfer risk and preserve its relationship with the GP.

A significant proportion of funds contain right of first refusal (ROFR) provisions, affording the GP and/or the existing investors an opportunity to acquire the selling LP's interest on the same terms offered by the prospective buyer. This may have a depressing effect on the price of the individual interests in question (and may deter prospective bidders from making an offer) and, in any event, will extend the time it takes to transfer the interest. In the case of the sale of a portfolio of LP interests, sellers sometimes attempt to circumvent ROFR provisions by allocating an artificially high price to the interests subject to ROFR and lower prices to other interests.

Due diligence

In common with other acquisitions, bidders will require a period of legal and financial due diligence. They will typically require access to quarterly and annual financial reports and valuations as well as to the constitutional and other contractual documents relating to the fund and the appointment of the manager and/or adviser.

Prospective buyers may also want to see all drawdown and distribution notices and capital statements so as to reconcile the financial position of the investment and quantify the future liability to contribute capital. The legal documents will include the original LPA (and amendments), subscription agreement, private placement memorandum, any side letters negotiated with the seller (and those with the other investors), and any legal opinions.

Buyers' diligence requirements will vary. Some will be satisfied with a desktop valuation restricted to available documentary information. Others employ a highly granular "bottom-up" approach and attempt to value each portfolio company and assess the likelihood of it reaching a successful exit.

In common with primary investors in private equity funds, a secondary buyer will also place significant weight on the skills and track record of the GP/fund manager and the individual members of the management team.

The current oversupply in the secondary market has led to bidders in auctions demanding cost coverage at the commencement of the due diligence phase. This may take the form of a break fee or indemnity for a pre-agreed level of costs in favor of the bidder. While unpalatable for a seller, it may well be the price it needs to pay in the current environment to bring bidders to the table.

Understandably, GPs are sensitive about the sharing of confidential information between seller and buyer in the due diligence process. Not only is the information often commercially sensitive, but the GP will also owe a fiduciary duty to other investors which they take seriously. Any due diligence should therefore be preceded by the execution of a full non-disclosure agreement (NDA), which should be written for the benefit of the GP, whether or not the seller has informed the GP of its intention to sell at that stage.

For a portfolio sale, it is not unusual for a seller to want to delay notifying or engaging with the GP until it has reached a binding deal with the buyer, in which case the existence of an NDA in favor of the GP should help to reduce the risk of the GP refusing its consent to the transfer once it is informed.

Where interests in more than one fund are being sold, the buyer and seller will typically enter into an umbrella sale and purchase agreement (SPA). A consequence of the restrictions on transfer in fund LPAs is that the signing of the SPA and the completion of the transfer will not be simultaneous. Rather, the SPA will contemplate a completion (or, in the case of a portfolio sale, multiple completions) which will occur once the restrictions on transfer in each LPA have been satisfied or waived.

The SPA should contain a mechanism to carve out those interests that are taken up by other investors under ROFR provisions or excluded because of lack of GP consent. However, buyers may not always be willing to proceed with the purchase of a portfolio that has been pared down in this way.

The SPA will contemplate individual assignment and assumption or other transfer agreements being entered into and exchanged at completion (the form of which will either be prescribed by, or drafted with the assistance of, the GP for the relevant fund). The SPA will need to identify clearly what liabilities are being assumed by the buyer, for example the liability to meet all future capital calls and to contribute capital that has been returned but is still subject to recall (the latter being a liability which buyers tend not to want to take on). The seller will want to achieve a clean break, and it is not always sufficient to rely on the allocation of liabilities under the transfer mechanisms in the LPA to achieve this.

The SPA will also contain contractual comfort for the buyer regarding the quality of the interest being transferred (in the form of warranties) and the preservation of value of the interests between signing and completion, which may be several months (in the form of pre-completion covenants from the seller to the buyer). Buyers will typically request a certificate from the GP of the fund confirming capital contributions and distributions made to date. However, GPs are not always obliged or prepared to provide such comfort to a buyer, who may be left to rely on contractual comfort from the seller under the SPA.

