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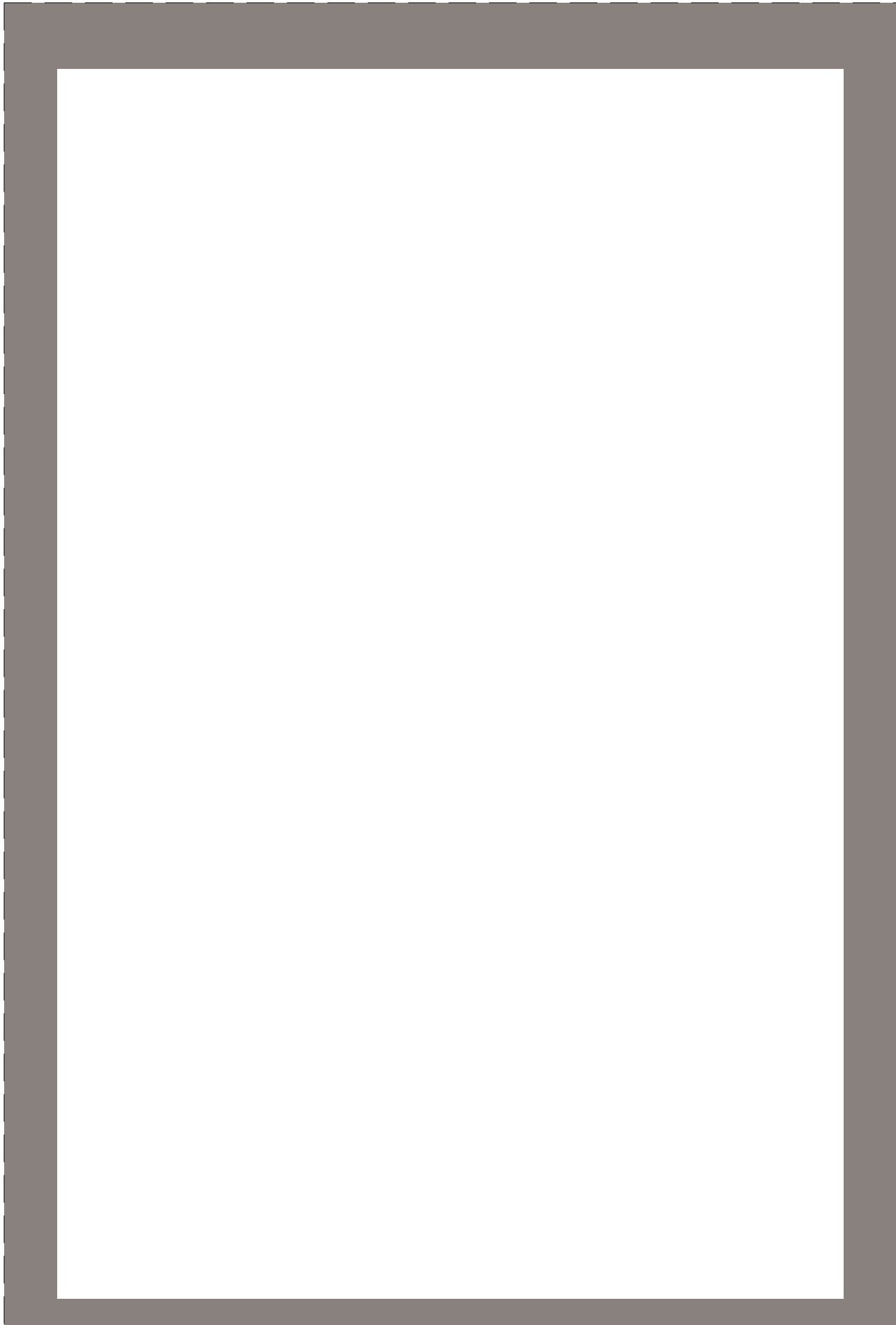
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A TALE OF TWO TAXES: A COMPARATIVE EXAMINATION OF THE INDIVIDUAL INCOME TAX IN THE UNITED STATES AND THE PEOPLE’S REPUBLIC OF CHINA

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Man is not like other animals in the ways that are really significant: animals have instincts, we have taxes.

Erving Goffman

I. INTRODUCTION

Individual income taxes have only existed in China since 1980, when they were enacted to tax a very limited segment of the Chinese

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population. Even today, China relies heavily on other sources of revenue to fund government operations.¹ In the United States, on the other hand, the history of the individual income tax stretches back to the U.S. Civil War in 1861. In contrast to the limited role the individual income tax plays in China, it provides nearly half of the revenue of the United States federal government.²

The goal of this article is to provide a comparative examination of the individual income tax systems of China and the United States. In comparing the two individual income tax systems, a number of similarities will be observed. For example, in both systems the definition of income to be taxed is quite broad, and both systems incorporate a system of exemptions (though significant differences still exist in how the two systems approach exemptions and deductions). Both systems employ progressive rate structures, although they differ as to the appropriate degree of progressivity. On the other hand, there are very significant differences between the two systems. For example, many of the exemptions that exist in the Chinese tax law are uniquely Chinese, reflecting very different cultural concerns than those that exist in the United States.

Parts II and III of the article provide an overview of the Chinese and United States individual income tax systems, respectively. For each system, the article provides a brief history of the tax from its introduction to the present, the coverage of the tax and how it is calculated, and a discussion of the collection and withholding requirements of the tax. Part IV provides a comparison of the Chinese and United States systems in four key areas: (1) who is subject to the tax; (2) the definition of income for tax purposes and the exemption of certain income from taxation; (3) the rate structure and progressivity of each system; and (4) the fairness of each system as a matter of tax policy.

¹ In 2012, revenue from the individual income tax totaled 582.02 billion yuan (\$92.69 billion U.S.), accounting for 5.8 percent of the total fiscal revenue of the Chinese government. *China's Personal Income Tax Revenue Slows Sharply*, XINHUANET (Feb. 11, 2013), http://news.xinhuanet.com/english/china/2013-02/11/c_132164722.htm.

² In fiscal year 2011 (the latest year for which full data is currently available), the United States had total revenue of \$2.3 trillion, \$1.091 trillion (47.7%) of which was from individual income taxes. *Budget Infographic – Revenues*, CONGRESSIONAL BUDGET OFFICE (Apr. 17, 2012), <http://www.cbo.gov/publication/43153>.

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II. THE CHINESE INDIVIDUAL INCOME TAX LAW

A. *History of the Chinese Individual Income Tax Law*³

China's first individual income tax was enacted in 1980.⁴ This tax primarily targeted high-income foreign professionals working in China by allowing a deduction of 800 yuan per month, a level sufficient to exempt most Chinese citizens from the tax.⁵ The State Council adopted regulations⁶ to apply the tax broadly to Chinese citizens and to individual entrepreneurs using a lower deduction of 400 yuan per month.⁷ These regulations were rescinded when the individual income tax law ("IITL") was revised in 1994,⁸ and the State Council issued new implementing regulations that primarily defined many of the terms contained in the law.⁹ In September 2011, the IITL was again revised to its current form.¹⁰ The 2011 amendments included an increased exemption amount (resulting in an estimated 60 million Chi-

³ The discussion in this article is limited to a brief history of the Individual Income Tax Law. For an excellent discussion of the history of general taxation in China, see Xu Yan, *No Taxation Without Representation: China's Taxation History and Its Political-Legal Development*, 39 HONG KONG L. J. 515 (2009).

⁴ [Individual Income Tax Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Sept. 10, 1980, effective Sept. 10, 1980).

⁵ Hua Xu and Huiyu Cui, *Personal Income Tax Policy in China and the United States: A Comparative Analysis*, PUB. ADMIN. REV., Dec. 2009, at S75, S76.

⁶ [Adjustment Tax on Individual Income Provisional Regulations] (promulgated by the St. Council, Sept. 25, 1986, effective Jan. 1, 1987) (last visited Mar. 7, 2013) (China) available at http://www.novexcn.com/ind_inc_adjust_tax.html.

⁷ Xu, *supra* note 5.

⁸ [Individual Income Tax Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 31, 1993, effective Jan. 1, 1994), (rev. by the Standing Comm. Nat'l People's Cong., Aug. 30, 1999), (rev. by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006) (LawInfoChina).

⁹ [Detailed Rules for the Implementation of the Individual Income Tax Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Jan. 28, 1994, rev. Dec. 19, 2005) (LawInfoChina) [hereinafter *Implementing Regulations*].

¹⁰ [Individual Income Tax Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Sept. 10, 1980) (rev. by the Standing Comm. Nat'l People's Cong., June 30, 2011, effective Sept. 1, 2011) (LawInfoChina) [hereinafter *IITL*]. Except as otherwise indicated, references to the *IITL* are to the September 2011 version.

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nese being exempted from the tax)¹¹ and a decrease in the number of income tax brackets from nine to seven.¹²

B. Coverage and Calculation of the Chinese Tax

The IITL taxes individuals domiciled in China¹³ or residing in China for a year or more¹⁴ on their worldwide income.¹⁵ Other individuals are taxed under the law on their income “gained within China”¹⁶ subject to a deduction from the amount of individual income tax paid outside China.¹⁷ The IITL applies to eleven categories of income, nine of them very specific¹⁸ and two of them very broad.¹⁹ Cer-

¹¹ See Peter Ford, *China to Cut Income Tax for 60 Million People*, THE CHRISTIAN SCIENCE MONITOR (Aug. 31, 2011), <http://www.csmonitor.com/World/Asia-Pacific/2011/0831/China-to-cut-income-tax-for-60-million-people>.

¹² See Xinhua, *New Regulations for Amended Personal Income Tax Law*, CHINADAILY.COM.CN (Jul. 27, 2011), http://www.chinadaily.com.cn/bizchina/2011-07/27/content_15953325.htm.

¹³ See *Implementing Regulations*, *supra* note 9, art. 2 (An individual is considered domiciled in China if, by reason of their registered permanent residence, families, or economic interests, they have habitual residence in China).

¹⁴ See *id.* art. 3 (An individual resides in China for a year or more if she has resided within the territory of China for 365 days in a tax year. No deduction is made for temporary trips outside China, defined as absence from China for not more than 30 days in a single trip, or not more than a cumulative total of 90 days over a number of trips, within the same tax year).

¹⁵ See *id.* art. 1.

¹⁶ See *id.* art. 1. The term “income derived from sources within China” means income, the source of which is inside China, and “income derived from sources outside China” means income, the source of which is outside China. See *Implementing Regulations*, *supra* note 9, art. 5(1)-(5). Under the regulations, the following types of income are deemed to be income gained within China, whether paid in China or not: income from services provided inside China during employment or performance of a contract; income from the lease of property to a lessee for use inside China; income from the transfer of property in China (including buildings, land-use rights, or any other property); income from the licensing of various proprietary rights in China; and income from interest, dividends and bonuses derived from companies, enterprises and other economic organizations or individuals in China.

¹⁷ *IITL*, *supra* note 10, art. 7.

¹⁸ The specific categories of income are: (1) income from wages and salaries; (2) income from production or business operations by self-employed industrial and commercial households; (3) income from contracted or leased operation of enterprises or institutions; (4) income from remuneration for personal services; (5) income from author’s remuneration; (6) income from royalties; (7) income from interest, dividends, and bonuses; (8) income from the lease of property; (9) income from the transfer of property. *IITL*, *supra* note 10, art. 2(1)-(9). These categories are more specifically detailed in the implementing regulations. See *Implementing Regulations*, *supra* note 9, art. 8(1)-(10).

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tain types of income are specifically exempt, including: awards granted by various levels of the Chinese government or by foreign or international organizations in the fields of science, education, technology, culture, public health, sports and environmental protection; interest on Chinese government debt; subsidies and allowances provided by Chinese regulations; welfare benefits, pensions for deceased family members, and relief payments; insurance indemnities; military severance pay; settlement pay, severance pay and retirement pay, as well as full-pay retirement pensions for veteran cadres and their living allowances, received by cadres and workers under state regulations; income of diplomatic representatives and consular officers and foreign embassy personnel; income subject to exemption according to international tax treaties; and income exempted by the approval of the department of finance under the State Council.²⁰ The law also provides an opportunity for reduction of tax upon approval for (1) income of the disabled, the aged without families, and the family members of martyrs; (2) those suffering great losses from natural disasters; or (3) other circumstances approved by the Department of Finance under the State Council.²¹

The rates applicable to a particular taxpayer²² depend upon the sources of that taxpayer's income. The IITL applies progressive rates to certain categories of income (such as wages and income from production and business operations²³) and fixed rates to others (including authors' remuneration, personal services, royalties, interest and dividends).²⁴ The progressive rates applicable to wages and salaries range from 3% to 45%²⁵ of taxable income, which is calculated as wages and salaries after applying a monthly deduction of 3,500 RMB²⁶

¹⁹ The broad categories of income are: (10) incidental income and (11) income from other sources specified as taxable by the department of finance under the State Council. *IITL*, *supra* note 10, art. 2(10)-(11).

²⁰ *IITL*, *supra* note 10, art. 4(1)-(10).

²¹ *Id.* art. 5(1)-(3).

²² The IITL applies to each individual taxpayer separately. Some commentators have suggested taxing on a family basis rather than an individual basis would be more fair. See He Bolin, *Income Tax on Families Would be Fairer*, CHINA DAILY, Apr. 20, 2012, http://www.chinadaily.com.cn/bizchina/2012-04/20/content_15953288.htm.

²³ *IITL*, *supra* note 10, art. 3(1)-(2).

²⁴ *Id.* art. 3(3)-(5).

²⁵ *Id.* art. 3(1).

²⁶ All categories of income under the IITL are computed in terms of Renminbi (RMB), with income in foreign currency converted into RMB according to the foreign exchange rate quoted by the State foreign exchange control authorities. *IITL*, art. 10. The Renminbi is the official currency of the People's Republic of China. *People's Republic of China's First Set of RMB Overview*, SINA FINANCE, <http://finance.sina.com.cn/money/collection/youbika/20050901/15471935211>, translated at

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for expenses.²⁷ For income from production and business operations, the rates range from 5% to 35%,²⁸ applied after deducting costs, expenses and losses²⁹ from the gross income during a tax year.³⁰ The fixed rate for author's remuneration is 20%, with the amount of tax payable reduced by 30%.³¹ The rate applicable to personal services,

Google Translate, <http://translate.google.com> (last visited Feb. 24, 2013). The primary unit of measurement for RMB is the yuan. As of February 22, 2013, the exchange rate is 6.2350. *Exchange Rates: New York Closing Snapshot*, WALL ST. J., http://online.wsj.com/mdc/public/page/2_3021-forex.html (last visited Feb. 24, 2013).

²⁷ *IITL*, art. 6(1). Wages & Salaries: The rate schedule is specified in seven brackets as follows:

Monthly Taxable Income	Tax Rate
1,500 RMB or less	3%
Between 1,500 and 4,500 RMB	10%
Between 4,500 and 9,000 RMB	20%
Between 9,000 and 35,000 RMB	25%
Between 35,000 and 55,000 RMB	30%
Between 55,000 and 80,000 RMB	35%
In excess of 80,000 RMB	45%

IITL, Schedule 1: Individual Income Tax Rates (Applicable to Income from Wages and Salaries).

²⁸ *IITL*, art. 3(2). Production and Business Operations Income: The rate schedule is specified in 5 brackets as follows:

Annual Taxable Income	Tax Rate
15,000 RMB or less	5%
Between 15,000 and 30,000 RMB	10%
Between 30,000 and 60,000 RMB	20%
Between 60,000 and 100,000 RMB	30%
In excess of 100,000 RMB	35%

IITL, Schedule 2: Individual Tax Rates (Applicable to income gained by self-employed industrial and commercial households from production or business operations, and income gained by enterprises and institutions from contracted or leased operation).

²⁹ "Costs" and "expenses" are defined as all direct expenditures, indirect expenses allocated as costs, and marketing, administrative and financial expenses incurred by taxpayers while engaging in production and business operation. The term "losses" means all non-operating expenditures incurred by taxpayers in the course of production and business operation. *Implementing Regulations*, *supra* note 9, art. 17.

³⁰ *IITL*, *supra* note 10, art. 46. The term "tax year" is defined as a calendar year (January 1 – December 31). *Implementing Regulations*, *supra* note 9, art. 46.

³¹ *IITL*, *supra* note 10, art. 3(3).

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royalties, interest, dividends, property leases, transfers of property, incidental income, and income from other sources is 20%, although extremely high one-time payment for services³² can be subject to an additional tax under specific measures prescribed by the State Council.³³ These fixed rates apply to income from personal services, royalties, and property leases after a deduction of 800 RMB for expenses from amounts received in a single payment up to 4,000 RMB or after a deduction of 20% for a single payment of 4,000 RMB or more.³⁴ In taxing income from transfers of property, a deduction is allowed for the original value of the property and the reasonable expenses from the income gained from the transfer.³⁵ For interest, dividends, incidental income, and income from other sources, no deductions are allowed.³⁶

C. Tax Collection and Withholding in China

In order to facilitate collection of the individual income tax, the law uses a system of withholding at the source. The paying entity is treated as a withholding agent³⁷ and is responsible for filing tax returns and paying over the tax withheld on a monthly basis.³⁸ Taxpayers who receive income from two or more sources, or in situations where there is no withholding agent, must file tax returns in accordance with State regulations.³⁹

³² The regulations indicate that this addition applies to a payment received by an individual at one time as remuneration for personal services with an amount of taxable income exceeding 20,000 yuan. The additional tax is 50% of the amount between 20,000 and 50,000 yuan, and 100% of the amount that exceeds 50,000 yuan. *Implementing Regulations*, art. 11.

³³ *IITL*, *supra* note 10, art.3(4)-(5).

³⁴ *Id.* art. 6(4).

³⁵ *Id.* art. 6(5).

³⁶ *Id.* art. 6(6).

³⁷ *Id.* art. 8. The withholding agent is entitled to be paid a service fee of two percent of the amount of tax withheld. *Id.* art. 11.

³⁸ *IITL*, *supra* note 10, art. 9. Tax payable on income from wages and salaries for particular industries specified by the State Council and on income from self-employed production or business operations may be computed on an annual basis and paid in advance in monthly installments. Income from contracted or leased operations is also computed on an annual basis and paid within thirty days after the end of the year. Tax on income from contracted or leased operations paid in installments shall be paid in advance within the first fifteen days after each installment, with a final settlement due three months after the end of the year.

³⁹ *Id.*

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III. OVERVIEW OF THE UNITED STATES INDIVIDUAL INCOME TAX LAW

A. *History of the United States Individual Income Tax Law*

The United States enacted its first revenue raising tax, the Revenue Act, in 1861 in an effort to fund the Civil War, creating a Commissioner of Internal Revenue and taxing individual income at a rate of 3% for individuals earning between \$600.00 and \$10,000.00, and a rate of 5% for individuals earning income greater than \$10,000.00.⁴⁰ By 1867, the income tax was repealed and the United States derived the majority of its revenue from excise taxes on liquor, beer, wine, and tobacco.⁴¹ The first flat rate federal income tax, enacted by Congress in 1894, was ruled unconstitutional by the United States Supreme Court on the grounds that the tax was a direct tax and not appropriately apportioned on the basis of state populations,⁴² as required by the United States Constitution.⁴³

The outbreak of World War I in Europe in 1913 encouraged the enactment and ratification of the Sixteenth Amendment,⁴⁴ which provided the federal government the power to lay and collect taxes.⁴⁵ The first income tax after the enactment of the Sixteenth Amendment imposed a tax on persons with a taxable income up to \$20,000.00,⁴⁶ though it affected less than 2% of wage earners in the United States

⁴⁰ *Historical Highlights of the IRS*, IRS.ORG, <http://www.irs.gov/uac/Historical-Highlights-of-the-IRS> (last updated Aug. 1, 2012); The Library of Congress Business Reference Services, *History of the US Income Tax*, LOC.ORG, http://www.loc.gov/rr/business/hottopic/irs_history.html (Feb. 2004).

⁴¹ *Id.*

⁴² *Pollock v. Farmers' Loan & Trust Co.*, 15 S.Ct. 673 (Apr. 8, 1895) (holding that a national tax imposed on personal income from real estate investments and rents, as well as personal income derived from personal property investments (stocks, bonds, etc.) was a violation of Art. I, § 9 of the U.S. Constitution because it was a direct tax and not properly apportioned.); see also *History of the US Income*, *supra* note 40.

⁴³ "Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers. . ." U.S. CONST. art. I, § 2, cl. 3; "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken." U.S. CONST. art. I, § 9, cl. 4.

⁴⁴ "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. CONST. amend. XVI.

⁴⁵ *History of the US Income Tax*, *supra* note 40.

⁴⁶ Jay M. Howard, *When Two Tax Theories Collide: A Look at the History and Future of Progressive and Proportionate Personal Income Taxation*, 32 *WASHBURN L.J.* 43, 47 (1992).

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between 1913-1915.⁴⁷ Later codified in 1918, the Revenue Act of 1918 raised considerable revenue to fund World War I and “imposed a progressive income-tax rate structure of up to 77%.”⁴⁸

From 1913-1939, the income tax was imposed as part of an annual revenue act that suspended and replaced the prior year’s act.⁴⁹ Each year’s act was essentially the prior year’s act and whatever amendments Congress deemed necessary. This process of reenactment made referencing the internal revenue laws difficult. As a result Congress enacted the Internal Revenue Code of 1939 (“IRC”) in 1939, the first codified and ongoing version of the U.S. internal revenue law. Major recodifications occurred in 1954 and 1986. The current code is the result of the 1986 recodification and amendments from 1986 to the present.

B. Coverage and Calculation of the United States Tax

Under the IRC, all U.S. citizens and resident aliens⁵⁰ are subject to tax on their worldwide income.⁵¹ Nonresident aliens⁵² are subject to tax only on income that is U.S. sourced.⁵³

An individual’s tax liability is computed by multiplying his taxable income by the applicable tax rate and subtracting allowable credits. The computation of taxable income begins with a taxpayer’s gross income. The IIRC broadly defines gross income as “all income from whatever source.”⁵⁴ Gross income includes: wages, salaries, bonuses, commissions, alimony, awards, back pay, business income,⁵⁵ compensation for personal services, director’s fees, dividends, employee awards, employee bonuses, fees, gains from the sale of property or se-

⁴⁷ *Id.* at 48.