As in a traditional M&A transaction, a seller will want to have the opportunity to disclose against the warranties. This will be particularly important for distressed or liquidity-constrained sellers who may have to disclose irregularities in relation to meeting capital call notices during the months leading up to the sale.

It is important to understand the legal character of the LP interest being transferred to ensure that the correct

procedures are followed to effect the transfer of the legal title to the buyer.

In some jurisdictions, legal or regulatory provisions governing limited partnerships prescribe the method and timing of the transfer of legal title. For example, in the case of an interest in an English or Scottish limited partnership, a notice of the transfer must be published in the London or Edinburgh Gazette respectively before the transfer is effective.

Whether for legal or commercial reasons, it is not always desirable or practical to effect a transfer of the legal title to a fund interest, and other structures are therefore sometimes employed to achieve the seller's objective of scaling back or exiting its investment in a fund. Synthetic structures cover a range of transactions where the buyer acquires only the beneficial or economic interest in the underlying fund.

One option is a structured joint venture between buyer and seller where the fund interests are transferred to a special purpose vehicle, the shares in which are held by the seller and the buyer. Alternatively, the LP may decide to sell a "horizontal strip" of its entire portfolio, for example contracting with the buyer to pass, say, a 25% beneficial interest in a portfolio to the buyer in return for the buyer promising to contribute an equal proportion of the future capital commitments, thereby maintaining relationships and sub-class weightings but reducing overall exposure for the seller. These structures are not without their risks since they rely on an active contractual relationship between buyer and seller for the remaining life of the funds in the portfolio (which could be 10 years or more).

For any synthetic secondary, care must be taken to check if the transfer provisions in the LPA prohibit such transfers. Somewhat surprisingly, LPA provisions for the majority of private equity funds do not (as yet) prohibit most synthetic transactions and, consequently, GP consent may be dispensed with, although, for relationship reasons, the parties may still wish to obtain the informal approval of the GP to the transaction.

In most jurisdictions fund entities are fiscally transparent. This means that for tax purposes, the disposal of an interest in a limited partnership is likely to be treated as a disposal by the LP of its fractional share in each of the partnership assets.

The fractional share of the limited partnership assets which an LP owns is determined by that partner's entitlement to profit. Consequently, the profit entitlement also determines the portion of the gain (or loss) arising from the disposal of the limited partnership asset that an LP is taken to receive. It also determines the acquisition cost of the asset that is apportioned to the LP.

The LP disposing of the interest will likely only be liable to pay tax on any resulting chargeable gain in a particular jurisdiction if it is within the scope of tax in that jurisdiction. Special rules, however, may apply to limited partnerships which have corporate members.

Regardless of the tax residence or status of the selling LP, care should be taken to check whether stamp duty or other transfer tax is chargeable on the transfer of an interest in the fund. Different jurisdictions have different rules in this regard.

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Outsourcing patent prosecution and management: cutting costs or cutting corners?

Simon Sellars weighs the pros and cons of outsourcing intellectual property management.

As companies strive to lower expenditure on legal services, outsourcing has become a major option to drive down costs. India, with an ever-increasing population of skilled graduates and professionals but also comparatively lower costs of living, is an example of a country which has been a significant beneficiary of outsourcing programs to date, but other countries, such as the Philippines, are also being considered. Faced with shrinking budgets and frozen headcounts, employers in services industries in high cost countries may turn to developing countries for solutions, and this may include legal and intellectual property services, including patent prosecution and patent portfolio management.

While there are clear financial benefits in outsourcing, it is not without its risks, and the process should be carefully managed to realize its full potential.

Various aspects of patent work may lend themselves to outsourcing; possibly focused around the less legal and more “mechanical” parts of the process from drafting to grant, and beyond. The value of a granted patent lies in the drafting of the specification and the scope of the claims, but some supporting parts of the process may represent an opportunity to save costs by exporting work to a third party which can do the work more cheaply but effectively.

Such exported work-streams might include, for example, clearance searching for prior art. Knowing the technical area with which a potential invention is concerned, a third party can search the internet, journal articles and published patent databases to uncover material in the same technical field. This can then form the basis of a more thorough evaluation in the light of the specifics of the invention sought to be patented when drafting the initial application.

Technical drawings can be prepared from the inventor’s or patent agent’s sketches, and certain clerical aspects of the filing process such as drawing up official forms, powers of attorney, and possibly translations can be attended to, as could the dispatch of instructions to agents for filing applications around the world. Depending on the ability and experience of the outsourcing partner, it might be possible to source initial drafts of patent specifications and sets of claims, although it is likely that these would need to be reviewed and edited further, including necessary revisions for compliance with local practice, and it will therefore be necessary to see if this process would end up costing more in the long run. Post-grant, payment of annuities, handling of programs for recordal of assignments and other transactions and management of licensed royalty income might also be contracted out. In principle, some aspects of the patent system are just as amenable to outsourcing as other industry sectors.

Risks v rewards

On the face of it, it makes clear business sense to send work to be done at, say, \$50 an hour instead of having it performed by someone charging many times that figure. However, whether it is in terms of additional attorney time to review a draft, or amendments for compliance with local legal practice, there will often be extra costs arising. Numerous surveys indicate that anywhere from 17 percent to 53 percent of customers have not realized the return on their investment from offshore outsourcing. It may be the little niggles that ultimately lead to dissatisfaction, as well as the costs of setting up local infrastructure and training, additional travel requirements for key personnel to supervise the set-up and ongoing operations, or even the potential local tax payments in addition to hourly wages.

In addition to the hidden costs which creep in, there are other risks which need to be borne in mind. Companies for which IP is a key asset should be aware of the risks of IP theft in outsourcing. A salutary warning is to be found in the tale of Shekhar Verma, who in 2002 had been dismissed from his position at an outsourcing company in Mumbai. By virtue of his employment, Verma had acquired a copy of the source code to the SolidWorks computer-aided design package, and he proceeded to attempt to sell it to a number of SolidWorks’s competitors.

An undercover operation between the FBI and India's Central Bureau of Intelligence led to Verma being arrested on charges of theft. To the best of the author's knowledge, the case is still going through the Indian court system today. Regardless of the outcome, the case demonstrates that IP is a genie that cannot be forced back into its bottle; once subject matter has been disclosed, the novelty of a potential patent application is destroyed. Therefore the risk of a valuable patent specification draft being offered for sale to the highest bidder by a rogue draftsman must be considered. Although this is not to suggest that the risks of data loss are materially higher in foreign territories, outsourcing does inevitably provide additional avenues for confidential information to seep out of an organization, and other factors may arise such as having to deal with such issues under a different legal framework.

Further down the line, when a patent is litigated, its prosecution history may become relevant. While lawyer/client privilege will generally protect a file history and any confidential information contained on record, the relationship with an outsourcing entity may not be similarly sheltered. The rules on what a party can and cannot be obliged to produce in discovery or disclosure exercises will vary according to the court rules of the jurisdiction in question, but the risk that early, perhaps aborted, drafts of patent specifications may be the subject of disclosure in litigation may have to be considered. On a practical note, producing employees of the outsourcing partner as witnesses in court proceedings may add expense and difficulties which may tend to increase with the remoteness of the outsourcing partner.

There has even been a suggestion, in the US at least, that the legal basis of outsourcing certain types of patent work may be unsound. In a July 2008 notice, the US Patent and Trademark Office (USPTO) expressed its opinion that the process of outsourcing invention information to a foreign country for the purposes of preparing a US patent application might be illegal. Understandably, this raises significant concerns for the potential patent outsourcer. USPTO rules control the "export" of patent applications in sensitive subject areas, in much the same way as sections 22 and 23 of the Patents Act 1977 operate in the UK to control overseas filing of patent application relating to inventions which might prejudice national security.

However, there is another layer of regulation in the US: certain types of unpublished information cannot be transmitted to specific countries and may require an export license from the US Commerce Department under the Export Administration Regulations. The US Commerce Department will grant blanket export waivers, favored by many multinational companies which have blanket export licenses covering their overseas operations, limiting the adverse effects of the applicable regulations. Still, for US-based companies, ensuring proper compliance with this regime is an important consideration.

Case studies

Perhaps the best way of investigating whether outsourcing patent work is to be discouraged or embraced is to consider the real examples of it having been attempted already.