⁴⁸ *Historical Highlights of the IRS*, *supra* note 40.

⁴⁹ J.S. SEIDMAN, SEIDMAN’S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX 1938-1861, at 1-294, 422-1007 (Prentice-Hall, Inc. 1953) (1938).

⁵⁰ A resident alien is an individual who “is a lawful permanent resident of the United States at any time during [the] calendar year;” or is an individual satisfying the substantial presence test with respect to the calendar year; or an individual electing such status. I.R.C. §§ 7701(b)(1)(A)(i) – (iii) (2010).

⁵¹ I.R.C. § 61 (2010); Treas. Reg. § 1.1-1(b) (2008).

⁵² “An individual is a nonresident alien if such individual is neither a citizen of the United States nor a resident of the United States. . .” I.R.C. § 7701(b)(1)(B).

⁵³ I.R.C. § 871 (2010), *amended by* Pub. L. No. 112-240, 126 Stat. 2313 (2013).

⁵⁴ I.R.C. § 61(a) (2010).

⁵⁵ Business income is reported as Net Profit from Business or Net Loss from Business. Deductible business expenses include amounts that are ordinary and necessary to carry on the business, to include: advertisements, office expenses, legal/professional services, repairs/maintenance, supplies, taxes/licenses, and utilities. I.R.C. § 162(a) (2010).

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curities,⁵⁶ interest, pensions, prizes, rental income,⁵⁷ severance pay, self-employment income, social security benefits, supplemental unemployment benefits, tips and gratuities, and unemployment compensation less standard deductions and personal exemptions.⁵⁸ Some forms of income are considered non-taxable income, including: child support,⁵⁹ damages received on account of physical injuries or physical sickness,⁶⁰ death payments,⁶¹ dividends on life insurance,⁶² gifts,⁶³ welfare payments and food stamps,⁶⁴ and worker's compensation.⁶⁵

From gross income, the taxpayer subtracts certain allowable deductions⁶⁶ to determine the taxpayer's adjusted gross income.⁶⁷ The deductions commonly used in the computation include moving expenses, alimony paid, etc. The taxpayer then deducts a personal exemption for himself, his spouse and each dependent,⁶⁸ and the higher

⁵⁶ Exclusions include up to \$250,000.00 of the gain on the sale of a personal residence for a taxpayer with single status and up to a \$500,000.00 exclusion for a taxpayer with Married filing Jointly status, though such exclusions may be reduced if taxpayer lived in the primary residence for less than 2 years. *See* I.R.C. § 121.

⁵⁷ Deductions for rental income include: mortgage interest, property taxes, advertisements, cleaning/maintenance, insurance premiums, mortgage premiums, commissions for collecting rental income, property management fees, repairs (painting, appliances, structural repairs, etc.), and utilities paid for tenants. I.R.C. §§ 62(a)(4), 212.

⁵⁸ *See id.*

⁵⁹ I.R.C. § 71(c) (2010).

⁶⁰ I.R.C. § 104(a)(2) (2010). The exclusion from income for damages from physical injury or sickness does not apply to punitive damages except in very limited situations involving civil wrongful death cases in which the relevant state law provides that only punitive damages may be awarded. *See* I.R.C. 104(c).

⁶¹ I.R.C. § 101(a) (2010).

⁶² I.R.C. § 72 (2010).

⁶³ I.R.C. § 102 (2010).

⁶⁴ Rev. Rule 73-87, 1973-1 C.B. 39.

⁶⁵ I.R.C. § 104(a)(1).

⁶⁶ These deductions are commonly called adjustments to gross income or "above-the-line" deductions.

⁶⁷ I.R.C. § 62 (2010). Adjusted gross income is an important figure in the calculation, since it is used in calculating the taxpayer's allowable deductions in such areas as medical expenses, charitable contributions and miscellaneous business deductions. *See, e.g.*, I.R.C. § 67 (2010) (providing that miscellaneous itemized deductions are allowed for a taxable year only to the extent the aggregate of such deductions exceeds 2 percent of adjusted gross income); I.R.C. § 170(b) (limiting deductions for charitable contributions to public charities to 50% of the taxpayer's adjusted gross income, with minor modifications).

⁶⁸ I.R.C. § 151 (2010). For 2013, the personal exemption is \$3,900. Rev. Pro. 2013-15, 2013-5 I.R.B. 444, § 2.11(1), available at <http://www.irs.gov/pub/irs-drop/rp-13-15.pdf>.

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of a standard deduction⁶⁹ or itemized deductions⁷⁰ to arrive at taxable income.⁷¹

In computing personal income tax liability, the applicable marginal tax rates range from 10%-39.6%⁷² and are determined based on the taxpayer's filing status.⁷³ Married individuals⁷⁴ and surviving spouses⁷⁵ may file a joint return⁷⁶ or a separate return.⁷⁷ Additional filing statuses include those for individuals who qualify as a "head of household"⁷⁸ and for unmarried individuals (other than surviving spouses and heads of households).⁷⁹ Once the taxpayer's taxable income and filing status are determined, the taxpayer then uses tables issued by the IRS to compute his or her income tax liability.⁸⁰

However, to complicate matters further, some types of income receive preferential treatment in the form of different tax rates. These

⁶⁹ I.R.C. § 63(c)(2) (2010). The standard deduction varies depending on the taxpayer's filing status and is indexed for inflation. For 2013, the standard deduction amount is \$6,100.00 for Unmarried Individuals and Married Individuals Filing Separately; \$8,950.00 for Heads of Household; and \$12,200.00 for Married Individuals Filing Jointly and Surviving Spouses. Rev. Proc. 2013-15 at § 2.07.

⁷⁰ Itemized deductions include medical/dental expenses; taxes paid; home mortgage interest paid; mortgage insurance premiums paid; gifts to charity; job expenses; and certain miscellaneous deductions. I.R.C. § 63(d) (2010); *see also* I.R.C. §§ 67, 68 (2010).

⁷¹ I.R.C. § 63(a) (2010).

⁷² A high-income taxpayer's effective marginal tax rate may exceed 39.6% due to special rules requiring a phaseout of itemized deductions and personal exemptions at certain levels of adjusted gross income. *See* I.R.C. § 68(b)(2) (2010); I.R.C. § 151(d) (2010). Although these phaseout rules expired at the end of 2009, they were reinstated by the American Taxpayer Relief Act, Pub. L. No. 112 – 240, 126 Stat. 2317, § 101 (2012).

⁷³ I.R.C. § 1 (2010).

⁷⁴ The determination of marital status is generally made as of the close of the taxpayer's taxable year. However, in the year of the death of an individual's spouse, the determination is made at the time of the spouse's death. I.R.C. § 7703(a)(1) (2010).

⁷⁵ The term "surviving spouse" means a taxpayer whose spouse died during either of the two taxable years immediately preceding the current taxable year, who maintains a home which is the principal residence of a dependent who is a child or stepchild of the taxpayer, and who has not remarried at any time before the close of the taxable year. I.R.C. § 2(a) (2010).

⁷⁶ I.R.C. § 1(a) (2010).

⁷⁷ I.R.C. § 1(d) (2010).

⁷⁸ I.R.C. § 1(b) (2010). The term "head of household" refers to an unmarried individual (other than a surviving spouse) who maintains a home for a dependent child (meeting certain conditions) or a dependent parent of the taxpayer.

⁷⁹ I.R.C. § 1(c) (2010).

⁸⁰ I.R.C. § 1; *see also* Rev. Proc. 2013-15 at § 2.01. The rate schedules are located in Appendix 1.

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preferential rates apply primarily to corporate dividends and long-term capital gains, which in 2013 are taxed at 20% for taxpayers in the 39.6% ordinary income bracket, 15% for taxpayers in the 25-35% ordinary income brackets, and 0% for taxpayers in the 10-15% ordinary income bracket.⁸¹

Finally, a taxpayer may be eligible for various tax credits.⁸² These include childcare/dependent care expense credits, child tax credits,⁸³ education credits including the American Opportunity Credit⁸⁴ and Lifetime Learning Credit,⁸⁵ Earned Income Tax Credit,⁸⁶ Credit for the Elderly or the Disabled,⁸⁷ Residential Energy Credits,⁸⁸ and the Foreign Tax Credit.⁸⁹

⁸¹ I.R.C. § 1(h) (2010). Beginning in 2013, an additional 3.8% tax applies to a taxpayer's "net investment income" for taxpayers with modified adjusted gross income of \$200,000, \$250,000 in the case of a married couple filing a joint return, or \$125,000 in the case of a married couple filing separate returns. I.R.C. § 1441 (2010).

⁸² A tax credit is a credit against income tax itself, whereby the amount is subtracted from tax liability, as opposed to a gross income deduction. BLACK'S LAW DICTIONARY 1501 (8th ed. 2004); see I.R.S. Topic 600, 601-02, 607-08, 610-12 (August 11, 2011), <http://www.irs.gov/taxtopics/tc600.html>.

⁸³ I.R.C. § 24 (2010).

⁸⁴ The American Opportunity Credit permits a credit up to \$2,500 per eligible student for four (4) tax years, of which 40% is refundable. I.R.C. § 25A(i) (West 2012). This credit applies to students pursuing an undergraduate degree or other recognized educational credential, enrolled in a part-time or full-time program. The credit may be reduced if the modified adjusted gross income ("AGI") is between \$80,000-90,000 for single status taxpayers (or \$160,000-180,000 if married filing jointly). AGI is defined as gross income minus deductions. I.R.S. Pub. 970 (2011), <http://www.irs.gov/pub/irs-pdf/p970.pdf>.

⁸⁵ The Lifetime Learning Credit allows a credit of up to \$2,000 per return and is available for all years of post-secondary education and for courses to acquire or improve job skills. I.R.C. § 25A(c). A taxpayer claiming the Lifetime Learning Credit need not pursue a degree. The credit may be reduced if the modified AGI is between \$50,000-60,000 for single status taxpayers (or \$100,000-120,000 if married filing jointly). I.R.S. Pub. 970.

⁸⁶ The Earned Income Tax Credit is a tax credit for low to moderate income working individuals and families which a taxpayer may qualify for based upon certain requirements. I.R.C. § 32, *amended by* Pub. L. 112-240, 126 Stat. 2313 (West Jan. 2, 2013). I.R.S. Topic 601. I.R.S. Pub. 596 (2011).

⁸⁷ I.R.C. § 22 (2010) (for qualified individuals whose income does not exceed certain limits).

⁸⁸ I.R.C. § 25D (2010).

⁸⁹ The Foreign Tax Credit helps U.S. Citizens and Resident Aliens avoid double taxation on worldwide income. I.R.C. § 901 (2010). To qualify, the taxpayer must have income from a foreign country upon which the taxpayer paid taxes on that income. Earned income in the following countries does not qualify for the foreign

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C. Tax Collection and Withholding in the United States

An employer is required to withhold income tax on each of an employee's wage payments.⁹⁰ Wages subject to withholding include all payments for services performed by an employee for an employer, including salaries, fees, bonuses and commissions, as well as non-excluded fringe benefits, pensions, and retirement pay.⁹¹ An employer who fails to withhold or pay over income taxes from an employee's wages is liable for the payment of tax that should have been withheld.⁹² In addition to employer withholding, the Code provides for withholding on gambling winnings (other than bingo, keno, or slot machine winnings) of more than \$5,000,⁹³ and for withholding on taxable payments from employer-sponsored retirement plans.⁹⁴ Certain taxpayers (primarily self-employed individuals) may effectively be required to make estimated tax payments during the course of the tax year.⁹⁵ While these estimated tax payments are not technically required, the law imposes a penalty on individuals for failure to pay enough taxes through either withholding or estimated payments.⁹⁶

IV. COMPARISON OF CHINA AND U.S. INDIVIDUAL INCOME TAX LAWS

This section of the article provides a comparison of the Chinese and United States individual income tax systems in four key areas: (1) who is subject to the tax; (2) the definition of income for tax purposes and the exemption of certain income from taxation; (3) the rate structure and progressivity of each system; and (4) the fairness of each system as a matter of tax policy.

A. Who is Subject to the Tax?

Both China and the U.S. IITL tax worldwide income for those residing within the country, with China imposing a tax on individuals "domiciled in China or residing in China for a year or more," and the U.S. taxing U.S. citizens and resident aliens. The determination of residence for income tax purposes is similar, in that it involves a calcu-

tax credit: Cuba, Iran, North Korea, Sudan, and Syria. I.R.S. Topic 856 (Aug. 11, 2011), <http://www.irs.gov/taxtopics/tc856.html>.

⁹⁰ I.R.C. § 3402(a) (2010).

⁹¹ I.R.C. §§ 3401(a) (2010).

⁹² I.R.C. § 3403 (2010).

⁹³ I.R.C. § 3402(q) (2010).

⁹⁴ I.R.C. § 3405 (2010). The employee may, however, elect not to have tax withheld. I.R.C. §§ 3405(a)(2), (b)(2).

⁹⁵ Estimated tax payments are filed on Form 1040-ES and are generally paid in four installments during the year. I.R.C. § 6654(c)(2) (2010).

⁹⁶ I.R.C. § 6654 (2010).

lation of time spent within the country. However, the precise method of making the calculation and the specific amount of time required to become a resident are different.⁹⁷

The United States also taxes the worldwide income of its citizens. In contrast, China does not tax based on citizenship. Thus, a significant difference in the two systems involves the tax treatment of citizens living abroad. A Chinese citizen who is permanently living overseas would not be domiciled in China, nor would she be a resident of China, so she would not be subject to tax in China. In contrast, a U.S. citizen who lives abroad is subject to tax on worldwide income, subject to exclusion⁹⁸ for a limited amount of foreign income⁹⁹ and housing allowance,¹⁰⁰ and a credit for any foreign taxes paid on the same income.¹⁰¹

B. The Definition of Income and the Exemption of Certain Income from Taxation

In terms of the income subject to taxes, both the China and U.S. taxes are quite broad. While the China IITL specifies categories of income subject to the tax, including two broad categories of “incidental income” and “income from other sources specified as taxable by the department of finance,”¹⁰² the U.S. statute defines “gross income” as “all income from whatever source” and then proceeds to list broad-ranging categories.¹⁰³ Both countries exempt certain income, al-

⁹⁷ Residence requires residing within China for 365 days in a tax year, excluding temporary trips outside the country. See Implementing Regulations, *supra* note 9, art. 3. By contrast, residence in the U.S. is determined based on either legal status as a permanent resident (i.e., a “green card”) or residence for at least 31 days in the current tax year, and 183 days for the current and two preceding tax years, calculated on a weighted basis. See I.R.C. §§ 7701(b)(1)(A)(i) – (iii) (2010).

⁹⁸ The foreign earned income exclusion allows an eligible taxpayer to elect to exclude from income for U.S. tax purposes earned income from foreign sources as well as a housing allowance. I.R.C. § 911(a) (2010). In order to be eligible the taxpayer must have a tax home in a foreign country and must meet either the bona fide residence test or the physical presence test. I.R.C. § 911(d)(1) (2010). The bona fide residence test requires that the taxpayer be a bona fide resident of a foreign country for an uninterrupted period that includes a full tax year. I.R.C. §§ 911(d)(1)(A), (d)(5) (2010). The physical presence test requires that the taxpayer be present in one or more foreign countries for 330 days out of any consecutive 12-month period. I.R.C. § 911(d)(1)(B).

⁹⁹ The maximum amount of foreign income that can be excluded for 2012 and 2013 is \$95,100 and \$97,600, respectively. Rev. Proc. 2011-52, 2011-45 I.R.B. 701; Rev. Proc. 2012-41, 2012-45 I.R.B. 539.

¹⁰⁰ I.R.C. § 911(a)(2) (2010).

¹⁰¹ I.R.C. § 901(a) (2010).

¹⁰² See *IITL*, *supra* note 10, art. 2.

¹⁰³ See, e.g., I.R.C. §§ 61, 62, 121, 162 (2010).

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though the precise categories vary widely. Both countries exempt amounts that are provided to assist the poor (welfare benefits, pensions for deceased family members, and relief payments in China; welfare payments and food stamps in the U.S.), certain awards for scientific or educational achievement,¹⁰⁴ and certain insurance payments. China also excludes interest on government debt, severance and retirement pay, and veteran's pensions,¹⁰⁵ while the U.S., perhaps reflecting the more litigious nature of U.S. society, excludes damages and worker's compensation benefits.¹⁰⁶

The China IITL also provides the opportunity to reduce tax for the needy (the disabled, the aged without families, and the family members of martyrs, as well as those suffering great losses from natural disasters) and under "other circumstances" approved by the Department of Finance.¹⁰⁷ Article 5 of China's IITL is not specific about when these opportunities will apply or how they will be determined, leaving the details seemingly within the hands of the Department of Finance.¹⁰⁸

In contrast, the U.S. statute seems to build some of these types of exemptions into its system through available deductions. For example, each individual, his spouse and each dependent receives a personal exemption¹⁰⁹ and, at a minimum, a standard deduction amount.¹¹⁰ For a married couple with two children, the personal exemptions would total \$15,600 and the standard deduction would be \$12,200 in 2013.¹¹¹ Thus, the first \$27,800 of income for our hypothetical family is effectively exempted under the U.S. system.¹¹² Other deductions for expenses such as alimony paid, moving expenses, medical/dental expenses, taxes paid, and charitable contributions¹¹³ can also serve to effectively reduce the amount of income subject to tax.

¹⁰⁴ See *IITL*, *supra* note 10, art. 4(1) – (10); I.R.C. § 74(a) (2010).

¹⁰⁵ See *IITL*, *supra* note 10, art. 4(7), I.R.C. § 72(a)(2) (2010).

¹⁰⁶ See I.R.C. § 104(a)(1)-(2) (2010).

¹⁰⁷ See *IITL*, *supra* note 10, art. 5.

¹⁰⁸ See *id.*

¹⁰⁹ See *supra*, note 69.

¹¹⁰ See I.R.C. § 63(c) (2010).

¹¹¹ I.R.S., *Annual Inflation Adjustments for 2013*, IR-2013-4 (Jan. 11, 2013), available at <http://www.irs.gov/uac/Newsroom/Annual-Inflation-Adjustments-for-2013>.

¹¹² In addition, the U.S. system incentivizes the poor to work through the use of an Earned Income Credit. I.R.C. § 32 (2010). The Earned Income Credit is a refundable credit, meaning it can generate a tax refund to the working poor even if the taxpayers' taxable income is below the threshold amount required to generate a tax liability.

¹¹³ Cf. I.R.C. § 63(d) (2010).



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C. Rate Structure and Progressivity

Both the Chinese tax and the U.S. tax are progressive. An exact comparison, however, is difficult because of the way the governments compute the taxes. Under both the U.S. and China taxes, different rates apply to different categories of income, and the rates and categories for each country differ from one another. Thus, the rates applicable to an individual taxpayer in either country will vary depending on the source of her income, and calculating a single marginal rate of tax is not possible. The differences in the methods of tax calculation make a direct comparison quite challenging.

What is possible, however, is to compare situations involving hypothetical taxpayers at various income levels within the Chinese and U.S. societies. For example, it is possible to compare the average salaries of workers in the U.S. and China who have similar careers. For example, a recent survey¹¹⁴ compared the average salary by careers for both the U.S. and China.¹¹⁵ Table 1 below provides a selected comparison of the responses for those careers that appeared in both surveys.

¹¹⁴ It should be noted that I am making no claim that this survey is statistically sound. It is based on self-selected participants who chose to report their salaries, with no verification of their entries. In addition, the number of entries in the survey is small. I am using these numbers only to demonstrate how the tax might hypothetically apply to individuals with similar careers in the U.S. and China.

¹¹⁵ See *Average Salary in United States*, AVERAGESALARYSURVEY.COM, www.averagesalarysurvey.com/article/average-salary-in-unitedstates/15200316.aspx (last updated Aug. 23, 2013); *Average Salary in China*, AVERAGESALARYSURVEY.COM, <http://www.averagesalarysurvey.com/article/average-salary-in-china/15201531.aspx> (last updated Aug. 23, 2013).

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TABLE 1

	Average Gross Annual Salary United States (in U.S. Dollars)	Average Gross Annual Salary China (in RMB)	Average Gross Annual Salary China (in 2013 U.S. Dollars ¹¹⁶)
Director	147,734	737,000	118,204
General Manager	117,969	782,391	125,484
Software Engineer	96,773	160,925	25,810
Manager	90,738	373,076	59,836
IT Manager	88,737	351,105	56,312
IT Project Manager	86,227	287,250	46,071
Operations Manager	81,237	387,085	62,083
Marketing Manager	80,094	241,284	38,698
Human Resources Manger	75,738	389,871	62,529
Engineer	71,694	157,997	25,340
Accountant	59,571	110,375	17,702

The careers in Table 1 reflect white collar jobs only. An older (but more reliable) salary comparison¹¹⁷ is available for select jobs and includes blue-collar jobs as well. Table 2 below includes a comparison of some of the jobs from this survey.

¹¹⁶ The conversion to U.S. dollars is for informational comparison only and is based on an exchange rate of 6.2350, the reported exchange rate as of February 22, 2013. Some of the more surprising results of this comparison are based on the self-selected nature of the participants in the salary survey. In several categories, such as "General Manager", the salary level in China seems extremely high compared to the salary level in the U.S. indicating that the salary information in these categories is not accurate.

¹¹⁷ See, e.g., *International Average Salary Income Database*, available at <http://www.worldsalaries.org> (last visited Mar. 8, 2013) (based on 2005 data).

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TABLE 2

	Gross Monthly Income United States (in 2005 U.S. Dollars)	Gross Monthly Income China (in RMB)	Average Gross Monthly Income China (in 2005 U.S. Dollars ¹¹⁸)
Firefighter	3,454	1,166	183
Miner	3,270	1,291	202
Car Mechanic	3,118	1,082	170
Carpenter	3,037	1,133	178
Bus Driver	1,898	1,083	170
Hotel Receptionist	1,749	1,001	157
Baker	1,739	676	106

The data in Tables 1 and 2 show what we would intuitively expect: average salaries in nearly every category¹¹⁹ are higher in the U.S. than in China. Using these salaries, we can compare the income tax burden of each system on hypothetical taxpayers¹²⁰ employed in these various fields in the U.S. and China.¹²¹

Based on the data in Table 3, the individual income tax¹²² in China appears more progressive overall than the U.S. tax. In the U.S., workers in more blue-collar-type jobs (Firefighter through Baker on Table 3) pay a higher effective tax rate than their counterparts in China, whose income is effectively exempt from individual income tax.¹²³ The effective tax rates for workers in white-collar-type jobs

¹¹⁸ The conversion to U.S. dollars is for informational comparison only and is based on an exchange rate of 8.0956, the reported exchange rate as of July 31, 2005.

¹¹⁹ The only category where the salary in China was higher than in the U.S. was the "General Manager" category in Table 1. This anomaly is likely due to the broad term for the category and the self-selection process in the collection of the survey date. *See supra*, note 116.

¹²⁰ For comparison purposes, this calculation assumes the taxpayers are unmarried and have no other legal dependents, and, in the U.S., that they are electing the standard deduction rather than itemized deductions.

¹²¹ This comparison is based solely on the impact of the individual income tax system of each country. Other taxes (including payroll taxes, sales taxes and real and personal property taxes in the U.S., and VAT taxes in China) would apply to these workers in varying degrees depending on their personal statistics, locality, and spending habits, among other factors.

¹²² It should be noted that this comparison takes into account only the individual income taxes; it does not include other taxes, such as payroll taxes in the U.S., the VAT tax in China, or state/local income or sales taxes in either country. A more detailed comparison involving the total tax burden on citizens of each country would be interesting, but it is beyond the scope of this article.

¹²³ This difference in the burden of the income tax may be attributable to the socialist nature of the Chinese society.

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TABLE 3

	Gross Monthly Salary	Gross Annual Salary	Annual Tax Payable	Effective Tax Rate	Gross Monthly Salary	Monthly Tax Payable	Annual Tax Payable	Effective Tax Rate
	US	US	US	US	China	China	China	China
	(in U.S. Dollars)	(in U.S. Dollars)	(in U.S. Dollars)		(in RMB)	(in RMB)	(in RMB)	
Director	12,311	147,734	31,859	21.6%	61,417	14,766	177,190	24.0%
General Manager	9,831	117,969	23,525	19.9%	65,199	16,090	193,077	24.7%
Software Engineer	8,064	96,773	17,622	18.2%	13,410	1,473	17,671	11.0%
Manager	7,562	90,738	16,113	17.8%	31,090	5,892	70,709	19.0%
IT Manager	7,395	88,737	15,613	17.6%	29,259	5,435	65,216	18.6%
IT Project Manager	7,186	86,227	14,986	17.4%	23,938	4,104	49,253	17.1%
Operations Manager	6,770	81,237	13,738	16.9%	32,257	6,184	74,211	19.2%
Marketing Manager	6,675	80,094	13,452	16.8%	20,107	3,147	37,761	15.7%
Human Resource Manger	6,312	75,738	12,363	16.3%	32,489	6,242	74,908	19.2%
Engineer	5,975	71,694	11,352	15.8%	13,166	1,412	16,939	10.7%
Accountant	4,964	59,571	8,322	14.0%	9,198	585	7,015	6.4%
Firefighter	3,454	41,448	4,271	10.3%	1,166	0	0	0.0%
Miner	3,270	39,240	3,940	10.0%	1,291	0	0	0.0%
Car Mechanic	3,118	37,416	3,666	9.8%	1,082	0	0	0.0%
Carpenter	3,037	36,444	3,520	9.7%	1,133	0	0	0.0%
Bus Driver	1,898	22,776	1,470	6.5%	1,083	0	0	0.0%
Hotel Receptionist	1,749	20,988	1,202	5.7%	1,001	0	0	0.0%
Baker	1,739	20,868	1,184	5.7%	676	0	0	0.0%

(Director through Accountant) in the U.S. and China varied considerably, depending on the job in question. Based on this data, accountants, engineers, human resource managers, marketing managers and operations managers are more heavily taxed in the U.S., while other managers, software engineers, and directors are taxed more heavily in China.

D. Fairness of Each System as a Matter of Tax Policy

The two tax systems can also be compared from a tax policy standpoint. The standard measures¹²⁴ of whether a tax is fair and eq-

¹²⁴ It is worth noting that there has been an ongoing debate for a number of years over whether horizontal equity has any significance separate and apart from vertical equity. This debate is far beyond the scope of this article. For an excellent

uitable proceed along two dimensions: horizontal equity and vertical equity.¹²⁵ Horizontal equity compares the effect of a tax on taxpayers at the same level of economic well-being.¹²⁶ Under this principle, those taxpayers with equal economic well-being should face similar tax burdens.¹²⁷ Thus, when considering fairness under a horizontal equity concept, two taxpayers with similar income levels and similar family sizes should, all other things being equal,¹²⁸ face similar tax burdens. Vertical equity, on the other hand, compares the tax burden of taxpayers of different levels of economic well-being.¹²⁹ Under a vertical equity concept, fairness requires that taxpayers with different levels of economic well-being should bear different tax burdens.¹³⁰ The argument for a progressive tax system is based on the concept of vertical equity,¹³¹ along with the ability to pay principle, under which a taxpayer's tax burden should be related to the taxpayer's level of economic well-being.¹³² Thus, in comparing the tax burden of a taxpayer earning \$85,000 per year with that of a taxpayer earning \$25,000 per year, vertical equity would suggest that their tax burdens should be different, while the ability to pay principle would suggest that the tax burden of the former should be larger than the tax burden of the latter.

As one might expect, both the U.S. and China systems could be praised as being fair or criticized as being unfair and inequitable, depending on the point of view of the person leveling the praise or criticism for each system. Consider first the U.S. system from the

summary of the debate and a current analysis of the issues involved, *see, e.g.*, James Repetti & Diane Ring, *Horizontal Equity Revisited*, 13 FLA. TAX. REV. 135 (2012).

¹²⁵ See Walter Hettich & Stanley Winer, *Blueprints and Pathways: The Shifting Foundations of Tax Reform*, 38 NAT'L TAX J. 423, 424 (1985).

¹²⁶ JOEL SLEMROD & JON BAKIJA, *TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES* 60 (4th ed. 2008) (hereinafter *TAXING OURSELVES*).

¹²⁷ *Id.*

¹²⁸ The question of when "other things are equal" can sometimes be difficult to determine. For example, in considering whether U.S. expatriates should be taxed on their worldwide income in the same manner as domestic taxpayers, it may be worth considering that short-term expatriates, long-term expatriates and accidental expatriates all have varying degrees of ties to the United States and, arguably, should not be considered "equal". See Bernard Schneider, *The End of Taxation Without End: A New Tax Regime for U.S. Expatriates*, 32 VA. TAX REV. 1, 44-45 (2012).

¹²⁹ *TAXING OURSELVES*, *supra* note 126, at 59-60.

¹³⁰ *Id.* at 59.

¹³¹ As one commentator suggests, "the desirability of progressive tax structures' is the core question of vertical equity." Jim Chen, *Progressive Taxation: An Aesthetic and Moral Defense*, 50 U. LOUISVILLE L. REV. 659, 676 (2012).

¹³² *TAXING OURSELVES*, *supra* note 126, at 64.

perspective of horizontal equity. The concern with the U.S. system is that two individuals with exactly the same economic income level could (and probably do) have very different tax burdens. For example, assume that two hypothetical individual taxpayers, A and B, both U.S. citizens, who each have \$90,000 in gross income. In considering fairness from a horizontal equity perspective, we would expect the two taxpayers with similar incomes to have similar tax burdens. The reality however is different. Taxpayer A's income represents salary earned as an employee. Taxpayer B's income is earned equally from interest, dividends, and capital gains. Taxpayer A's income is taxed at ordinary income rates, as is Taxpayer B's interest income (assuming it is not from tax-exempt sources such as municipal bonds¹³³). Taxpayer B's income from dividends and long-term capital gains are taxed at preferential rates. Using 2013 rates, Taxpayer A's tax liability¹³⁴ would be \$15,929,¹³⁵ representing an effective tax rate of 17.7%. Taxpayer B's tax liability would be only \$11,554,¹³⁶ representing an effective tax rate of 12.8%. As this simple example demonstrates, while the two taxpayers have the same gross income, their relative tax burdens are significantly different.

This example raises another related problem. The fact that Taxpayer B's income is from investment sources might suggest that Taxpayer B is better off economically—i.e., more wealthy—even though the amount of their gross income is the same. Thus, one could argue that the two taxpayers do not have the same level of economic well-being and that, therefore, their tax burdens should not be the same. Under this analysis, the problem is not one of horizontal equity but of vertical equity. While fairness from a vertical equity perspective might suggest that the underlying economic well-being of these two taxpayers justifies a different sharing of tax burdens, the actual result is backwards from what we would expect. The more economically advantaged taxpayer, the taxpayer with the greater ability to pay, is subject to a significantly lower tax burden. Arguably, this result suggests equity concerns in the preferential treatment the U.S. system gives to certain categories of income—in this case, dividend and capital gain income.¹³⁷

¹³³ I.R.S. Pub. 525 (2012), <http://www.irs.gov/publications/p525/index.html>.

¹³⁴ As before, these calculations assume both taxpayers are unmarried and filing under a single status, with no other dependents, and electing the standard deduction rather than itemized deductions.

¹³⁵ I.R.C. § 1(c) (2010).

¹³⁶ I.R.C. § 1(h) (2010).

¹³⁷ The U.S. system favors other types of income as well. For example, interest from municipal bonds is tax exempt. I.R.C. § 103(a) (2010). One of the key political issues in the 2012 U.S. Presidential election involved the low effective tax rate of candidate Mitt Romney, whose effective tax rate was only 14.1% in 2011, de-

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By comparison, the Chinese system is subject to similar criticisms concerning preferential categories of taxed income. The Chinese system applies a progressive system of taxation to wages and net income from business operations, while a flat rate of 20% applies to certain preferential categories of income, including royalties, interest, dividends, and gains from the transfer of property. Thus, if our hypothetical Taxpayers A and B were Chinese residents rather than U.S. citizens, each earning 561,150 RMB (the equivalent of \$90,000),¹³⁸ Taxpayer A's income tax liability would be 10,224¹³⁹ RMB per month, representing an effective tax rate of 24.1%. Taxpayer B's tax liability would be 9,127 RMB per month, an effective tax rate of 19.5%, reflecting the preferential rates applied to investment income, similar to the U.S. example above.¹⁴⁰

The same analysis applies here as in the U.S. hypothetical. Taxpayer A is subject to a greater effective tax rate than Taxpayer B, who is likely more economically advantaged. The same ability-to-pay analysis would suggest that Taxpayer B's economic wealth would make it fairer for Taxpayer B to be subject to a higher tax burden than Taxpayer A; and, like the U.S. system, the difference is due to the preferential tax treatment given under the Chinese system to investment income as opposed to salary.

Of course, one cannot consider the preferential tax rates given to investment income in a vacuum. There has been much debate in the U.S. about the benefits of such preferences, both from an economics and a tax policy standpoint.¹⁴¹ I make no claim in this article to a

spite a taxable income of \$13.7 million for that year. John D. McKinnon and Sara Murray, *Romney Offers New Tax Details*, WALL ST. J., September 21, 2012. Mr. Romney's comparatively low tax burden was the result of the categories of income he received (primarily investment income and capital gains). Much of the debate centered around Mr. Romney's receipt of so-called "carried interests" he received as a fund manager with Bain Capital. These carried interests are taxed at preferential capital gain rates rather than ordinary income rates, despite their fundamental nature as compensation. For a detailed discussion of the issues surrounding the tax treatment of carried interests, see, e.g., Heather M. Field, *The Return-Reducing Ripple Effects of the "Carried Interest" Tax Proposals*, 13 FLA. TAX REV. 1 (2012).

¹³⁸ See *supra*, note 6.

¹³⁹ An annual income of 561,150 RMB would be a monthly income of 46,762.50. The monthly exclusion of 3,500 would result in a monthly taxable income of 43,262.50. Tax is then calculated under the rates specified in IITL art. 6(1), 3(2).

¹⁴⁰ See *supra*, note 81 and accompanying text.

¹⁴¹ See e.g., Annie Lowery, *Politics Complicates the Math in Ending Tax Breaks for the Rich*, N.Y. TIMES (Nov. 20, 2012), <http://www.nytimes.com/2012/11/21/business/no-pain-no-gain-in-meeting-in-the-middle-on-taxes.html>; John D. McKinnon, *Some Taxes Are Sure to Go Up*, WALL ST. J. (Nov. 4, 2012), <http://online.wsj.com/article/SB10001424052970203707604578090981852692500.html>.

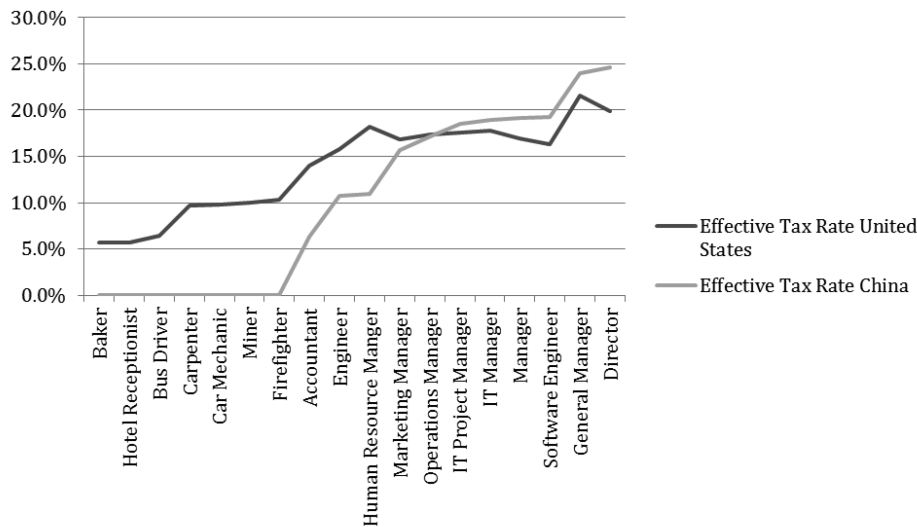
solution to this ongoing debate. Rather, my goal in this article is to show the similarities of the two systems on this issue.

V. CONCLUSION

The U.S. and China individual income taxes are both progressive tax systems that, in a broad sense, employ similar definitions of taxable and tax-exempt income. The Chinese tax seems more progressive in the sense that it exempts more of the lower income taxpayers overall and imposes a higher marginal rate on higher-income taxpayers as a result. Both systems employ preferences (in the form of lower marginal tax rates) for certain types of income, although the specifics for each tax differ. Arguments about the horizontal equity of each system can be made both for and against fairness. The arguments against the fairness of each system are largely based on the preferences it makes for certain types of income.

The comparison of the two individual income tax systems is interesting, although it is not complete. As I suggested at the beginning of this article,¹⁴² China relies heavily on other sources of revenue for government funding, while in the U.S., nearly half of the federal government's revenue is from the individual income tax. An opportunity for additional research exists in a broader project that would compare the tax burdens of the entire tax system of each country, taking into account the other sources of government revenue and the burdens they impose on the citizenry.

FIGURE 1

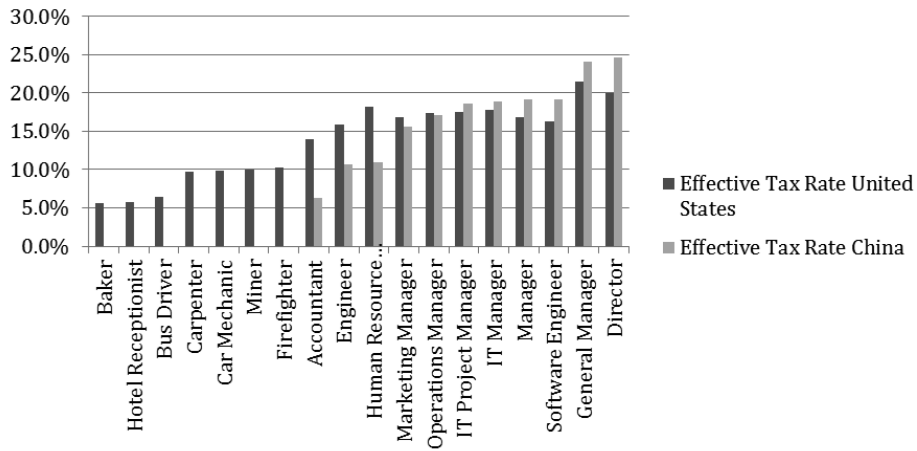


¹⁴² See *supra* notes 1-2 and accompanying text.



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FIGURE 2



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APPENDIX 1: RATE SCHEDULES FOR FOOTNOTE 80

MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES

If Taxable Income Is:	The Tax Is:
Not over \$17,850	10% of the taxable income
Over \$17,850 but not over \$72,500	\$1,785 plus 15% of the excess over \$17,850
Over \$72,500 but not over \$146,400	\$9,982.50 plus 25% of the excess over \$72,500
Over \$146,400 but not over \$223,050	\$28,457.50 plus 28% of the excess over \$146,400
Over \$223,050 but not over \$398,350	\$49,919.50 plus 33% of the excess over \$223,050
Over \$398,350 but not over \$450,000	\$107,768.50 plus 35% of the excess over \$398,350
Over \$450,000	\$125,846 plus 39.6% of the excess over \$450,000

HEADS OF HOUSEHOLDS

If Taxable Income Is:	The Tax Is:
Not over \$12,750	10% of the taxable income
Over \$12,750 but not over \$48,600	\$1,275 plus 15% of the excess over \$12,750
Over \$48,600 but not over \$125,450	\$6,652.50 plus 25% of the excess over \$48,600
Over \$125,450 but not over \$203,150	\$25,865 plus 28% of the excess over \$125,450
Over \$203,150 but not over \$398,350	\$47,621 plus 33% of the excess over \$203,150
Over \$398,350 but not over \$425,000	\$112,037 plus 35% of the excess over \$398,350
Over \$425,000	\$121,364.50 plus 39.6% of the excess over \$425,000

UNMARRIED INDIVIDUALS (OTHER THAN SURVIVING SPOUSES AND HEADS OF HOUSEHOLDS)

If Taxable Income Is:	The Tax Is:
Not over \$8,925	10% of the taxable income
Over \$8,925 but not over \$36,250	\$892.50 plus 15% of the excess over \$8,925
Over \$36,250 but not over \$87,850	\$4,991.25 plus 25% of the excess over \$36,250
Over \$87,850 but not over \$183,250	\$17,891.25 plus 28% of the excess over \$87,850
Over \$183,250 but not over \$398,350	\$44,603.25 plus 33% of the excess over \$183,250
Over \$398,350 but not over \$400,000	\$115,586.25 plus 35% of the excess over \$398,350
Over \$400,000	\$116,163.75 plus 39.6% of the excess over \$400,000

478 RICHMOND JOURNAL OF GLOBAL LAW & BUSINESS [Vol. 12:4**MARRIED INDIVIDUALS FILING SEPARATE RETURNS**

If Taxable Income Is:	The Tax Is:
Not over \$8,925	10% of the taxable income
Over \$8,925 but not over \$36,250	\$892.50 plus 15% of the excess over \$8,925
Over \$36,250 but not over \$73,200	\$4,991.25 plus 25% of the excess over \$36,250
Over \$73,200 but not over \$111,525	\$14,228.75 plus 28% of the excess over \$73,200
Over \$111,525 but not over \$ 199,175	\$24,959.75 plus 33% of the excess over \$111,525
Over \$199,175 but not over \$225,000	\$53,884.25 plus 35% of the excess over \$199,175
Over \$225,000	\$62,923 plus 39.6% of the excess over \$225,000

EXITING THE EURO

By
*Frederick V. Perry, Ph.D., J.D.**
and
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ABSTRACT

The Crisis in the Euro Zone threatens to break up the Euro and perhaps derail the European Union itself. Many argue that a Member State exiting the Euro would be not only unthinkable, but also a practical impossibility, given the status of the “constitutionality” of European law, the treaties forming the European Union and the Euro, and customary European law. Europeans have been, for centuries, very creative in forging economic and trading alliances—some that appeared to be political alliances and even elementary union. They have also, on more than one occasion, attempted to confect monetary stability. Some of these attempts were successful for long periods, while the monetary bits have often not been so successful. This article explores the proposition that a unilateral exit, an expulsion of a member, a breakup of the European Monetary Union (EMU), or even a breakup of the European Union itself is possible under international law. Indeed, some or a combination of the foregoing may transpire. Some consider such an action impossible inasmuch as Member States have relinquished their sovereignty. It can, however, be argued that a Member State can either withdraw or be ejected from the EMU under existing law.

INTRODUCTION

On October 12, 2012, the European Union won the Nobel Peace Prize.¹ At the time, the EMU was struggling to bail out a number of

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¹ Alan Cowell & Nicholas Kulish, *Nobel Committee Gives Prize to European Union*, N.Y. TIMES, Oct. 12, 2012, available at <http://www.nytimes.com/2012/10/13/world/nobel-peace-prize.html>.

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Member States—Greece in particular—and some said the award symbolized “as much hope as achievement.”² With the award, the Nobel committee seemed to be urging the EU not to allow its recent struggles to abort its grand mission of a unified Europe and “sounded at times like a plea to support the endangered institution at a difficult hour.”³ The committee thereby forcefully demonstrated the continuing strong appeal of European unity to the psyche of many Europeans.

Though it began as an economic exercise, the EU was clearly intended to serve as a mechanism to prevent another European war and would be “indispensable to peace.”⁴ Additionally, the Euro was intended to be the ultimate achievement of European solidarity and was designed to fortify the common market by “reducing transaction costs and removing the risks of competitive devaluation.”⁵ Now, some question whether the Euro will survive and, more importantly, whether it could destroy the EU.⁶

A breakup of the EU—or any feature of it—is supposed to be difficult. In many respects, its founders meant the EU to be permanent. Thus, when discussing a possible exit of a Member State, the rethinking by a Member State of its conditions of membership, a breakup of the EU, or the disintegration of the single European currency, one must be careful to analyze the legal foundations of the EU, custom and practice in the EU and international law, and the text of various treaties.