A 2005 article considered the experience of US firm Carpenter & Kulas LLP, which experimented with the offshore outsourcing of patent application drafting to an Indian company, despite concerns about becoming known as the "Wal-Mart of patent prosecution." In one instance, a draft was returned to the firm by the outsourcing partner simply comprising a copy-and-paste of the inventor's comments on the invention into a precedent template, accompanied by an invoice for US\$1,500. That said, they persevered through the procedure of training their Indian partner and now use them on a regular basis, even though they admit themselves that if the IP is important enough, the work should be left to a home-grown attorney, who will do the work better.

As an alternative to offshore outsourcing, Deutsche Bank recently asked its legal panel advisors to transfer its UK legal work (not specifically IP-related) to the UK regions away from London. This tried and tested alternative has been prevalent for some time and represents the response to cost pressures in metropolitan centers. Interest in "insourcing" may be rekindled in the present economic circumstances. Indeed, with the Indian economy predicted to grow up to 6 percent this year and with the European Commission expecting the UK economy to shrink by 3.8 percent over the same time period, transfer of services to other areas of the UK may actually be cheaper overall than some overseas alternatives.

An outsourcing program inevitably incorporates an amount of consolidation, perhaps in terms of cutting back on the number of external providers, or maybe simply reducing the headcount of staff directly employed in doing the work. An example of how this can be successfully implemented is the recent outsourcing of the Unilever portfolio of over 160,000 trademarks. Unilever selected Baker & McKenzie to handle Unilever's global trademark administration work, including new filings, oppositions, renewals and general portfolio management. Managed from London and taking advantage of a specifically-created team in the Philippines and Baker & McKenzie's international network, the program benefits Unilever in a multitude of ways: as well as generating cost savings. Unilever's in-house workload is lightened to focus on more strategic decisions, and the streamlining of the process has enabled more detailed and granular reporting on productivity.

It is not just IP owners who are looking to take advantage of offshoring of work: the UK Intellectual Property Office has elected to maintain indefinitely its "Patent Prosecution Highway" schemes with the US and Japanese Patent Offices. Under these schemes, national IP offices make use of relevant work already conducted by another IP office when undertaking patent examination, with the aim of increasing patent quality and rendering the patent prosecution process faster and more efficient. Admittedly, this does not amount to outsourcing as such, but it does demonstrate the benefits of international cooperation.

Outsourcing alternatives

Outsourcing is a hot topic, but it is not the only way to budget one's way through the economic downturn: there are many other ways to maximize value from IP. Portfolios can be rationalized, and unused patents licensed out to create additional sources of revenue. Indeed, the UK Intellectual Property Office IPO provides a service for publicizing patents for which licenses of right are available. Strategic patent filings can be made through the Patent Co-operation Treaty system to defer deadlines and national phase entry costs.

Consolidation of legal and IP services with a sole provider, one point of contact which can provide information more quickly, reliably, and in greater detail, offers advantages which cannot be exclusively described in a quantitative manner. The demand for expertise in internationally acceptable patent specifications is growing: IP owners are looking for people with experience in overcoming prosecution objections in the key international markets who can act as one-stop-shops. Cost should never be the sole driving factor though; there should be an overriding consideration of the need to retain quality in the work product, especially if a company's value resides primarily in its IP.

The broad variety of work streams which go in to the development, drafting, prosecution, maintenance and exploitation of a typical patent offer multiple opportunities for work to be outsourced, as long as the risks are understood. Exposing confidential information which may one day form the basis for a patent application to an additional third party may increase the risk of a novelty-destroying exposure or, worse, disclosure to a competitor. Given that patent drafting and prosecution is a subtle art, finding an outsourcing partner with the right pool of talent may be difficult, and the legality of outsourcing patent drafting, in the US at least, has been questioned.

Outsourcing has many nuances, and the alternative avenues of transferring work within a jurisdiction or consolidation of work with a single services provider may offer many of the same benefits with fewer strings attached. There is no one-size-fits-all solution, and anybody contemplating outsourcing their patent work should carefully consider all available options to see what is most appropriate for their business model.

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