In 2009, Member States ratified the Treaty of Lisbon.⁷ Among its provisions, the treaty included an article on “voluntary withdrawal of a Member State from the Union.”⁸ Article 50 of the Treaty of Lisbon allows a Member State to withdraw without any preconditions and

² *Id.*

³ *Id.*

⁴ Harold Callender, *France Proposes a Coal-Steel Pool With Germans in it*, N.Y. TIMES, May 10, 1950, available at <http://www.nytimes.com/packages/pdf/topics/eu/1950-05-10-NewsArticle.pdf>.

⁵ *Charlemagne: Coming off the Rails*, THE ECONOMIST, Oct. 20, 2012, available at <http://www.economist.com/news/europe/21564851-euro-was-meant-underpin-single-market-it-may-end-up-undermining-it>.

⁶ *Id.*

⁷ Treaty of Lisbon Amending the Treaty on European Union and the Treaty Establishing the European Community, Dec. 17, 2007, 2007 O.J. (C 306) 1 [hereinafter Treaty of Lisbon] (amending the Treaty on European Union and the Treaty Establishing the European Communities). The Treaty of Lisbon renamed the amended treaties the Treaty on the Functioning of the European Union (commonly referred to as the TFEU). In doing so, the Treaty of Lisbon diplomatically avoided referring to the document as a “constitution.” *Id.*

⁸ Press Release, European Union, Explaining the Treaty of Lisbon (Dec. 1, 2009), http://europa.eu/rapid/press-release_MEMO-09-531_en.htm.

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provides that any such withdrawal will become effective upon the occurrence of either (1) negotiation of withdrawal arrangements with the other Member States, or (2) two years following the initial election of withdrawal.⁹ Regardless of the reasons for inclusion of such a provision, it is now clear that there is a path by which a Member State can leave the EU in its entirety. Less clear, however, is whether a Member State can choose to stop using the Euro and return to using a national currency, without abandoning the European Union as a whole.

Some features of the European Union remain popular, such as elimination of trade barriers and freedom of movement. European citizens now take these essential features for granted.¹⁰ However, it has become clear that the main challenge to preservation of the EU is managing the ongoing financial crisis within the structure of a single currency. If the EU cannot continue to exist in its current formulation and membership without a single currency, then this is more than a Greek, Italian, or Spanish problem alone. Instead, it is an existential challenge to the EU. It is therefore critical to carefully analyze how one or a number of Member States can exit the EMU, within the current legal framework of the EU and without destroying the EU in its entirety. This article will explore the proposition and make the argument that such an exit or modification of treaty obligations, while challenging, is legally possible.¹¹

EUROPEAN CREATIVITY

In order to understand the current state of the Euro, we must first explore the origins and evolution of the EMU and the EU. Since the Middle Ages, Europeans have been at the forefront in the area of legal and economic integration. Economists from the days of Adam Smith¹² to the modern day have argued for the benefits of free trade. The Charter of the United Nations calls for all nations to “employ international machinery for the promotion of the economic and social advancement of all peoples.”¹³ The famous twentieth Century economist, Paul Samuelson, in extolling the virtues of free trade stated:

There is essentially only one argument for free trade or freer trade, but it is an exceedingly powerful one,

⁹ *Id.*

¹⁰ Jack Ewing, *Despite Prize, European Union Loses Much of Its Appeal as Unity Eludes Continent*, N.Y. TIMES, Oct. 12, 2012, <http://www.nytimes.com/2012/10/13/world/europe/despite-prize-unity-is-elusive-in-the-european-union.html>.

¹¹ See Frederick V. Perry et al., *Is There A Way out of the Euro?*, 25 INT’L J. FIN. 1 (forthcoming 2013).

¹² ADAM SMITH, AN INQUIRY INTO THE NATURE AND THE CAUSE OF THE WEALTH OF NATIONS bk. IV, at 414 (Modern Library ed. 1937) (1776).

¹³ U.N. Charter pmbl.

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namely: Free trade promotes a mutually profitable division of labor, greatly enhances the potential real national product for all nations, and makes possible higher standards of living all over the globe.¹⁴

Europeans have waived the banner of free trade for centuries and have been among the world's innovators in cooperation in the legal, commercial, and economic spheres. The *Lex Rhodia*, or the Rhodian law, for example, provided a codification of merchant practices governing trade in the Mediterranean area.¹⁵ In the thirteenth century, codified laws, thought to have originated in Barcelona, were carried by merchants throughout Europe.¹⁶ Because "(t)hroughout the centuries, consensuality appears as the bastion of international commerce,"¹⁷ these laws were adopted as custom and used throughout the trading area. Thus, from approximately 1340 AD, the *Consolato del Mare* became recognized as an "international body of mercantile custom."¹⁸

As a result of a growth in sea borne commerce, regulations arose in the twelfth and thirteenth centuries which formed a true international law governing commerce in the European area. This was not a codified law of any particular sovereign, but rather a customary law,¹⁹ which later, when codified in various sovereign areas, was all similarly based on the universal law merchant, since:

The socioeconomic features which typified this ancient law Merchant also constituted the reasons for its subsistence. There was the underlying need to promote trade based on freedom, subject to the need to pay a "just price" and subject to the need to avoid usurious interest rates. Law which mandated trade beyond this arena would generate economic loss, cause social disapproval and infringe upon public welfare. Rulers who sought by means of national law to rigidify this free commerce would inhibit the success of exchanges in the marketplace—to the loss of both the foreign and the local merchant community.²⁰

A demand for expanding trade and a mutual need for free trade and uniform laws or customs made Medieval Europe an ideal place for

¹⁴ PAUL A. SAMUELSON, *ECONOMICS* 692 (10th ed. 1976).

¹⁵ Leon E. Trakman, *The Evolution of the Law Merchant: Our Commercial Heritage*, 12 J. MAR. L. & COM. 153, 156 (1981).

¹⁶ *Id.*

¹⁷ *Id.* at 153.

¹⁸ *Id.* at 156.

¹⁹ *Id.* at 157.

²⁰ *Id.*

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such a generalized set of law and custom accepted by, if not all, at least most.²¹

A sort of precursor to the European Union was formed in the 12th century by a group of European cities wishing to trade among themselves and provide not only common rules for trade, but also security for such trade. This group became known as the Hanseatic League.²² The league lasted for 300 years and came about because feudal overlords were generally weak and because people who lived in cities had different interests from those of such overlords. City dwellers wanted trade.²³ “The main activities of the groups of nobles involved marrying and feuding with one another and raising taxes from their subjects. They were rarely noted for their interest in trade, except as a source of taxation.”²⁴ Trading cities in Germany, Belgium, the Baltic States,²⁵ Poland, the Netherlands, and Russia traded among themselves as members of this alliance. The rise of the nation-state around the time of the Peace of Westphalia led to the demise of the League. Prominent merchants from the cities banded together to form a loose alliance in order to protect themselves and share risks associated with trade, travel, and troublesome feudal lords.²⁶

The Hanseatic League had a form of parliament that discussed common interests, such as common approaches to piracy, trading matters, and troublesome sovereigns. The league raised soldiers and fleets to protect themselves when necessary.²⁷ They even defeated King Valdemar of Denmark, who had attacked the Hansa city of Visby over trading disputes. Over 70 cities of the league contributed to that defeat.²⁸ The league, however, was never a coherent political organization, since its members’ conflicting interests prevented any real political cohesion.²⁹ Even so, the league was successful in imposing its political and commercial will over the region and in defending itself and its interests for centuries.

²¹ *Id.* at 158.

²² See Stephen Halliday, *The First Common Market?*, 59 HIST. TODAY 31 (July 2009), available at <http://www.historytoday.com/stephen-halliday/first-common-market-hanseatic-league>.

²³ *Id.*

²⁴ *Id.* at 32.

²⁵ The term “state” or “states” will be used throughout this Article. It is used in its international legal context to mean a sovereign nation state. To the extent that the term refers to a sovereign state, a member of the United States of America, such as the state of Ohio, it will be precisely so stated.

²⁶ Halliday, *supra* note 22.

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

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Stephen Halliday has suggested a comparison between the efforts of the League and the modern European Union because “(t)he EU started as a means of promoting peaceful trading relationships among its members, in particular the old enemies of France and Germany, and has attempted to develop a degree of ever greater political union among them. Like the Hansa, the EU has often promoted the trading interests of its own members at the expense of others.”³⁰

We know also that modern Public International Law is said to have been first created in Europe, and that it rose to prominence with the rise of the European nation-state.³¹ The period between the Peace Treaty of Westphalia of 1648³² and the Congress of Vienna of 1815,³³ very much a European phenomena, is generally considered the formation period of classical international law.³⁴ The Dutch writer Hugo Grotius (1583-1645) is widely considered the father of modern international law,³⁵ though it appears that the Spanish friar, Francisco de Vitoria (1492-1546), was the first to write on the subject.³⁶ Both writers were European, and their writings have had a great deal of influence on subsequent developments. In fact, international law was generally Eurocentric until after World War II.

In 1951, with the goal of preventing future wars, France, West Germany, Italy, Belgium, the Netherlands, and Luxembourg formed the European Coal and Steel Community by pooling the region’s coal and steel industries.³⁷ Six years later, those same six states created the European Economic Community, thereby removing tariff barriers among themselves.³⁸ In 1967, they become the European Community and, in 1991, after being joined by Britain, Greece, Spain, and Portugal, the Member States signed a treaty in Maastricht, the Netherlands, which laid the groundwork for a common currency.³⁹ The Maastricht Treaty was a major addition to the Treaty of Rome and created a common citizenship, a common defense and security policy,

³⁰ *Id.*

³¹ César Sepúlveda, *Derecho Internacional Público* 7 (5th ed. 1973).

³² The Treaty of Westphalia ended the so-called Thirty Years War—a general European war arising partly as a result of the Protestant Reformation. See The Treaty of Westphalia, available at http://avalon.law.yale.edu/17th_century/westphal.xasp.

³³ The Congress of Vienna ended the Napoleonic Wars in Europe.

³⁴ ALINA KACZOROWSKA, *PUBLIC INTERNATIONAL LAW* 3 (4th ed. 2010).

³⁵ *Id.*

³⁶ SEPÚLVEDA, *supra* note 31, at 13.

³⁷ *The March Toward Unity*, SCHOLASTIC UPDATE, Mar. 22, 1999, at 4.

³⁸ *Id.*

³⁹ *Id.* at 4-5.

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and economic and monetary union.⁴⁰ To symbolize this renewed commitment, the name was changed from European Community to European Union.⁴¹

Since the Treaty of Rome, the Member States have tried various methods to attain monetary stability, but not all have been successful.⁴² The march toward a common currency was fraught with difficulties.⁴³ At first the Member States wished merely to be able to have stable exchange rates.⁴⁴ In the 1970's, the German Mark was buffeted by an unstable dollar.⁴⁵ This led to unstable exchange rates throughout the European Community, which gave rise to serious planning and coordination problems among the Member States, distorting intra-Community trade.⁴⁶ Then, in 1972, there was an effort to coordinate Community currencies by means of a "Snake" mechanism, whereby the currencies, linked together, were supposed to move together against outside currencies.⁴⁷ The British left the Snake a few weeks after it started; the French left twice and rejoined.⁴⁸ The Snake appeared to be neither popular, nor widely successful.⁴⁹

In 1978, the Council of Ministers adopted a Resolution to create a European Monetary System ("EMS"). Thus, the EMS created the Exchange Rate Mechanism.⁵⁰ The Exchange Rate Mechanism served as a mini-Bretton Woods arrangement among the currencies of the Member States.⁵¹ The Member States' currencies could float in tandem against the Dollar and the Yen, providing a counterweight against them, and, thereby, it was thought, provide for stable exchange rates and economic growth.⁵²

⁴⁰ Treaty Establishing the European Economic Community art. 1, Mar. 25, 1957, 298 U.N.T.S. 11 [hereinafter Treaty of Rome], available at http://ec.europa.eu/economy_finance/emu_history/documents/treaties/rometreaty2.pdf ("By this Treaty, the high contracting parties establish among themselves a European Economic Community."); Maastricht Treaty, arts. 2, 8, 199, Feb. 7, 1992, 2002 O.J. (C 325) 5, available at <http://www.eurotreaties.com/maastrichtec.pdf>.

⁴¹ *Id.*

⁴² See Terence Fokas, *Economic and Monetary Union in Europe: The Legal Framework and Implications for Contractual Obligations*, 36 Tex. J. Bus. L. 2, 5-9 (1999).

⁴³ *Id.* at 5-13.

⁴⁴ *Id.* at 5-9.

⁴⁵ LOWENFIELD, *INTERNATIONAL ECONOMIC LAW* 782 (2d ed. 2008).

⁴⁶ *Id.* at 772.

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ LOWENFIELD, *supra* note 45, at 773.

⁵¹ *Id.*

⁵² *Id.* at 774.

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Each of the Member States that participated in the Exchange Rate Mechanism was required to both establish a rate for its currency, denominated in terms of a European Currency Unit (ECU), and to maintain that rate with a prescribed margin.⁵³ If the currency approached either extreme of that margin, the issuing country of the currency, or its central bank, was required to intervene.⁵⁴ If it needed money to do that, it could borrow on a short-term basis from a central fund to which all Members had contributed.⁵⁵ The ECU was a precursor to the Euro, which was created twenty years later.⁵⁶ The ECU functioned as both a unit of account, based on a basket of currencies that had different values weighted in accordance with their relative economic importance, as well as an asset that could be used for intervention and settlement among the central banks of the Community.⁵⁷ This system depended not only upon the Member States following the foregoing mechanism, but also upon their economic performance.⁵⁸ If both operated smoothly, the system would work.⁵⁹ However, if the economic performance of the Member States was not sufficiently uniform, the system simply could not boost the weaker currencies.⁶⁰

Though the EMS had many ups and downs in its brief history, it appeared to be working by the end of the 1980s.⁶¹ That success led to the creation of the Maastricht Treaty, calling for the formation of an Economic and Monetary Union (EMU) with a common currency and a single European Central Bank.⁶² After execution of the Maastricht Treaty in February 1992, and prior to its ratification and implementation, the EMU essentially collapsed.⁶³ The German Mark was adversely impacted, the Pound and the Lira were unable to maintain stability, and the French Franc was in turmoil.⁶⁴ The Maastricht Treaty was barely ratified.⁶⁵ Supporters achieved ratification with the backing of Denmark, which only ratified the treaty on the condition that it would not have to become a user of the Euro.⁶⁶

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ LOWENFIELD, *supra* note 45, at 774.

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.* at 775.

⁵⁹ *Id.*

⁶⁰ LOWENFIELD, *supra* note 45, at 775.

⁶¹ *Id.* at 776.

⁶² *Id.* at 777.

⁶³ *Id.* at 782.

⁶⁴ *Id.* at 778-79.

⁶⁵ LOWENFIELD, *supra* note 45, at 785.

⁶⁶ *Id.*

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The objective of the Euro was to do away with divergence of currency values and interest rates.⁶⁷ Members would no longer be able to devalue their currencies.⁶⁸ Moreover, although fiscal policies (decisions regarding expenditures and revenues) were to be controlled by each Member State, these decisions were to be subject to strict convergence criteria and under the supervision and control of authorities in Brussels.⁶⁹ Just as importantly, a single currency had a symbolic political value: unification.

The Maastricht Treaty requires that the Member States ensure that their governments do not manage their central banks or require the banks to report to them:

ARTICLE 106

1. The ESCB shall be composed of the ECB and of the national central banks.
2. The ECB shall have legal personality.
3. The ESCB shall be governed by the decision-making bodies of the ECB which shall be the Governing Council and the Executive Board. . .

ARTICLE 108

Each Member State shall ensure, at the latest at the date of the establishment of the ESCB, that its national legislation including the statutes of its national central bank is

compatible with this Treaty and the Statute of the ESCB.⁷⁰

Another requirement of the Maastricht Treaty is that Member States “regard their economic policies as a matter of common concern and shall co-ordinate them within the (European) Council . . .”⁷¹ Surveillance by the European Commission must focus on two main issues: (1) the ratio of government deficit to gross domestic product, and (2) the ratio of government debt to gross domestic product.⁷² During the transition stage, the performance of all Member States was closely monitored.⁷³ Once the Euro took effect, it was highly questionable as to whether Belgium and Italy would be able to comply with the new

⁶⁷ *Id.* at 782.

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ Maastricht Treaty, arts. 106, 108, Feb. 7, 1992, 2002 O.J. (C 325) 5, available at <http://www.eurotreaties.com/maastrichtec.pdf>.

⁷¹ *Id.* at art. 103.

⁷² LOWENFIELD, *supra* note 45, at 783-84.

⁷³ *Id.* at 784.



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guidelines.⁷⁴ In the end, they were both permitted to enter the EMU, since it appeared that their trends were heading in the right direction.⁷⁵ Economists agreed that, at the moment of its formation, the Euro zone was not an optimum currency area, but many believed that over time it could become closer to being one.⁷⁶

However, not all Member States followed the directives. As a result, economies diverged and the measures put in place by the Maastricht Treaty were not followed, and/or, arguably, did not work. For example, even after its first bailout, the Greek politicians failed to live up to their obligations for reform.⁷⁷ Thus, from the beginning of this crisis, the northern Europeans have resented funding what they see as the profligacy and low work ethic of their southern brethren.

German leaders believe there is a need to fix the problem.⁷⁸ It is not as if the Euro crisis is a matter that can be easily rectified, however, or even that it is simply a western European problem. The issues at hand are, and have been, so serious that *The Economist* proclaimed in 2011:

So grave, so menacing, so unstoppable has the euro crisis become that even rescue talk only fuels ever-rising panic. Investors have sniffed out that Europe's leaders seem unwilling ever to do enough. Yet unless politicians act fast to persuade the world that their desire to preserve the euro is greater than the markets' ability to bet against it, the single currency faces ruin. As credit lines gum up and outsiders plead for action, it is not just the euro that is at risk, but the future of the European Union and the health of the world economy.⁷⁹

Further still, some Europeans are losing faith in the "European Experiment."⁸⁰ They wonder if it is worth it to lose their sovereignty in both everyday and fiscal matters.⁸¹

⁷⁴ *Id.* at 787.

⁷⁵ *Id.*

⁷⁶ Antonin Rusek, *The Nature of Shocks in Eurozone*, 36 *ATL. ECON. J.* 371 (2008).

⁷⁷ *The Euro Crisis: What to Do About Greece*, *THE ECONOMIST*, Jan. 28, 2012, <http://www.economist.com/node/21543536>.

⁷⁸ *See Europe's Currency Crisis: How to Save the Euro*, *THE ECONOMIST*, Sept. 17, 2011, <http://www.economist.com/node/21529049>.

⁷⁹ *Id.*

⁸⁰ *See Charlemagne: A Flawed Temple*, *THE ECONOMIST*, Mar. 16, 2013, <http://www.economist.com/news/europe/21573553-loss-legitimacy-may-now-be-biggest-threat-european-project-flawed-temple>.

⁸¹ *See id.*

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THE LAW OF TREATIES

Social and political groups, whether they are primitive tribes or modern states, commonly have rules by which they regulate their conduct.⁸² At the modern state level, we typically call them laws. Of course in earlier, more primitive times, social groups governed themselves by custom, which was not written down anywhere, but was merely remembered and followed.⁸³ Such customs took on an “aura of historical legitimacy.”⁸⁴ States have recognized this notion of historical legitimacy in the international arena for centuries,⁸⁵ and it has come to define customary international law today. The role it plays in international legal obligations,⁸⁶ as international custom, is evidence of a general practice accepted as law.⁸⁷

Within those domestic systems of laws, modern states have rules governing relations, economic and otherwise, between individuals and entities. The documentation and the measure of those relations are generally referred to as “contracts.” A contract is simply a set of promises that the law will recognize as worthy of being enforced.⁸⁸ Such law of contracts or, more generally, obligations as they are referred to in many civil law countries,⁸⁹ has rules defining when a contractual relationship arises, requirements for the formation of contractual obligations, the precise obligations, when such obligations arise, what constitutes a breach of the obligations, when the breach arises, and what the remedies are for such breach.

This principle of making enforceable promises has also existed at the state level, between states, for a very long time.⁹⁰ We often call such international arrangements “treaties.”⁹¹ Every state can enter

⁸² See generally Perry et al., *supra* note 11.

⁸³ MALCOLM S. SHAW, *INTERNATIONAL LAW* 72 (6th ed. 2008).

⁸⁴ *Id.*

⁸⁵ SEPÚLVEDA, *supra* note 31, at 93.

⁸⁶ For example, the Statute of the International Court of Justice, in defining the sources of international law, places treaties and customary international law as the as the primary source. See Statute of the International Court of Justice art. 38, Oct. 24, 1945, available at www.icj-cij.org/documents/index.php?p1=4&p2=2&p3=0#CHAPTER_II.

⁸⁷ *Id.*

⁸⁸ See generally JOHN D. CALAMARI & JOSEPH M. PERILLO, *THE LAW OF CONTRACTS* 1 (4th ed. 1998).

⁸⁹ See MANUEL BEJARANO SÁNCHEZ, *OBLIGACIONES CIVILES* 26 (5th ed. 1999).

⁹⁰ The first international treaty of which we have written evidence occurred between the city-states of Ummah and Lagash in Mesopotamia around the year 3100 B.C. See CARLOS ARRELLANO GARCIA, *PRIMER CURSO DE DERECHO INTERNACIONAL PÚBLICO* 3 (4th ed. 1999).

⁹¹ SHAW, *supra* note 83, at 72.



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into a treaty.⁹² The law of treaties deals with many of the same issues as the domestic law of contract, but on an international level.⁹³ In international law, treaties are generally the source of written law,⁹⁴ as opposed to customary international law. Treaties are an important element of international law; they work as a tool for both recognition and creation of international legal obligations, and “have always been an indispensable tool of diplomacy.”⁹⁵ We see that “states transact a vast amount of work using the device of the treaty; . . . wars [are] . . . terminated, disputes settled, territory acquired, special interests determined, alliances are established, international organizations are created,”⁹⁶ and private or individual rights and obligations are generated.⁹⁷

Accordingly, “[r]ecognizing the ever-increasing importance of treaties as a source of international law and as a means of developing peaceful co-operation among nations, whatever their constitutional and social systems,”⁹⁸ Member States of the United Nations created the Vienna Convention on the Law of Treaties, which codified prior customary international law on treaties and created some new norms.⁹⁹ The Vienna Convention applies to treaties completed after the Vienna Convention entered into effect as to its signatories.¹⁰⁰ The Treaties relating to the formation and continuation of the European Union and the EMU are multilateral treaties, and in the case of multilateral treaties, as to those Member States who ratified or acceded to the Vienna Convention prior to signing any such EU treaties, the Vienna Convention applies to their EU treaty signature and compliance.¹⁰¹

Where the Vienna Convention does not control matters, customary international law continues to apply.¹⁰² Accordingly, despite the fact that the Vienna Convention itself does not apply retroactively, customary international law does apply to any such treaties entered into by contracting states. However, inasmuch as the Vienna Convention codifies existing customary international law, it is generally con-

⁹² Vienna Convention on the Law of Treaties art. 6, May 23, 1969, 1155 U.N.T.S. 331 [hereinafter Vienna Convention].

⁹³ See VALERIE EPPS, *INTERNATIONAL LAW* 55 (4th ed. 2009).

⁹⁴ CONWAY W. HENDERSON, *UNDERSTANDING INTERNATIONAL LAW* 67 (2010).

⁹⁵ ANTHONY AUST, *MODERN TREATY LAW AND PRACTICE* 1 (2d ed. 2007).

⁹⁶ SHAW, *supra* note 83, at 902-03.

⁹⁷ See, e.g., United Nations Convention for the International Sale of Goods, April 11, 1980, 1498 U.N.T.S. 3.

⁹⁸ *Id.* pmbl.

⁹⁹ SHAW, *supra* note 83 at 903.

¹⁰⁰ Vienna Convention, *supra* note 92, art. 4.

¹⁰¹ SHAW, *supra* note 83, at 903.

¹⁰² Vienna Convention, *supra* note 92, pmbl., art. 38.

sidered by states to reflect the norms of treaty law for signatory states and non-signatory states alike.¹⁰³

In other words, the Vienna Convention is considered a reflection of customary international law by both non-signatory states, who consider themselves bound by it,¹⁰⁴ and by international and domestic tribunals, who apply its terms even to treaties entered into decades before its creation.¹⁰⁵

The famous legal writer, J. L. Brierly, writing in the 1920's, long before the creation of the Vienna Convention, stated that: "[c]ustom in its legal sense means something more than mere habit or usage; it is a usage felt by those who follow it to be an obligatory one."¹⁰⁶ Customary international law binds states, so long as it is generally accepted. This is ascertained from the practice and behavior of states.¹⁰⁷ Nevertheless, what states generally do is half of the equation needed to determine the obligations provided by customary international law. States must act in a certain way out of the belief that such acts are legally required. They must act, in other words, under what is termed *opinion juris*.¹⁰⁸

Customary international law has governed the law of treaties for thousands of years. By the time of the outbreak of World War I, there were around 8,000 international treaties in operation.¹⁰⁹ The League of Nations registered 4,822 treaties. Since 1945, the United Nations has registered over 54,000 treaties.¹¹⁰ States have deposited over 500 multilateral treaties with the United Nations.¹¹¹ It is estimated that this figure accounts for only about 70% of treaties entered into force since the formation of the United Nations.¹¹² Customary international law governed treaties in the absence of any codification of treaty rules¹¹³ as set forth in the Vienna Convention.

We will examine the matter of whether and to what extent a state may suspend obligations under a treaty, exit from certain obligations created by a treaty relationship—whether that exit be unilateral

¹⁰³ NANCY KONTOU, *THE TERMINATION AND REVISION OF TREATIES IN THE LIGHT OF NEW CUSTOMARY INTERNATIONAL LAW* 13 (1994).

¹⁰⁴ AUST, *supra* note 95, at 12.

¹⁰⁵ *Id.* at 12-13.

¹⁰⁶ J.L. BRIERLY, *THE LAW OF NATIONS: AN INTRODUCTION TO THE INTERNATIONAL LAW OF PEACE* 59 (6th ed. 1963).

¹⁰⁷ SHAW, *supra* note 83, at 73.

¹⁰⁸ *Id.* at 75.

¹⁰⁹ Aust, *supra* note 95, at 1.

¹¹⁰ *Id.*

¹¹¹ *Global Issues: International Law*, UN.ORG, <http://www.un.org/en/globalissues/internationallaw/> (last visited July 2, 2013).

¹¹² AUST, *supra* note 95, at 1.

¹¹³ See, e.g., BRIERLY, *supra* note 106, at 337.

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or multilateral, including the exiting state's agreement or request to exit, or agreed upon only by those opposing a contracting state's continued treaty relationship—or simply terminate the treaty. As set forth above, states' obligations respecting the treaties they have entered into are governed by either the Vienna Convention, customary international law, or both.

The United Nations espouses the proposition that all Member States are equal sovereigns under the law, inasmuch as its charter states: "The Organization is based on the principle of the sovereign equality of all its Members."¹¹⁴ We can therefore start from the proposition that all states are considered sovereign, inasmuch as "[t]he sovereignty and equality of states represents the basic constitutional doctrine of the law of nations, which governs a community consisting primarily of states having uniform legal personality."¹¹⁵ The corollary of this notion is that "membership of international organizations is not obligatory; and the powers of the organs of such organizations to determine their own competence, to take decisions by majority vote, and to enforce decisions, depend on the consent of Member States."¹¹⁶ Accordingly, the Member States of the European Union are sovereign states. As such, they are each free to enter into treaties, however denominated.¹¹⁷ The corollary of such freedom is the freedom to amend or exit from a treaty.

Of course, states cannot exit from treaty obligations whenever they wish, since allowing such an activity would render treaties worthless.¹¹⁸ The rule of *pacta sunt servanda* is still valid international law.¹¹⁹ However, conditions do arise where suspension or termination of a treaty may be justified.¹²⁰

All the members of the EMU, except France, have either ratified or acceded to the Vienna Convention and are thus bound by its terms.¹²¹ Five of them have filed reservations to the convention.¹²² All the members of the European Union, except France and Romania, have either ratified or acceded to the Vienna Convention and are thus

¹¹⁴ U.N. Charter art. 2, para. 1.

¹¹⁵ IAN BROWNLIE, *PRINCIPLES OF INTERNATIONAL LAW* 280 (7th ed. 2008).

¹¹⁶ *Id.* at 281.

¹¹⁷ "[T]reaty' means an international agreement concluded between States in written form and governed by international law, whether embodied in a single instrument or in two or more related instruments and whatever its particular designation." Vienna Convention, *supra* note 92, art. 2, para. 1(a).

¹¹⁸ See KACZOROWSKA, *supra* note 34, at 127.

¹¹⁹ Vienna Convention, *supra* note 92, art. 26.

¹²⁰ KACZOROWSKA, *supra* note 34, at 127.

¹²¹ See Vienna Convention, *supra* note 92.

¹²² They are Belgium, Finland, Germany, the Netherlands and Portugal. *Id.*

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bound by its terms.¹²³ None of those reservations have anything to do with treaty formation, treaty abrogation, unilateral or multilateral withdrawal from a treaty or its obligations, or expulsion from a multilateral treaty.¹²⁴

It follows, therefore, that those provisions of the Vienna Convention that deal with the issues of treaty formation, treaty abrogation, unilateral or multilateral withdrawal from a treaty or its obligations, or expulsion from a multilateral treaty are binding on both the Member States of the E.U. and the Member States of the E.M.U. Of course, all members of the E.M.U. are members of the E.U., but the converse is not true.¹²⁵

The treaties that form the E.U. and the E.M.U. are not subject to interpretation under international law in exactly the same way as other treaties. Rather, they give rise to a new and different kind of regime, whereby rather than having the domestic courts of the Member States provide interpretations of the treaty obligations of such states, the E.U. courts are responsible for the interpretation.¹²⁶

Contracts and treaties require respect. Otherwise, relations governed thereby would be unpredictable, and no one would use either instrument. Accordingly, similar to obligations under the general law of contracts, with which most people in the modern world are familiar, a state cannot relieve itself of the obligation to adhere to and perform pursuant to the terms of a treaty to whose terms that state has agreed.

As mentioned above, any state entering into a treaty can expect to be bound by it because, under the long valued norm of interna-

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ The E.U. is composed of Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and the United Kingdom. *See Member Countries of the European Union*, EUROPEAN UNION, <http://europa.eu/about-eu/countries/member-countries/> (last visited July 15, 2013). The E.M.U. is composed of Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain. *See The Euro*, EUROPEAN COMMISSION, http://ec.europa.eu/economy_finance/euro/ (last visited July 15, 2013).

¹²⁶ Treaty of Lisbon, *supra* note 7, art. 19(1) (“The Court of Justice of the European Union shall include the Court of Justice, the General Court and specialised courts. It shall ensure that in the interpretation and application of the Treaties the law is observed.”); *see also The Court of Justice and the Court of First Instance*, EUROPEAN PARLIAMENT, http://www.europarl.europa.eu/factsheets/1_3_9_en.htm (last visited July 15, 2013).

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tional law, *pacta sunt servanda*, the agreement must be respected.¹²⁷ Initially, this principle was merely a matter of customary international law,¹²⁸ simply respected by states. By the 19th century, however, it was set forth in writing as an international legal obligation: first in the 1871 Declaration of London¹²⁹ and later in the Covenant of the League of Nations, calling for “a scrupulous respect for all treaty obligations,”¹³⁰ and the Charter of the United Nations, providing: “All Members, in order to ensure to all of them the rights and benefits resulting from membership, shall fulfill in good faith the obligations assumed by them in accordance with the present Charter.”¹³¹ Further, Article 26 of the Vienna Convention, entitled *Pacta Sunt Servana*, states: “Every treaty in force is binding upon the parties to it and must be performed by them in good faith.”¹³² Article 5 of the Vienna Convention provides that it “applies to any treaty which is the constituent instrument of an international organization and to any treaty adopted within an international organization . . .”¹³³

Even so, there are times when suspension or termination of a treaty is necessary and justified¹³⁴ under the doctrine of *rebus sic stantibus*.¹³⁵ In the case of suspension, a treaty is still valid, but its operation has been suspended, while in the case of treaty termination, the treaty no longer exists.¹³⁶ The Vienna Convention recognizes this notion and provides for both suspension¹³⁷ and termination of treaties.¹³⁸ A treaty may be terminated or denounced, or a party may withdraw from it only under the provisions of the treaty or under the terms of the Vienna Convention.¹³⁹

The situations under which a treaty may be suspended are set forth in Articles 57 and 58 of the Vienna Convention. Under Article 57(a), treaties can be suspended by resorting to the mechanisms set forth in the treaty. Most other treaties do not provide such language or mechanisms. In that event, all the contracting parties may agree to

¹²⁷ *Pact Sunt Servana*, INTERNATIONAL JUDICIAL MONITOR, September 2008, judicialmonitor.org/archive_0908/generalprinciples.html.

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ League of Nations Covenant pmbl.

¹³¹ U.N. Charter art. 2, para. 2.

¹³² Vienna Convention, *supra* note 92, art. 26.

¹³³ *Id.*, art. 5.

¹³⁴ KACZOROWSKA, *supra* note 34, at 127.

¹³⁵ BRIERLY, *supra* note 106, at 335.

¹³⁶ *Id.*

¹³⁷ Vienna Convention, *supra* note 92, art. 72.

¹³⁸ *Id.* art. 42(2).

¹³⁹ *Id.*

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suspend the treaty.¹⁴⁰ In the case of a multilateral treaty, parties can resort to any suspension mechanism mentioned in the treaty.¹⁴¹ In the absence of such a clause, and provided the treaty does not specifically prohibit it, a suspension as to one or more parties may be allowed if it would not deprive the other remaining contracting parties of the benefits of the treaty, would not adversely affect the performance of their treaty obligations, and would not be deemed incompatible with the object and purpose of the treaty.¹⁴²

Additionally “(a) treaty may be amended by agreement between the parties.”¹⁴³ As such, the Member States can change the obligations of any or all Member States. If the treaty does not have language regarding amendment, the Vienna Convention provides for notification and negotiations for the effect of any amendment.¹⁴⁴ A treaty and or any of its terms may be suspended, despite the fact that there may be no clause allowing for such suspension in the treaty itself.¹⁴⁵ A treaty may be terminated or a party may withdraw at any time, provided all the contracting parties consent.¹⁴⁶

If a party to a bilateral treaty commits a material breach of its obligations under the treaty, the non-breaching party is entitled to either terminate the treaty or suspend its operation in whole or in part.¹⁴⁷ In the case of multilateral treaties, however, there are a variety of treaty rights and obligations to contend with: the rights of the parties as a group and the rights of individual states.¹⁴⁸

With respect to multilateral treaties, The Vienna Convention provides:

2. A material breach of a multilateral treaty by one of the parties entitles:

(a) the other parties by unanimous agreement to suspend the operation of the treaty in whole or in part or to terminate it either:

(i) in the relations between themselves and the defaulting State; or

(ii) as between all the parties;

(b) a party specially affected by the breach to invoke it as a ground for suspending the operation of the treaty in

¹⁴⁰ *Id.* art. 57(b).

¹⁴¹ *Id.* art. 58.

¹⁴² *Id.* art. 58(1)(b)(i)-(ii).

¹⁴³ Vienna Convention, *supra* note 92, art. 39.

¹⁴⁴ *Id.* art. 40.

¹⁴⁵ *Id.* art. 72.

¹⁴⁶ *Id.* art. 54(b).

¹⁴⁷ *Id.* art. 60(1).

¹⁴⁸ KACZOROWSKA, *supra* note 34, at 131.

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whole or in part in the relations between itself and the defaulting State;

(c) any party other than the defaulting State to invoke the breach as a ground for suspending the operation of the treaty in whole or in part with respect to itself if the treaty is of such a character that a material breach of its provisions by one party radically changes the position of every party with respect to the further performance of its obligations under the treaty.

3. A material breach of a treaty, for the purposes of this article, consists in:

(a) a repudiation of the treaty not sanctioned by the present Convention; or

(b) the violation of a provision essential to the accomplishment of the object or purpose of the treaty.¹⁴⁹

As is evident, non-breaching Member States have a variety of actions at their disposal *vis à vis* the defaulting Member States, either by virtue of such default, or by virtue of the defaulting Member State having misrepresented its fiscal and monetary performance prior to such defaults. If a contracting party to a treaty finds it impossible to perform its obligations under a treaty, such party may invoke such impossibility for either terminating or withdrawing if that impossibility arises because of the permanent disappearance or destruction of something necessary for the execution of the treaty itself.¹⁵⁰ However, if the impossibility is temporary, such impossibility can only be invoked for suspending the operation of the treaty.¹⁵¹ Under international law, if the impossibility is a result of a breach by the party invoking impossibility, such impossibility may not be invoked for breaching either a treaty obligation or some other obligation owed to the another contracting party.¹⁵²

In general, the parts of a treaty are not separable and a party may not withdraw from or denounce a particular clause of a treaty unless the treaty so provides.¹⁵³ It is generally all or nothing,¹⁵⁴ unless

(a) the said clauses are separable from the remainder of the treaty with regard to their application;

(b) it appears from the treaty or is otherwise established that acceptance of those clauses was not an essential basis of the consent of the other party or parties to be

¹⁴⁹ Vienna Convention, *supra* note 92, art. 60(2)-(3).

¹⁵⁰ *Id.* art. 61(1).

¹⁵¹ *Id.*

¹⁵² *Id.* art. 61(2).

¹⁵³ *Id.* art. 44.

¹⁵⁴ Vienna Convention, *supra* note 92.

bound by the treaty as a whole; and (c) continued performance of the remainder of the treaty would not be unjust.¹⁵⁵

It is suggested that, inasmuch as the EU existed for some years prior to the birth of the Euro, and since there are a number of Member States who are not currently using the Euro, those portions of the EU treaties—particularly the Lisbon Treaty—which deal with the Euro, may be “separable from the remainder of the treaty.”¹⁵⁶

The proposition that *sovereign states* are those who traditionally have entered into treaties is an important one in this analysis. Under international law, states have the ability to make all manner of agreements, but particular principles have evolved to ensure that persons representing states have the necessary power to enter into a treaty.¹⁵⁷ Where exactly the power to enter into treaties is vested is generally a matter of each state’s internal laws.¹⁵⁸ As an example, in the United States, the President, with the advice and consent of the Senate, has the power to enter into treaties.¹⁵⁹ Likewise in Mexico, the President has the power to enter into treaties that then must be ratified by the Senate.¹⁶⁰

SOVEREIGNTY

Some influential commentators have suggested that the Member States have relinquished sovereignty to a substantial degree.¹⁶¹ In fact, so much so that the treaties that make up the European Union, on the one hand, and the European Court of Justice (ECJ) on the other, work in tandem, to create a constitutional framework, much like that of the United States Constitution, so that withdrawal is not an option.¹⁶² The argument continues that, for one to believe that the Member States have retained sovereignty to the extent that they can withdraw, one would have to believe in “an extreme and largely obsolete concept of sovereignty” under public international law.¹⁶³ The ECJ itself has said that “the transfer by the States from their domestic

¹⁵⁵ *Id.* art. 44(3).

¹⁵⁶ *Id.* art. 44(3)(a).

¹⁵⁷ SHAW, *supra* note 83, at 908.

¹⁵⁸ *Id.*

¹⁵⁹ U.S. CONST. art. II, § 2.

¹⁶⁰ Constitución Política de los Estados Unidos Mexicanos [C.P.], art. 89, Diario Oficial de la Federación [DO], 5 de Febrero de 1917 (Mex.).

¹⁶¹ Phoebus Athanassiou, *Withdrawal and Expulsion from the EU and EMU: Some Reflections* 1, 5 (European Central Bank, Working Paper No. 10, 2009) available at <http://www.ecb.int/pub/pdf/scplps/ecblwp10.pdf>.

¹⁶² *Id.* at 15.

¹⁶³ *Id.*

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legal system to the Community legal system of the rights and obligations arising under the Treaty carries with it a permanent limitation of their sovereign rights.”¹⁶⁴

Can this notion of a permanent relinquishment of sovereignty be plausible? Can it be accurate, especially in light of the Lisbon Treaty? Could it have been the case even before the construction of the Treaty of Lisbon? We suggest that, however much certain actors within the European Union may argue otherwise, there is evidence to uphold the argument that the Member States retain their sovereignty. We suggest, therefore, that such a proposition is not based on an obsolete notion of sovereignty.

It has been settled law for some time that “(t)here is a presumption against derogation from sovereign freedom of action,”¹⁶⁵ and “(if) the wording of a treaty provision is not clear, in choosing between several admissible interpretations, the one which involves the minimum of obligations for the Parties should be adopted.”¹⁶⁶ This presumption disappears only if there is a clear, express intention to restrict sovereignty.¹⁶⁷ The oft cited international jurists, Charles Rousseau and Hans Kelsen, both believe that any notion of limited sovereignty is simply a contradiction in terms, as they believe sovereignty, by its very nature, is absolute.¹⁶⁸ Of course, this view admits that a sovereign state is still subject to what they then called the “law of nations,” or what is today “international law.”¹⁶⁹ It is a general principle that being subject to international law does not diminish a state’s independence or sovereignty.¹⁷⁰

By looking at what has actually happened “on the ground” in Europe, it is evident that the Member States have relinquished only so much sovereignty as to make the system work. Member States who have joined the Euro Zone have “surrender(ed) their monetary sovereignty to the Community.”¹⁷¹ However, those Member States with

¹⁶⁴ Case 6/64 *Costa v ENEL*, 1964 E.C.R. 585, 594.

¹⁶⁵ D.P. O’CONNEL, *INTERNATIONAL LAW* 256 (2d ed. 1970).

¹⁶⁶ Article 3, Paragraph 2 of the Treaty of Lausanne (Frontier Between Turkey and Iraq), Advisory Opinion, 1925 P.C.I.J. (ser. B) No. 12, at 12 (Nov. 21).

¹⁶⁷ O’CONNEL, *supra* note 165, at 257; *see also* S.S. Wimbledon (U.K. v. Japan), 1923 P.C.I.J. (ser. A) No. 1, at 114 (Aug. 17).

¹⁶⁸ CARLOS ARRELLANO GARCÍA, *PRIMER CURSO DE DERECHO INTERNACIONAL PÚBLICO* 143 (4th. ed. 1999).

¹⁶⁹ *Id.* at 153.

¹⁷⁰ SHAW, *supra* note 83, at 181.

¹⁷¹ Erich Vranes, *The “Internal” External Relations of EMU on the Legal Framework of the Relationship of “In” and “Out” States*, 6 *COLUM. J. EUR. L.* 361, 365 (2000).

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derogation “retain their monetary policy powers according to national law.”¹⁷²

Commentators believe that one of the primary reasons for the failure to ratify the Draft Treaty Establishing a Constitution for Europe was a concern on the part of many Member States that it would require them to relinquish too much sovereignty.¹⁷³ That was the reason for the negotiation and drafting of the Treaty of Lisbon, which eliminated many of the trappings of statehood that the draft constitution seemed to give the European Union, and thus allayed many fears.¹⁷⁴

Some even say a “British exit from the European Union looks increasingly possible.”¹⁷⁵ Pressure is mounting in the United Kingdom for the government to call a referendum on continued membership.¹⁷⁶ The British Prime Minister appears ready to warn the world of that clear possibility.¹⁷⁷ That is hardly the position of a state that believes that it has relinquished sovereignty or that it has no options, having signed the various treaties creating the European Union.

At least one commentator has suggested that a reason behind, or secondary result of the creation by the Lisbon Treaty of the position of High Representative and Vice President of the European Commission in one person and then the election/appointment of a person to the post considered a light weight or “weak” player, was so that the person in the position would not overshadow the discreet Member States.¹⁷⁸ It seems that the EU Member States want the “high representative to be their servant, not their rival.”¹⁷⁹ Despite the creation of the foreign policy mechanisms of the Lisbon Treaty, Member States are left to set and implement their own foreign policy agendas.¹⁸⁰ Whether this has

¹⁷² *Id.* at 366.

¹⁷³ See Georgio Maganza, *The Lisbon Treaty: A Brief Outline*, 31 FORDHAM INT’L L.J. 1603 (2007-08); see also Anthony Luzzatto Gardner & Stuart E. Eizenstat, *New Treaty, New Influence?* 89 FOREIGN AFF. 104 (2010).

¹⁷⁴ Maganza, *supra* note 173, at 1610-13

¹⁷⁵ *Britain’s Future: Goodbye Europe*, THE ECONOMIST, Dec. 8, 2012, available at <http://www.economist.com/news/leaders/21567940-british-exit-european-union-looks-increasingly-possible-it-would-be-reckless>.

¹⁷⁶ *Britain and Europe: Making the Break*, THE ECONOMIST, Dec. 8, 2012, available at <http://www.economist.com/news/briefing/21567914-how-britain-could-fall-out-european-union-and-what-it-would-mean-making-break>.

¹⁷⁷ John F. Burns & Alan Cowell, *Cameron Warns that Britain Could Leave European Union*, N.Y. TIMES, Jan. 19, 2013, available at http://www.nytimes.com/2013/01/19/world/europe/david-cameron-delays-talk-on-new-role-in-europe.html?_r=0.

¹⁷⁸ Desmond Divan, *Governance and Institutions: Implementing the Lisbon Treaty in the Shadow of the Euro Crisis*, 49 J. COMMON MARKET STUD. 103, 112 (2011).

¹⁷⁹ Gardner & Eizenstat, *supra* note 173, at 104.

¹⁸⁰ *Id.* at 110.

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come about because of the election and appointment of individuals or because of the terms of the Treaty itself is a matter of conjecture.

The Treaty on European Union, known as the Maastricht Treaty, states that:

The Union shall respect the equality of Member States before the Treaties as well as their national identities, inherent in their fundamental structures, political and constitutional, inclusive of regional and local self-government. It shall respect their essential State functions, including ensuring the territorial integrity of the State, maintaining law and order and safeguarding national security. In particular, national security remains the sole responsibility of each Member State.¹⁸¹

Thus, domestic constitutional courts—high courts within the Member States—are permitted to set limits on the primacy of the law of the European Union as to themselves;¹⁸² in other words, such courts and their States retain legal sovereignty. So that this multi-level constitutional structure¹⁸³ does not provide for a wholly subordinated set of Member States, they are considered sovereign states, even though they are members of a union, which provides for substantial benefits. Accordingly, it can be cogently argued that there are ways out of or around treaty obligations respecting either continued membership in the European Union, the EMU, or both.

TREATY OF LISBON MODIFICATIONS

A. *Background*

On November 3, 2009, President Vaclav Havel of the Czech Republic signed the Treaty of Lisbon. With that signature, the Treaty of Lisbon cleared the last procedural hurdle to its effectiveness.¹⁸⁴ Ratification of the treaty by a sufficient number of Member States marked the end of a long and arduous process. However, initial intentions differed.

This process first began in 2001, with negotiations for the adoption of a constitution for the European Union.¹⁸⁵ This constitu-

¹⁸¹ See Maastricht Treaty, *supra* note 40, art. 4(2).

¹⁸² Armin von Bogdandy & Stephan Schill, *Overcoming the Absolute Primacy: Respect for National Identity Under the Lisbon Treaty*, 48 *COMMON MKT. L. REV.* 1417, 1417 (2011).

¹⁸³ See *id.*

¹⁸⁴ Dan Bilefsky & Stephen Castle, *European Union Reform Moves Ahead*, *N.Y. TIMES*, Nov. 3, 2009, <http://www.nytimes.com/2009/11/04/world/europe/04europe.html>.

¹⁸⁵ *Id.*

tion was intended to give the European Union many of the trappings of statehood—a president, a foreign minister, and even a public prosecutor (akin to an attorney general), as well as a flag and national anthem.¹⁸⁶ In addition, the Constitutional Treaty would replace the complex web of international agreements, which form the legal basis for the European Union.¹⁸⁷ Though executed by representatives of each of the Member States with great fanfare, the Constitutional Treaty was far from complete, since it required ratification by the national legislatures of each of the then twenty-five Member States.¹⁸⁸ In the end, only eighteen of the Member states ratified the Constitutional Treaty.¹⁸⁹

The constitution was never implemented. In the years following the adoption of the treaty, public sentiment in a number of Member States turned against the treaty, with skeptics fearing that the constitution would unduly impinge upon national sovereignty.¹⁹⁰ Ultimately, efforts to implement the Constitutional Treaty collapsed when France and the Netherlands rejected the treaty in national referenda.¹⁹¹ Following this event, European leaders went back to the drawing board, began deliberations on a replacement treaty, and produced the Treaty of Lisbon.¹⁹²

Rather than replacing the prior European Union documents in their entirety, the Treaty of Lisbon took a more modest approach by amending the existing European Union treaty documents but otherwise leaving those treaties in place.¹⁹³ Though it included many of the same concepts that were included in the Constitutional Treaty, most importantly, the Treaty of Lisbon did not call itself a “constitution,” as proponents sought to avoid the same political upheaval that doomed the Constitutional Treaty.¹⁹⁴ It also dropped all references to the symbols of the EU—the flag, the national anthem, and the motto—all matters closely associated with the relinquishment of Member States’

¹⁸⁶ Thomas Fuller & Katrin Bennhold, *Leaders Reach Agreement on a European Constitution*, N.Y. TIMES, June 14, 2004, <http://www.nytimes.com/2004/06/19/world/leaders-reach-agreement-on-a-european-constitution.html>.

¹⁸⁷ *Id.*

¹⁸⁸ *Id.*

¹⁸⁹ Maganza, *supra* note 173, at 1603-04 (discussing adoption and ratification process).

¹⁹⁰ *Id.* at 1604.

¹⁹¹ Marlise Simmons, *Dutch Voters Solidly Reject New European Constitution*, N.Y. TIMES, June 2, 2005, <http://travel.nytimes.com/2005/06/02/international/europe/02dutch.html>.

¹⁹² Maganza, *supra* note 173, at 1603.

¹⁹³ *Id.* at 1609.

¹⁹⁴ *Id.* at 1608-09.

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individual identity and sovereignty to a higher authority, issues thought to be political hot buttons.¹⁹⁵

B. Article I-60 of the Constitutional Treaty – A Path to Withdrawal

During the deliberations for the Constitutional Treaty, the Member States negotiated the provision for voluntary withdrawal of a Member State. As stated above, prior to efforts to implement the Constitution, it was generally accepted wisdom that there was no unlimited right of a Member State to withdraw from the EU.¹⁹⁶ The Constitutional Treaty negotiations sought to clarify this matter, and if it were ever true, to change it. There was extensive discussion and debate regarding the final language of the withdrawal provision.¹⁹⁷ Ultimately, the final text of Article I-60 of the Constitution Treaty stated:

Voluntary withdrawal from the Union

1. Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements.

2. A Member State which decides to withdraw shall notify the

European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union.

That agreement shall be negotiated in accordance with Article III-325(3). It shall be concluded by the Council, acting by a qualified majority, after obtaining the consent of the European Parliament.

3. The Constitution shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the no-

¹⁹⁵ Q&A: *The Treaty of Lisbon*, BBC NEWS, <http://news.bbc.co.uk/2/hi/europe/6901353.stm> (last visited Oct. 23, 2012).

¹⁹⁶ Jochen Herbst, *Observations on the Right to Withdraw from the European Union: Who are the "Masters of the Treaties?"*, 6 GERMAN L. J. (SPECIAL ISSUE) 1755-59, 1755 (2005), available at http://www.germanlawjournal.com/pdfs/Vol06No11/PDF_Vol_06_No_11_1755-1760_Special%20Issue_Herbst.pdf (discussing right to withdraw under Constitutional Treaty).

¹⁹⁷ *Id.* at 1756 (referencing the numerous proposed amendments to the proposed Constitution and related documentation which are available at <http://european-convention.eu.int/EN/amendments/amendmentsdfd1.html?content=46&lang=EN>).

tification referred to in paragraph 2, unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period.

4. For the purposes of paragraphs 2 and 3, the member of the European Council or of the Council representing the withdrawing Member State shall not participate in the discussions of the European Council or Council or in European decisions concerning it.

A qualified majority shall be defined as at least 72% of the members of the Council, representing the participating Member States, comprising at least 65% of the population of these States.

5. If a State which has withdrawn from the Union asks to rejoin, its request shall be subject to the procedure referred to in Article I-58.¹⁹⁸

Member States seemed concerned about relinquishing sovereignty, and it is apparent that the exit provision was a critical aspect of the Constitutional Treaty. Inserting an exit clause in a constitutive document is not a novel idea. For example, Joseph Stalin's 1936 constitution for the Soviet Union established an exit right for its Member States.¹⁹⁹ Similarly, Canada's Supreme Court concluded that a province could secede from the Canadian Confederation, subject to negotiation of the terms of secession by way of an amendment to the Canadian Constitution.²⁰⁰ Contrast this with the United States Constitution, which provides no such express right, though this did not prevent the U.S. from fighting a bloody civil war to resolve the debate about whether an implied right of withdrawal existed.²⁰¹ Nevertheless, when considering the enhanced federal powers for the EU contemplated by the Constitutional Treaty, it is not surprising that Member States would be hesitant about committing to this new structure without reserving a way to pull out if circumstances change.

In general, withdrawal mechanisms in international federations fall into three broad categories: (1) state primacy; (2) federal pri-

¹⁹⁸ Treaty Establishing a Constitution for Europe art. I-60, June 14, 2004, 2004 O.J. (C310) 1, available at http://news.bbc.co.uk/2/shared/bsp/hi/pdfs/09_01_05_constitution.pdf.

¹⁹⁹ WHAT THE EU CONSTITUTION DOES: A 14 POINT CRITICAL SUMMARY, NATIONAL PLATFORM EU RESEARCH & INFORMATION CENTRE (Mar. 2005), available at <http://www.europarl.europa.eu/inddem/docs/papers/14%20point%20summary.pdf>.

²⁰⁰ Anthony DePalma, *Canadian Court Rules Quebec Cannot Secede on its Own*, N.Y. TIMES, Aug. 21, 1998, available at <http://www.nytimes.com/1998/08/21/world/canadian-court-rules-quebec-cannot-secede-on-its-own.html>.

²⁰¹ U.S. CONST.



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macy; and (3) federal control.²⁰² First, state primacy would provide “an absolute, immediate and unilateral right for a Member State to withdraw from the federation.”²⁰³ Second, a federal primacy model would conversely absolutely prohibit any Member State from withdrawing, “effectively making membership a one-way valve.”²⁰⁴ Lastly, a federal control approach, on the one hand, would recognize the sovereign right of the Member State to withdraw but, on the other hand, would condition such withdrawal upon a mutual agreement between the departing Member and those remaining, establishing the terms for such withdrawal along the lines of the Canadian system.²⁰⁵

Article 50 adopts a federal control approach. A Member State can decide to withdraw unilaterally in accordance with the provisions of its state constitution.²⁰⁶ Once this decision is made, the Member State notifies the European Council. The EU then must negotiate an agreement with the seceding Member, “setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union.”²⁰⁷ However, the negotiation period is not open ended. The withdrawal automatically becomes effective two years following the date of notification of the decision of the Member State to withdraw, regardless of whether the agreement on the terms of withdrawal has been finalized, with such two-year period only subject to extension if the withdrawing Member and the European Council unanimously agree.²⁰⁸ Ultimately, the agreement requires the approval of a so-called “qualified majority” of the European Council (i.e. 72% of the members of the European Council, representing Member States comprising at least 65% of the population of the voting Members), after obtaining the consent of the European Parliament.

C. *Article 50 of the Treaty of Lisbon*

Article 50 of the Treaty of Lisbon carried forward the withdrawal provisions of the Constitutional Treaty, with insignificant modifications, virtually leaving the Constitution’s escape clause intact. The following is a comparison between the text of Article 50 of the Treaty of Lisbon with its predecessor, Article I-60 of the Constitutional

²⁰² Raymond J. Friel, *Providing a Constitutional Framework for Withdrawal from the EU: Article 59 of the Draft European Constitution*, 53 *INT’L & COMP. L.Q.* 407, 422 (2004) (discussing framework for withdrawal mechanism).

²⁰³ *Id.*

²⁰⁴ *Id.*

²⁰⁵ *Id.* at 423.

²⁰⁶ Treaty of Lisbon, *supra* note 7, art. 50(1).

²⁰⁷ *Id.* art. 50(2).

²⁰⁸ *Id.* art. 50(3).

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Treaty (note that deletions are shown by ~~striketrough~~ and additions are shown by underlining):²⁰⁹

~~Constitutional~~ Treaty of Lisbon

Article I-6050

~~Voluntary withdrawal from the Union~~

1. Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements
2. A Member State which decides to withdraw shall notify the European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. That agreement shall be negotiated in accordance with Article ~~III-325(3)~~218(3) of the Treaty on the Functioning of the European Union. It shall be concluded on behalf of the Union by the Council, acting by a qualified majority, after obtaining the consent of the European Parliament.
3. The Constitution *Treaties* shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that two years after notification referred to in paragraph 2, unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period.
4. For the purposes of paragraphs 2 and 3, the member of the European Council or of the Council representing the withdrawing Member State shall not participate in the discussions of the European Council or Council or in European decisions concerning it.

A Qualified majority shall be defined as ~~at least 72% of the members of the Council representing the participating Member States,~~ comprising at least 65% of the population of these States, in accordance with Article 238(3)(b) of the Treaty on the Functioning of the European Union.

²⁰⁹ While these markings may appear to be Track Changes that have not been accepted, they actually amount to purposeful changes that are still marked in order to show the changes that the Treaty drafters made.

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5. If a State which has withdrawn from the Union asks to rejoin, its request shall be subject to the procedure referred to in Article I-58-49.

Note that the definitions of “qualified majority” in each provision function essentially in the same manner. Though the definition of “qualified majority” in the TFEU²¹⁰ has a number of meanings, in the case of a withdrawing Member, the voting process on the European Council would be identical to the Constitutional Treaty, which requires approval by 72% of the members of the European Council, representing Member States comprising at least 65% of the population of the voting Members.²¹¹

UNDERSTANDING THE WITHDRAWAL MECHANISM

A. *Withdrawal Under International Law*

What exactly do we mean by the term “withdraw”? There are thirteen references to the word “withdraw” (or variations thereof) in the Treaty of Lisbon, the TFEU.²¹² Six of these thirteen references appear in Article 50; references to the word “withdraw” in other parts of the documents are related to other issues.²¹³ However, nowhere in either document, or in the Constitutional Treaty, is the term “withdraw” defined. Even though the Vienna Convention on the Law of Treaties mentions the term more than 30 times, it does not define the term with any exactitude either. When the Vienna Convention uses the term, however, it is normally in conjunction with the terms terminating and suspending.²¹⁴

The Vienna Convention does say that a party must give at least 12 months’ notice prior to denunciation or withdrawal.²¹⁵ *Black’s Law Dictionary* defines “withdrawal” as “the act of taking back or away; withdrawal of consent; the act of retreating from a place, position or situation; . . . Renunciation.”²¹⁶ Therefore, the common legal usage of

²¹⁰ See generally Consolidated Version of the Treaty on the Functioning of the European Union, May 9, 2008, 2008 O.J. (C115) 47 [hereinafter TFEU].

²¹¹ *Id.* art. 15.

²¹² See generally *id.*

²¹³ *E.g.*, Article 7(2) of the TFEU refers to withdrawal of proposed legislation in the European Parliament, while Article 78(2)(d) of the TFEU refers to “common procedures for the granting and withdrawing of uniform asylum or subsidiary protection status.” *Id.* art. 7(2); *id.* art. 78(2)(d).

²¹⁴ See, *e.g.*, Vienna Convention, *supra* note 92, art. 61.

²¹⁵ *Id.* art. 56, para. 2.

²¹⁶ BLACK’S LAW DICTIONARY 712 (9th ed. 2009). Note that other related definitions in the dictionary refer to removing funds from a banking institution, exiting from a criminal conspiracy, and other irrelevant usages of the term.

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the term, except perhaps for the idea of “renunciation,” is unhelpful to our analysis.

B. Meaning of Article 50

The question then is what did the framers of the Treaty of Lisbon (and the Constitutional Treaty) intend in Article 50? Did they mean that the electing Member State may decide to leave the EU in its entirety? Or, did they intend to allow for a partial withdrawal, such as removing the Member State from certain aspects of the EU, but remaining part of the EU for other purposes? This article addresses the proposition or the possibility of whether the withdrawing Member State can elect to withdraw solely from the EMU and remain part of the EU for all other purposes. After all, the language does provide, in the case of withdrawal negotiation, that an agreement is to be reached regarding the withdrawing state’s “future relationship with the Union.”

C. Consensus Among Commentators

One commentator has concluded that Article 50 is intended to be an “all or nothing” proposition.²¹⁷ Under this theory, when a Member State seeks to “withdraw” under Article 50, that Member State is electing to leave the EU in its entirety, including all of the EU’s associated organizations and subsets, including the Euro. The arguments against permitting an interpretation which would allow selective withdrawal from aspects of the EU fall into three general categories: textual, procedural, and practical.

The textual critics take a “strict constructionist” approach towards the text of Article 50. They argue that the text is clear; the phrase “withdraw from the Union” in Article 50(1) means secession from the entire Union. Their argument continues, that had the drafters intended to allow the electing Member State to withdraw from only aspects of the EU, such as the EMU, they would have specifically provided for that inside the text of the provision.²¹⁸ Supporting this view is the language of Article 50(3), which provides that “[t]he *Treaties* shall cease to apply to the State in question . . .” (Emphasis added). This provision implies that *all* of the EU treaties will cease to apply to the withdrawing state, not *some* of them. Textual commentators argue that any other interpretation of the text would “amount to a very ex-

²¹⁷ Hans Hofmeister, *Goodbye Euro: Legal Aspects from Withdrawal from the Euro Zone*, 18 COLUM. J. EUR. L. 111, 131 (Fall 2011) (discussing interpretation of Article 50 text).

²¹⁸ *Id.* at 132.

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tensive reading of this provision and exceed the limits of jurisprudential interpretation.”²¹⁹

The procedural arguments focus on the language in Article 50(2). This language provides for the negotiation of “an agreement with the [withdrawing] State setting out the arrangements for its withdrawal” and the requirement of Article 50(3), which mandates that such an agreement be finalized within “two years” after the Member State initially notifies the European Council of its decision to withdraw.²²⁰ The two-year deadline provided for in the text, these critics argue, would prevent an interpretation that the provision was meant to intend for the negotiated agreement to provide for partial or selective membership in the EU. The reasoning is that the agreement is not mandatory: if it is never signed, the withdrawal takes place anyway. Thus, the withdrawing Member State could not reasonably expect to utilize Article 50 to exit only the EMU, because if an agreement is never finalized, the withdrawal would take place and the only conclusion is that the withdrawal would be comprehensive.²²¹ Supporting this conclusion is the language in Article 50(5), which provides that a Member State that elects withdrawal, but later changes its mind, must reapply for membership in the EU as if it were a new applicant.²²²

Those who take a practical approach fear the “slippery slope” that selective withdrawal from the EU could allow. One commentator points to the nebulous “agreement” that must be negotiated following an election to withdraw and responds to suggestions that the negotiation phase of the agreement is intended to allow the departing state to choose which EU institutions to keep and which to discard.²²³ The argument continues that this approach is “questionable, not least from a public policy perspective,”²²⁴ in that allowing a departing nation to “pick and choose” among which treaty obligations to retain and which to ignore would “effectively encourage an *à la carte* approach to EU participation” in general.²²⁵ This would work against the philosophical underpinnings of the EU in the sense that, by joining the EU, the Member States were making an irreversible commitment to European unity and discarding the outdated prejudices of nationalism.²²⁶ Moreover, this “would pose a qualitatively different and arguably intolerable

²¹⁹ *Id.*

²²⁰ Treaty of Lisbon, *supra* note 7, art. 50(2)-(3).

²²¹ Hofmeister, *supra* note 217, at 125-26.

²²² Treaty of Lisbon, *supra* note 7, art. 50(5).

²²³ *See* Athanassiou, *supra* note 161, at 39.

²²⁴ *Id.*

²²⁵ *Id.*

²²⁶ *See generally* Callender, *supra* note 4.

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challenge to the EU's integrity and sustainability,"²²⁷ in that it may encourage Member States to seek selective participation in the EU in other areas as well.

THE ARGUMENT FOR SELECTIVE WITHDRAWAL

A. *Answering the Critics*

Nevertheless, there are ample arguments to refute each of the concerns raised by those skeptical about interpreting Article 50 to allow selective withdrawal from the EU. There is considerable textual evidence that selective withdrawal may have been contemplated in the adoption of Article 50.²²⁸ Similarly, one may raise procedural arguments in support of a selective withdrawal mechanism.²²⁹ Lastly, there are significant practical reasons for why a selective withdrawal framework may benefit the EU and contribute to the survival of the EMU.²³⁰

B. *The Textual Argument*

Regarding the negotiation of the agreement for withdrawal, Section 2 of Article 50 provides that:

In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of *the framework for its future relationship with the Union* (emphasis added).²³¹

By including the phrase "framework for its future relationship," the drafters "thus assume that some kind of (legal) relationship will still remain between the Union and the withdrawing member state even after the withdrawal has come into effect."²³² Therefore, if the drafters contemplated some future association, it seems logical to explore whether the Member State could remain part of some EU institutions following its election to secede from the EU—all of which would be specified in the withdrawal agreement. Moreover, if some form of continuing involvement is in fact contemplated, it is not much of a leap to contend that continued participation by the withdrawing Member State in many EU institutions, with the exception of the EMU, would

²²⁷ Athanassiou, *supra* note 161, at 40.

²²⁸ See generally Herbst, *supra* note 196.

²²⁹ *Id.*

²³⁰ *Id.*

²³¹ Treaty of Lisbon, *supra* note 7, art. 50.

²³² Herbst, *supra* note 196, at 1757.

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be considered during the negotiation of any such withdrawal agreement. As stated above, there are currently Member States who do not use the Euro.²³³ The terms of the agreement are not limited in the text and could be far reaching to include creative and expansive provisions implementing a strong and multi-faceted relationship between the EU and the withdrawing member.

C. *The Procedural Argument*

Unfortunately, Section 3 provides specifically that “[t]he Treaties shall cease to apply” to the withdrawing member state.²³⁴ The use of this phrase seems to foreclose the possibility of selective application of some of the EU treaties following withdrawal, therefore prohibiting partial “membership” pursuant to the existing Treaties. Section 5 of Article 50 supports this interpretation, in that it requires that if a withdrawing member changes its position on withdrawal, it must reapply to the EU as if it were a brand new applicant for membership.²³⁵

However, though the withdrawing Member cannot retain its status as a Member state pursuant to the treaties within the framework of Article 50, by providing for a “future relationship,” the framers of the Article left open the possibility of continued involvement by the withdrawing Member with some EU institutions. Since the terms of the agreement are not delineated in Article 50, there is no reason that such an agreement cannot take the form of a new treaty between the EU and its remaining Members, on the one hand, and the withdrawing Member State on the other hand, thus replacing the “Treaties” referenced in Section 3. A new treaty could, therefore, effectively allow for the continuation of some of the EU institutions for the benefit of the withdrawing Member State and its citizens.

In addition, Section 3, which provides that “[t]he Treaties shall cease to apply,”²³⁶ and Section 2, which provides for a “future relationship”²³⁷ between the withdrawing Member and the EU, can be harmonized. One can argue that by not providing that *all* of the Treaties shall cease to apply, the drafters allowed for the possibility that *some* of the Treaties could continue to apply. In this vein, the agreement contemplated by Section 2 would then establish which of the Treaties or treaty provisions would continue to apply to the withdrawing Member State. However, “such an interpretation would amount to a very

²³³ See *supra* notes 125, 156 and accompanying text.

²³⁴ Herbst, *supra* note 196, at 1757.

²³⁵ Treaty of Lisbon, *supra* note 7, art. 50(5).

²³⁶ *Id.* art. 50(3).

²³⁷ *Id.* art. 50(2).

extensive reading of this provision and exceed the limits of jurisprudential interpretation.”²³⁸

Lastly, some commentators point to the two-year deadline imposed by Section 3 as support for their argument against selective withdrawal.²³⁹ Section 3 provides that if the withdrawal agreement is not concluded within two-years following the withdrawing Member State’s election to withdraw, the withdrawal becomes effective automatically.²⁴⁰ This deadline, they argue, effectively makes the withdrawal agreement optional, rather than mandatory and, because it is optional, withdrawal from some (but not all) of the EU institutions was never contemplated. Departing a “highly complex institution such as the EMU,” one scholar writes, “requires a detailed agreement, specifying the legal consequences for the parties concerned.”²⁴¹ In essence, reconfiguring the European monetary system is too dangerous a task to be left to an optional agreement.

The deadline argument, however, does not appear to be persuasive. The drafters needed some deadline, if only to be an incentive to the negotiators to conclude their deliberations on the withdrawal terms. Instituting a deadline should not be interpreted to mean that the agreement is itself insignificant or that the scope of such an agreement was meant to be limited in any way. In fact, Section 3 of Article 50 allows the European Council, albeit unanimously, and the withdrawing Member to extend the deadline if needed.²⁴²

D. *The Practical Argument*

An exit from the European Union is not unprecedented. Greenland, formerly a colony of Denmark and then a part of Denmark, was allowed to exit the European Union.²⁴³ Greenland submitted a formal request for withdrawal and then negotiated that withdrawal and its subsequent status.²⁴⁴ In fact, due to the monetary crisis in

²³⁸ Hofmeister, *supra* note 217, at 132.

²³⁹ See generally *id.*

²⁴⁰ *Id.* at 125-26.

²⁴¹ *Id.* at 133.

²⁴² Treaty of Lisbon, *supra* note 7, art. 50(3).

²⁴³ See The Greenland Treaty of 1985, Jan. 1, 1985, 1985 O.J. (I 29) 1, available at <http://eu.nanoq.gl/Emner/EuGI/-/media/419EF30F356645048639049D197273D3.ashx>.

²⁴⁴ *Id.* (“A referendum was held in 1982 and a majority voted in favour of withdrawal. Between 1982 and 1984 the terms were negotiated and on February 1, 1985 Greenland formally withdrew from the Community. A Treaty on Greenland’s withdrawal from the Community was made – the Greenland Treaty – declaring Greenland as a “special case. This special case provided a fisheries agreement between the parties, in which the EU kept its fishing rights and Greenland kept its financial contribution as before withdrawal. It also gave Greenland tariff free

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Cyprus, Cyprus nearly left the Euro.²⁴⁵ *The Wall Street Journal* recently stated that, absent a viable bailout scheme, Cyprus “could find itself with little choice but to leave the Euro zone.”²⁴⁶ Cyprus negotiated a memorandum of understanding with the European Commission, the European Central Bank, and the IMF in November of 2012, requiring cost cutting measures. That has not worked.²⁴⁷ The negotiations to secure a bailout deal have been rancorous,²⁴⁸ and a deal was again reached on March 24, 2013.²⁴⁹ All are hopeful that the bailout will work. The larger Euro Zone countries, such as Germany, have been willing to take a hard line approach with Cyprus.²⁵⁰ A potential exit from the Euro, whether forced or voluntary on the part of Cyprus, points to neither an iron clad treaty (with no potential for being forced out in the event such a forced exit were to occur) nor a loss of sovereignty in the latter case of a voluntary exit. There is now pressure mounting on Malta and Slovenia to put their economic and monetary houses in order and there has even been talk of expulsion from the EMU if they do not.²⁵¹

Article 50 has textual shortcomings, including problems relating to timing, lack of specificity, and provisions that appear internally inconsistent. However, despite the assertions of other commentators to the contrary, there is sufficient ambiguity in the text and mechanics of Article 50 to contend that a Member can effectively accomplish a

access of fisheries products to the EU as long as there exists a satisfactory fisheries agreement.”).

²⁴⁵ See Mark Memmott, *Cypriots Are Suspicious, but Bailout Deal Seems Set*, NPR, March 25, 2013.

²⁴⁶ See Charles Forelle, Matina Stevis & David Enrich, *Clock Ticks on Cyprus*, WALL. ST. J., Mar. 22, 2013, at A1.

²⁴⁷ See Nikolas Kulish, *conservative is Elected President in Cyprus*, N.Y. TIMES Feb. 24, 2013, available at http://www.nytimes.com/2013/02/25/world/europe/conservative-candidate-elected-president-in-cyprus.html?_r=0.

²⁴⁸ See *A Bungled Bank Raid*, THE ECONOMIST, Mar. 23, 2013, at 75; see also Liz Alderman, *Rejection of Deposit Tax Scuttles Deal on Bailout for Cyprus*, N.Y. TIMES, Mar. 19, 2013, http://www.nytimes.com/2013/03/20/business/global/cyprus-rejects-tax-on-bank-deposits.html?_r=0; see also Von Sebastian Jost, Karsten Seibel & Dorothea Siems, *Large investors Lose up to 90 percent in Cyprus*, DIE WELT, Mar. 23, 2013, available at <http://www.welt.de/wirtschaft/article114760715/Grossanleger-verlieren-auf-Zypern-bis-zu-90-Prozent.html>.

²⁴⁹ James Kanter, Liz Alderman & Andrew Higgins, *E.U. Officials Agree to a Deal Rescuing Cyprus*, N.Y. TIMES, Mar. 24, 2013, available at <http://www.nytimes.com/2013/03/25/business/global/cyprus-and-europe-officials-agree-on-outlines-of-a-bailout.html?pagewanted=all>.

²⁵⁰ See Thomas Straubhaar, *Why the Hard Line Against Cyprus Is Proper*, DIE WELT, Mar. 26, 2013, <http://www.welt.de/wirtschaft/article114767497/Warum-die-harte-Linie-gegen-Zypern-richtig-ist.html>.

²⁵¹ See NPR News, Apr. 4, 2013.

partial withdrawal from the EU. This withdrawal may take the form of a new agreement or treaty between the EU and the departing Member, which would establish the terms and obligations for a revised relationship. That being said, if the current crisis revolves around the Euro, it behooves European leaders to explore legal avenues which would solve the source of the problem rather than resorting to legal formalities to support an all or nothing approach to EU membership.

Also, something must be said for the nature of the EMU as opposed to other EU institutions. Certain Members, such as England and Denmark, opted out from adopting the Euro.²⁵² These two States negotiated separate arrangements for the right to remain outside the EMU,²⁵³ which demonstrated that the Euro was never intended to be a “one size fits all” solution. Similarly, though the EU treaties envision that all Member States will eventually become part of the EMU, the treaties require the fulfillment of four so-called “convergence criteria” before these states can become part of the Euro.²⁵⁴ Currently, there are 10 Member States which have either opted out, or are considered Member States “with a derogation,” meaning that they have not yet achieved the convergence criteria.²⁵⁵ This is an interesting, yet problematic matter. Sweden, for example, despite clear requirements and textual exhortations otherwise,²⁵⁶ appears not to be willing to adopt the Euro.²⁵⁷ This appears to be a clear breach of the treaty, not simply a situation where a Member State has taken advantage of a legal loophole.²⁵⁸ It seems, therefore, that the decision making process respecting EMU membership is either flawed or lenient. It has been argued, as mentioned above, that neither Italy nor Belgium met the convergence criteria, yet were still admitted.²⁵⁹ Would they or should they be equally lenient with those Member States who might wish to renegotiate either their EU or EMU member status, or end their EMU member status altogether? Therefore, if certain Members elected to stay out of the Euro, while other Members may never achieve the criteria required to join the Euro, it seems unfair and impractical to now require that a Member must completely abandon the EU structure in order to change their currency—a right which other Member States effectively retain.

²⁵² Hofmeister, *supra* note 217, at 119.

²⁵³ *Id.*

²⁵⁴ *Id.* at 115 (discussing the criteria which include price stability, sustainable financial position, currency exchange standards, and the ability of the Member State to maintain the other standards).

²⁵⁵ *Id.* at 118.

²⁵⁶ See generally TFEU, *supra* note 210, art. 98.

²⁵⁷ Vranes, *supra* note 171, at 373.

²⁵⁸ See *id.* at 369.

²⁵⁹ See *id.* at 374.

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As can be seen from the foregoing, despite what cheerleaders for the European Union and the EMU might say about either the impossibility of withdrawal or the notion that withdrawal is unthinkable, there are ways out. Under customary international law and modern treaty law, the way that the European Union has dealt with Member States who either do not wish to or do not qualify for EMU membership (or do not fulfill their obligations under such membership) and the words of the Lisbon Treaty itself, a variety of avenues of escape are open to Member States. If a Member State has problems complying with the needs of monetary union, that state is not doomed to remain a member. Indeed, the easiest approach for a Member State might be simply to become a Member with derogation status like Romania, or become a Member State that has opted out, like the United Kingdom or Denmark. The United Kingdom and Denmark have opted out by means of Protocols to the Treaty of Lisbon. Such Protocols have the same legal significance as the treaty itself.²⁶⁰ Certainly the United Kingdom, Romania, and Denmark are not second-class citizens within the European Union.

LOAN COMMITMENTS

One might ask what happens if a Member State, like Greece for example, defaults on its loan payment obligations, either as a continuing member of the EU and the EMU, or if Greece were to exit either the EU or the EMU and then default thereafter? What are the loan terms and to whom is it to be repaid? Indeed, does an exit from the Euro Zone or the EU amount to a default under the terms of the loan? The loan facilities to Greece are both through the European Central Bank²⁶¹ and through the IMF.²⁶² Each loan facility is extended to Greece as a sovereign state, and must be repaid by Greece alone; in the case of the IMF facility, to the IMF, and in the case of the European Central Bank facility, to the discrete Member States who have contributed to the facility in the amounts and proportions they have contributed.²⁶³ Regardless of the status of Greece as either a Member State of

²⁶⁰ See Vranes, *supra* note 171, at 368.

²⁶¹ See *ECB Saves Greece from Bankruptcy by Securing Emergency Loans-paper*, CHICAGO TRIBUNE, Aug. 3, 2012, http://articles.chicagotribune.com/2012-08-03/business/sns-rt-us-ecb-greecebre87302p-20120803_1_ecb-emergency-liquidity-assistance-greece.

²⁶² See Press Release No. 12/85, Int'l Monetary Fund, IMF Executive Board Approves €28 Billion Arrangement under Extended Fund Facility for Greece (Mar. 15, 2012), available at <http://www.imf.org/external/np/sec/pr/2012/pr1285.htm>; see also Press Release No. 10/187, Int'l Monetary Fund, IMF Executive Board Approves €30 Billion Stand-By Arrangement for Greece (May 9, 2010), available at <http://www.imf.org/external/np/sec/pr/2010/pr10187.htm>.

²⁶³ See generally *Euro Area Loan Facility Act 2010* (Nov. 7, 2010).

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the EU or of the EMU, or not a member of either, Greece must repay the loans in any event. There is no default escape clause or reduction in obligations for a change in any such status.

However, the ECB loan facility agreement states that it can be cancelled as to a lender (State) if “a constitutional court of a Lender or other court with competent jurisdiction in relation to such Lender decides in a final judgment that this Agreement or a Loan is violating the constitution of the Lender and such violation cannot be remedied,”²⁶⁴ the loan commitment of that lender will be cancelled.²⁶⁵ It is clear, therefore, that both the lender states and Greece entered into the facility as sovereign states. EU directives or any other mechanism, other than perhaps a perceived need, did not force them into it.

CONCLUSION

The Europeans have for centuries been very creative in forging economic and trade alliances, some that smacked of political alliances and even elementary union. They have also, on more than one occasion, attempted to confect monetary stability. Some of these attempts were successful for long periods, but the monetary bits have often not been so successful. Will this current attempt at monetary union be ultimately successful?

The March 2013 elections in Italy have once again jolted confidence in the Euro. Not only do politicians seem unable to effectively deal with the Euro crisis, but voters do not want to implement reforms of any sort.²⁶⁶ What will happen? Whether Greece, Cyprus, Slovenia, Portugal, or any other Member State will exit either the Euro Zone or the European Union, or be ejected by its fellow Member States is a matter of current, ongoing debate. Will the EMU end up being another sputtering, failed experiment, or will it survive? This is a matter that continues to ebb and flow, with the leaders of the region unable or unwilling to take a politically difficult stand to fix the problem once and for all. They resort to temporary bandages that do not really have a long-term salutary effect. As Desmond Dinan, the Irish professor and expert on the Euro problems has stated:

Apart from its implications for the stability of the Eurozone and economic governance in the EU, the euro crisis therefore revealed serious divergences among Member States and rifts among national governments that are bound to make the conduct of EU institutions

²⁶⁴ See *id.* par. 6(6)(b).

²⁶⁵ *Id.*

²⁶⁶ See *Send in the Clowns: How Beppe Grillo and Silvio Berlusconi Threaten the Future of Italy and the Euro*, THE ECONOMIST, Mar. 2, 2013.

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and governance even more challenging in the years ahead.²⁶⁷

This issue is far from resolved. New currency crises are certain to crop up. Whether these crises force European leaders to reexamine whether it is advisable to maintain the EMU in its current membership configuration remains to be seen. Nevertheless, it is clear that reconfiguration of the EMU is legally possible and must be one of the tools which leadership considers in charting any new course.

²⁶⁷ Desmond Dinan, *Governance and Institutions: Implementing the Lisbon Treaty in the Shadow of the Euro Crisis*, 49 *J. COMMON MARKET STUD.* 103, 119 (2011).

Marco Ventoruzzo*

ISSUING NEW SHARES AND PREEMPTIVE RIGHTS: A COMPARATIVE ANALYSIS

1. Introduction

The question of whether the corporate laws of Europe and America are converging is still largely unanswered.¹ One fundamental area in which the two systems diverge concerns how they regulate the issuing of new shares, in particular preemptive rights—a problem rarely addressed by comparative corporate law scholars.² This essay fills that gap by examining the major comparative differences between the approaches followed on the two sides of the Atlantic and offers some possible explanations for this divergence.

The issuing of new shares by a corporation is often a recipe for litigation. In fact, when new shares are issued and not offered to existing shareholders, shareholders may suffer two types of damages. On the one hand, shareholders' voting power within the corporation is diluted. On the other hand, the value of their investment can be reduced if the selling price is lower than the actual value of the shares.

Consider the following scenario. Corporation XYZ, worth four million dollars, has 1,000 shares outstanding. Shareholder A owns 25% of the shares (250 shares). A controls one-fourth of the voting power, and the value of her investment is one million dollars. If the corporation issues 1,000 new shares and sells them to a third party, A's voting power is reduced to 12.5% (250 shares over 2,000 outstanding). Depending on the price at which the new shares are offered, the value of A's investment could also be jeopardized. If XYZ sells the new shares at \$4,000 each (the value before the new issue), no damage is caused. In fact, A will still own 12.5% of a corporation worth eight million dollars, which equals one million dollars. If, however, XYZ

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¹ See CORPORATE GOVERNANCE REGIMES: CONVERGENCE AND DIVERSITY (Joseph A. McCahery et al. eds., 1st ed. 2002); Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329 (2001); Douglas M. Branson, *The Very Uncertain Prospect of "Global" Convergence in Corporate Governance*, 34 CORNELL INT'L L. J. 321 (2001).

² REINER R. KRAAKMAN ET AL., *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* 192 (Oxford University Press, 2nd ed. 2009) (giving a brief comparative overview of the regulation of share issuance).

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sells the shares at a “discount,” the value of A’s investment will be proportionally reduced. If, for example, the new 1,000 shares are sold for \$3,000 each, the value of A’s stake in the corporation will decrease to \$875,000 (12.5% * \$7,000,000).

Of course the law could dramatically curb this risk by providing that all existing shareholders always have a mandatory preemptive right to buy newly issued shares. Similar protections, however, would be detrimental to the corporation. It is essential that directors retain a certain degree of flexibility in designing the financial structure of the corporation. Granting preemptive rights to shareholders is time-consuming because the shares must be first offered to existing stockholders and might hinder the ability of the corporation to quickly obtain fresh financial resources when market conditions are favorable. The law must therefore strike a delicate balance between the protection of existing shareholders, on the one hand, and the ability of the corporation to pursue its optimal financial structure, on the other.

There are three basic sets of rules that contribute to strike such a balance: rules concerning the allocation of powers between directors and shareholders to decide on the issuing of new shares, preemptive rights in case new shares are sold, and fiduciary duties of directors engaging in the sale of new shares. The purpose of this essay is to consider how different legal systems strike this balance in regulating the issuance of new shares, focusing in particular on preemptive rights. The comparison is not only important for the relevance of the problem, but also because it illuminates some of the fundamental differences in the corporate governance philosophies underlying different legal systems.

This essay compares the systems in the U.S. and continental European jurisdictions with particular reference to Italy. Focusing on these systems is particularly apt because the two models follow nearly opposite approaches. In the U.S., directors enjoy broad powers in the issuing of new shares, and there is greater freedom of contract in regulating preemptive rights in the corporate charter. Under this system, shareholders are mainly protected through directors’ fiduciary duties. In Europe, shareholders are protected through statutory rules that mandate preemptive rights. Shareholders have the power to waive preemptive rights, but only in limited circumstances.

One might argue that European systems still follow the approach adopted in the U.S. until roughly the 1960s, and a possible explanation is that Europe did not experience the same separation between ownership and control that occurred in the U.S. The comparison will allow exploration of a more general difference between shareholder protection in the U.S. and in the civil law systems of continental Europe, namely, the fact that the former jurisdiction relies more on ex-post litigation, and the latter on ex-ante mandatory rules.

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Part I analyzes the American regulation of the issuing of new shares. Part II turns to its European counterpart, with a focus on the Italian system. Part III concludes by pointing out the differences in approaches to this crucial legal issue.

PART I: U.S. LAW

1. *Competence to Issue New Shares*

In the U.S., the power to issue new shares is primarily entrusted to the board of directors. Directors enjoy a great degree of freedom in issuing new shares; however one important limitation is that they can only issue the number of shares authorized by the articles of incorporation.³ Generally, corporations have outstanding shares, which are shares already sold to shareholders that form the capital of the corporation; but the articles of incorporation provide for additional authorized shares that directors can issue and sell.⁴ For example, a corporation can have 100 outstanding shares held by two shareholders, but the articles of incorporation can authorize the issuing of an additional 200 shares. If directors want to issue more than the additional 200 shares, they need to obtain shareholders' approval to increase the number of the authorized shares.

This rule gives shareholders some control over the financial structure of the corporation. Sales of shares that might dilute shareholders' ownership of the corporation above the threshold set by the authorized shares must be voted by shareholders as an amendment to the articles of incorporation.⁵ The practice, however, is to provide for a number of authorized shares significantly larger than the number of outstanding shares, so that if new financial resources are needed, directors can easily issue new shares. In contrast to European law, issuing new shares in the U.S. is substantially and practically in the hands of directors.⁶ In addition, minority shareholders in corporations with a controlling shareholder derive little protection from this rule because majority shareholders can consent to increase the number of authorized shares.

³ See ANDREAS CAHN & DAVID C. DONALD, *COMPARATIVE COMPANY LAW* 205 (Cambridge University Press, 2010) (stating that, in Delaware "[w]ithin the limits of the authorized stock, the board of directors is free to issue stock on its own authority until all the authorized stock has been issued. Delaware law thus places considerably more power in the hands of the board than either Germany or the United Kingdom.").

⁴ See generally MODEL BUS. CORP. ACT §§ 6.01, 6.02 (2002); DEL. CODE ANN. tit. 8, § 161 (2010).

⁵ See FRANKLIN A. GEVURTZ, *CORPORATION LAW* 135 (West, 2000); see also Mira Ganor, *The Power to Issue Stock*, 46 WAKE FOREST L. REV. 701, 709 (2011).

⁶ See generally DEL. CODE ANN. tit. 8, §§ 141, 161.

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One exception to this allocation of powers is established by M.B.C.A. § 6.21(f), which requires shareholders' approval if (i) the shares are issued for consideration other than cash, and (ii) the voting power of shares that are issued comprises more than 20 percent of the voting power of the outstanding shares.⁷ Also in listed corporations, shareholders' approval is necessary when the issuing of new shares might determine a shift in control. Rules enacted by the NYSE, the NASD, and the American Stock Exchange require a vote at the shareholders' meeting when a listed corporation issues an amount of new common shares exceeding 20% of the outstanding ones, if the issuance is not made through a public offer for cash.⁸

2. *Preemptive Rights*

Another way to protect shareholders in the event new shares are issued is to grant them a preemptive right to purchase these shares.⁹ In this case, shareholders who want to avoid the dilution of their participation can acquire pro-rata the new shares paying the required consideration.¹⁰ Of course, this protection is effective only to the extent that shareholders have the financial means and the willingness to buy the new shares but if they do, no dilution will occur.

The traditional approach in the U.S. was that shareholders enjoyed preemptive rights.¹¹ This was the rule followed at common law. Probably the first case to enunciate preemptive rights was *Gray v. Portland Bank*, a Massachusetts case decided in 1807.¹² The first general corporation statutes followed this judicial doctrine and granted preemptive rights to shareholders. Massachusetts is an interesting example, as chapter 179 of the Acts of 1870 provided that whenever a corporation increased its capital stock, it was required to give notice to each shareholder, and the shareholders were able to buy the new shares pro-rata at their par value.¹³ Interestingly, and in contrast to what is provided in other legal systems, shareholders were only entitled to a pro-rata preemptive right: if some shares remained unsold, the directors could sell them on the market. However, any premium (the difference between the par value and the selling price) had to be

⁷ STEPHEN M. BAINBRIDGE, *CORPORATE LAW* 39 (Foundation Press, 2nd ed. 2009).

⁸ KRAAKMAN, *supra* note 2, at 194.

⁹ See Ganor, *supra* note 5, at 706.

¹⁰ *Id.*

¹¹ See GEVURTZ, *supra* note 5, at 136 n. 61 (citing *Stokes v. Cont'l Trust Co.*, 78 N.E. 1090 (N.Y. 1906), which provides an illustration of the traditional approach in the U.S.).

¹² See Andrew L. Nichols, *Shareholder Preemptive Rights*, 39 BOS. BAR J. 4, 4 (1995) (citing *Gray v. Portland Bank*, 3 Mass. 363 (1807)).

¹³ See *id.*

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paid to the shareholders that had not exercised their preemptive right in proportion to their shares.¹⁴

Preemptive rights might, however, interfere with the ability of the corporation to raise new funds, if nothing else because the need to give some time to existing shareholders to exercise their right slows down the sale of the new shares. Some early amendments to general corporation statutes simply provided that shareholders could determine the terms and manners of the disposition of newly issued shares, meaning that they could limit or exclude preemptive rights. This was the case, for example, with the 1903 Acts of Massachusetts.¹⁵

More modern corporate statutes abandon this approach and generally deny preemptive rights unless the governing documents of the corporation opt for them. The default rule is that shareholders do not have a preemptive right in case of issuance of new shares, unless the articles of incorporation (or sometimes, the bylaws) expressly provide so.¹⁶ In Massachusetts this rule was adopted in 1964, under chapter 156B, section 20 of the general corporation statute.¹⁷ The M.B.C.A. and Delaware law also provide for similar rules.¹⁸

Notably, there are some differences in how preemptive rights are structured. Some statutes allow shareholders to opt-in to preemptive rights, both in the charter and in the bylaws of the corporation. The effect is obviously different, because if the rule is in the charter, shareholders' approval is necessary to amend it, while if it is in the bylaws, directors could be able to amend it without shareholders' consent. It follows that shareholders' rights are more protected if the preemptive rights are set forth in the articles of incorporation.¹⁹

Alternatively, a different approach followed by a minority of corporate statutes provides an opt-out mechanism for some corporations. Under this regime, shareholders enjoy preemptive rights as a default rule, but the articles of incorporation can waive them.²⁰

¹⁴ See *id.*

¹⁵ See E. Merrick Dodd, Jr., *Statutory Developments in Business Corporation Law, 1886-1936*, 50 HARV. L. REV. 27, 37 (1936) (outlining the provisions of Mass. Acts & Resolves 1903, c. 437).

¹⁶ See GEVURTZ, *supra* note 5, at 136 n. 63.

¹⁷ See MASS. GEN. LAWS ch. 156B § 20 (1964).

¹⁸ MODEL BUS. CORP. ACT § 6.30 (2002); DEL. CODE ANN. tit. 8, § 102(b)(3) (2012).

¹⁹ More precisely, in some jurisdictions shareholders can prevent the risk that directors will amend a bylaws rule introduced by them by explicitly providing that directors do not have this power. See MODEL BUS. CORP. ACT § 10.20 (b). There are more doubts that this is possible under Delaware law. See BAINBRIDGE, *supra* note 7, at 16.

²⁰ GEVURTZ, *supra* note 5, at 136 n. 6 (citing N.Y. BUS. CORP. § 622 (providing a similar rule for corporations formed before 1997)).

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Whether shareholders can individually negotiate for preemptive rights in a separate contract with the corporation presents an interesting interpretive question. If this is not possible, the only way to grant preemptive rights would be to include them in the governing documents of the corporation. If individually negotiated rights are permissible, however, it would be possible that only some shareholders would enjoy preemptive rights. If such agreements are not permitted, all shareholders in a similar situation would be able to exercise preemptive rights. The language of most statutes raises this ambiguity; for example, section 102(b)(3) of the Delaware General Corporation Law provides, in relevant part, that: "No stockholder shall have any preemptive right to subscribe to an additional issue of stock or to any security convertible into such stock unless, and except to the extent that, such right is expressly granted to him in the certificate of incorporation."²¹

There are two possible readings of such a provision. On the one hand, it can be interpreted as simply repealing the previous rule according to which shareholders had, as a general matter, preemptive rights, and stating how general preemptive rights can be established. If this interpretation is adopted, the statute does not prohibit shareholders from entering into a separate contract with the corporation to enjoy preemptive rights. The statutory provision could, however, also be given a broader meaning. Under this reading, the only way to grant preemptive rights is to include them in the charter and, therefore, make them available to all shareholders. The first interpretation is preferable, and it seems supported by the limited authority existing on the point.²²

Even when the articles of incorporation provide for preemptive rights, several delicate problems can arise, especially when the corporate contract does not regulate all the situations that can arise in the life of a corporation. The most important of these questions are discussed below.

3. *Interpretation Questions on the Applicability of Preemptive Rights*

The first issue concerns the possibility for existing shareholders to exercise their preemptive rights only pro-rata. Imagine, for example, that a corporation has issued 200 shares, and that its two shareholders own 100 shares each. If the corporation issues 100 new shares and only one shareholder exercises her pre-emptive right, she would be allowed to buy 50 shares in order to maintain her 50% stake

²¹ DEL. CODE ANN. tit. 8, 102(b)(3).

²² See Nichols *supra* note 12, at 26 (citing *Garza v. T.V. Answer, Inc.*, Civ. A. No. 12784, 1993 WL 77186 (Del. Ch., March 15, 1993)).

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in the corporation. In this scenario, can she also exercise her preemptive right on the remaining 50 shares that the other shareholder decided not to buy, or can these shares be freely sold to third parties by the directors? The existing shareholders might have an interest to prevent new investors from becoming shareholders, something that, especially in a close corporation, can be highly desirable. The answer depends on how the preemptive right clause is written in the charter, and the scope of the preemptive right is something that the drafters of the articles of incorporation should take into careful account. However, it is worth noting that even old corporate law statutes that provided for preemptive rights limited these rights to a pro-rata percentage of the newly issued shares.

Another important problem can occur when the corporation wants to issue new shares for a consideration in kind, such as property or services. If the corporation is issuing new shares for cash, the exercise of a preemptive right set forth in the articles of incorporation is simple: since cash is fungible, shareholders will pay the price set for the shares and acquire the new securities issued. However, when the corporation wants to obtain property, such as the assets of another corporation, real estate from a third party, or services from a specific individual or business, shareholders simply cannot offer to the corporation the same consideration that it is seeking to obtain. In this case, therefore, courts tend not to apply preemptive rights, unless the articles of incorporation explicitly state so.²³ This solution is adopted also by the M.B.C.A. § 6.30(b)(3)(iv).²⁴

The issue arose in a 1930 Maryland case, *Thom v. Baltimore Trust Co.*²⁵ The Baltimore Trust intended to issue new shares in exchange for the shares of National Union Bank of Maryland. Two-thirds of the shareholders of the former company approved the plan, which required Baltimore Trust to issue 15,000 shares at a price of \$112 per share, for the purpose of acquiring 10,000 shares of National Union Bank at a valuation of \$168 per share.²⁶ The increase of the capital of Baltimore Trust was approved as a charter amendment, but a contemporaneous amendment introduced a preemptive right in case new shares were issued, also providing, however, that the directors could issue stock without preferential subscription rights in order to accomplish a merger or acquisition.²⁷ The Court of Appeals of Maryland reasoned that the charter provision complied with the then-established

²³ See generally *Thom v. Baltimore Trust Co.*, 148 A. 234 (Md. 1930).

²⁴ MODEL BUS. CORP. ACT § 6.30(b)(3)(iv).

²⁵ *Thom*, 148 A. at 234.

²⁶ *Id.*

²⁷ *Id.* at 235.

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doctrine of preemptive right, and it legitimately excluded preemptive rights when new shares were issued for property.²⁸

A somewhat similar situation might occur when a corporation wants to issue new shares as part of a compensation scheme for its employees and officers. Do preemptive rights also apply to these transactions? In this case, the corporation has an interest in ensuring that the new shares are attributed to the employees. The M.B.C.A. provides that, in the absence of an explicit provision to the contrary in the charter, no preemptive rights apply when new shares are issued as compensation to directors, officers, and employees of the corporation.²⁹

Another important exception to the preemptive rights rule concerns mergers. Similar to what happens in case of a contribution in kind, in a merger the assets of the merged corporation are transferred to the acquiring corporation, which issues new shares that will be given to the shareholders of the merged corporation according to an exchange ratio.³⁰ If the shareholders of the buyer could exercise their preemptive rights, a stock-for-stock merger would not be possible. Unless expressly provided in the governing documents of the corporation, courts tend to exclude preemptive rights in case of merger. Also in this context, the interest of the corporation to accomplish the merger is considered superior to the shareholders' interest in maintaining their stake in the corporation. In addition, shareholders are protected by appraisal rights for dissenting shareholders³¹ and, as will be discussed below, by fiduciary duties of directors. Directors engaging in an unfair merger, in which the exchange ratio does not accurately reflect the value of the two merging corporations, can be liable for breach of their duty of care or of loyalty.³²

To sum up, there are situations in which, even if a general preemptive right is included in the governing documents of the corporation, courts could deny the right after weighing the interests of the corporation and of the shareholders. Three of the most important cases have been mentioned above: when the corporation is issuing new shares for property or services, as compensation to employees, and in the case of a merger. In all of these situations, granting the exercise of preemptive rights can adversely affect the corporation, which might not be able to pursue its goals. Following the same rationale as the

²⁸ *Id.* at 236.

²⁹ MODEL BUS. CORP. ACT § 6.30(b)(3).

³⁰ See generally Frederic A. Bittner, *Capital Stock-Corporations-Members and Stockholders-A Minority Shareholder Has a Primary Cause of Action for Denial of Preemptive Rights in a Corporate Merger*, 42 TEX. L. REV. 908 (1964).

³¹ One of the best analyses of the role and regulation of appraisal rights in the United States can be found in Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1, 15 (1995).

³² See GEVURTZ, *supra* note 5, at 654.

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basis of the preemptive rights doctrine, courts will generally limit the application of preemptive rights in these circumstances, unless the charter or bylaws of the corporation expressly indicates that these rights apply.³³

So far we have considered situations in which the corporation had only issued one class of shares. What happens, however, when there are different classes of outstanding shares? If, for example, the corporation has common and preferred shares outstanding, and issues new common stock, do owners of preferred shares have a preemptive right on the newly issued shares? The M.B.C.A. generally excludes preemptive rights among different classes of shares.³⁴ This position is coherent with case law on the issue.³⁵ Some authors have suggested a more nuanced approach, arguing that preemptive rights should be granted when the issuing of new shares would have an impact on the economic or voting rights of a class.³⁶ This approach is probably preferable, but it is difficult to apply because in many instances it is not clear when the issuing of new shares affects, at least indirectly, other classes of shares.

4. *Sale of Treasury Shares and Preemptive Rights*

A situation similar to the issuing of new shares occurs when the corporation sells treasury shares. Treasury shares are shares that the corporation issued to shareholders but later repurchased.³⁷ The buy back of own shares raises an issue of equal treatment of shareholders; if the corporation selectively purchases shares only from some shareholders, the ones left out might complain that controlling shareholders or directors abused their power to favor certain shareholders.³⁸ When the corporation resells the shares, from an economic standpoint, the situation is similar to the selling of newly issued shares.

³³ *See id.* at 136, 654.

³⁴ MODEL. BUS. CORP. ACT § 6.30(b)(4), (5).

³⁵ *See* GEVURTZ *supra* note 5, at 137. *But see* Thomas Branch & Co. v. Riverside & Dan River Cotton Mills, Inc., 123 S.E. 542 (Va. 1924) (recognizing a preemptive right of preferred shareholders to subscribe newly issued common stock).

³⁶ GEVURTZ *supra* note 5, at 137.

³⁷ *Id.*

³⁸ In the famous case of *Donahue v. Rodd Electrotpe Company of New England, Inc.*, 328 N.E.2d 505 (Mass. 1975), the Supreme Judicial Court of Massachusetts held that stockholders in a closely held corporation owe one another the same fiduciary duties as partners in a partnership, and that therefore, if the corporation buys back shares from a controlling shareholder, then the controlling shareholder should grant an equal opportunity to minority shareholders to sell their shares at the same price.

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Once again, the position of existing shareholders might be jeopardized because their voting powers and economic rights might be diluted by the sale of shares. Some corporate statutes, in fact, have extended the common law preemptive rights rule to include sales of treasury shares.³⁹ Notwithstanding this similarity, courts have generally taken the position that preemptive rights do not apply in this case, unless the articles of incorporation expressly provide for such a right.⁴⁰

In *Borg v. International Silver Co.*, the Second Circuit clearly identified the rationale for excluding preemptive rights for the sale of treasury stock.⁴¹ After stating that shareholders have a preemptive right when new shares are issued, but not in case of sale of treasury shares, the court opined that:

When a person buys into a company with an authorized capital, he accepts that proportion of the voting rights which his purchase bears to the whole. This applies certainly so far as the other shares are issued at the same time, and perhaps, also, though they are issued much later. But treasury shares have by hypothesis once been issued, and have diluted, as it were, the shareholder's voting power ab initio. He cannot properly complain that he is given no right to buy them when they are resold, because that merely restores the status he originally accepted.⁴²

As the court explains, if shareholders had a preemptive right at the time the shares were issued, they either exercised it or decided not to.⁴³ If they exercised their rights, they might have resold the shares to other investors, who in turn sold them to the corporation or might have sold them back to the corporation. Their preemptive right has been respected at the time of the issuing and, by selling the shares to other shareholders or to the corporation, they decided to have a lower participation in the corporation. On the other hand, if the shareholders did not exercise their preemptive rights, they accepted the dilution to their stake in the corporation at the time of the issuing of new shares.

³⁹ An example is § 2.22(C) of the Texas Business Corporation Act, cited by Bittner, *supra* note 30, at 911.

⁴⁰ See *GEVURTZ*, *supra* note 5, at 137; *Enright v. Heckscher*, 240 F. 863, 874 (2d Cir. 1917); *Page v. Smith*, 48 Vt. 266 (1876); *Crosby v. Stratton*, 68 P. 130, 133 (Colo. App. 1902).

⁴¹ *Borg v. Int'l. Silver Co.*, 11 F.2d 147 (2d Cir. 1925).

⁴² *Id.* at 151

⁴³ See *id.*

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In both cases, shareholders have been given the opportunity to maintain their percentage of capital and have declined it.⁴⁴

Similarly, shareholders buying shares in a corporation that already owns treasury shares accept the risk that these shares might be sold to third parties. In all these cases, shareholders cannot invoke preferential rights merely because, at a certain time, the shares have been bought back by the corporation and held as treasury stock. The only protection that shareholders have, in this case, concerns the possible damage to the value of their investment if the treasury shares are sold for less than their actual value. For this reason shareholders can expect treasury shares to be resold at their fair value, and, if not, directors might face liability.⁴⁵

It is clear, therefore, that even when shareholders have a preemptive right (either a statutory one, as it was in the past, or because of a charter provision, as it might be today), that right does not extend to the sale of treasury stock.⁴⁶ Obviously this conclusion also holds when shareholders do not have a preemptive right in the first place.

5. *Directors' Fiduciary Duties and Other Limitations to the Sale of New Shares*

A delicate issue that might arise is whether directors are allowed to freely sell shares only to some shareholders, therefore altering the balance of power within the corporation. In general terms we have seen that when preemptive rights do not apply, directors can sell new shares (or treasury shares) as they see fit. This freedom is, however, not unlimited.⁴⁷ Consider, for example, a situation where the charter of the corporation provides for a supermajority of two-thirds of the votes to approve certain extraordinary transactions, such as a merger. One shareholder owns 60% of the outstanding shares, and another one owns 40%. Can the directors sell shares only to the first shareholder, thus bringing his participation above the 66.6% threshold and giving him absolute control over those transactions? In this case, the solution should not be found in preemptive rights, but rather in directors' fiduciary duties and in the principle of equal treatment of shareholders.

As mentioned above, directors' fiduciary duties are a powerful and flexible instrument to limit directors' discretion in issuing shares. Whenever directors have a conflict of interest, the general rule is that either the transaction is approved by disinterested directors or shareholders, or that it is entirely fair to the corporation. The simplest case

⁴⁴ *See id.*

⁴⁵ *See id.* at 152.

⁴⁶ *See* GEVURTZ, *supra* note 5, at 137.

⁴⁷ *See generally id.* at 273.



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occurs if directors issue shares to themselves or their affiliates at a bargain price.⁴⁸ In this case there is a clear conflict of interest, and the transaction is not fair. To go forward, it would require the approval of disinterested parties.⁴⁹ However, the situation can often be trickier.

A first problem occurs when directors issue shares to themselves at a fair price. In this case, the effect of the issuing could be a shift in control, but the rule applicable to conflicted transactions would not be very helpful because the transaction is fair to the corporation (the price is adequate) and is only unfair to diluted shareholders.⁵⁰ In this scenario, some courts have taken the position that directors must demonstrate a corporate purpose for the selective sale.⁵¹ A second case deserving consideration occurs when directors offer new shares to all shareholders at a bargain price, but some shareholders do not have the financial resources or the willingness to buy additional shares. Directors might exploit the lack of financial means of one or more shareholders to dilute their participation, claiming that formally all shareholders had an equal opportunity to buy the discounted shares.⁵² Also, in this instance, some courts have required a business purpose for the bargain sale of the shares.⁵³

The situation is more complicated when directors want to favor a particular shareholder with whom they have no formal affiliation, for example, because they expect that the shareholder will continue to retain them on the board of directors. To do so, they might selectively sell new shares only to this shareholder at a fair price, thus determining a shift in control or in any case diluting the voting power of other shareholders.⁵⁴

In this scenario the first issue would be one of fact, demonstrating that there is a conflict of interest. The rules governing conflicted transactions, however, might not be sufficient to protect shareholders because the sale is fair to the corporation. The best solution would be to require a business purpose for the transaction, arguing that in the absence of such a purpose, shareholders should be treated equally.

⁴⁸ *Id.* at 138.

⁴⁹ *Id.*

⁵⁰ *See id.* at 138-39.

⁵¹ *Schwartz v. Marien*, 335 N.E.2d 334 (N.Y. 1975). *But see Tallant v. Executive Equities, Inc.*, 209 S.E.2d 159 (Ga. 1974) for an example of a case in which the court has not required a showing of business purpose. The case is illustrated by *GEVURTZ*, *supra* note 5, at 138.

⁵² *See GEVURTZ*, *supra* note 5, at 138.

⁵³ *Id.* at 138-39 (citing *Katzowitz v. Sidler*, 24 N.Y.2d 512, 301 N.Y.S.2d 470, 29 N.E.2d 359 (1969) as a case in point).

⁵⁴ *Id.*

PART II: EUROPEAN LAW

1. *The European Framework: The Second Company Law Directive*

The Second Company Law Directive, enacted in 1977 and amended several times,⁵⁵ sets forth a harmonized regulation of the formation of corporations, focusing in particular on legal capital and its maintenance and alteration. Its breadth spans from the minimum amount of capital to eligible contributions and from purchasing of owned shares to distributions to shareholders. For the purposes of this essay the relevant provisions are contained in Articles 25, applicable to publicly held corporations.⁵⁶ Two key principles need to be emphasized here. First, Article 25, Paragraph 1, provides that any increase in capital must be decided upon by the general shareholders' meeting.⁵⁷ Second, Article 29 establishes that when the capital is increased and the new shares are paid in cash, the shares must be offered on a preemptive basis to shareholders in proportion to the capital represented by their shares.⁵⁸

These two provisions establish a minimum level of harmonization that is very different from, and arguably opposite of, the American regulatory model. The European approach gives more powers to the shareholders' meeting in deciding the issuing of new shares, and mandates preemptive rights as a general rule when shares are issued for a consideration in cash.

To get a clearer sense of how the general provisions of the Second Company Law Directive have been implemented in some Member States, it is helpful to examine some specific European jurisdictions.

2. *Italian Law: Regulation of Issuing of New Shares for a Consideration*

The Italian system offers an excellent example of the way in which the regulation of issuing new shares adopted in continental Europe compares with U.S. law. In fact, as we will discuss, the Italian Civil Code (I.C.C.) follows an approach that is considered opposite to the American one, characterized by mandatory regulation that leaves little room for freedom of contract and directors' discretion.⁵⁹ Under

⁵⁵ Second Council Directive, Dec. 13, 1976, 1977 O.J. (L 026) 1 [hereinafter Second Council Directive] (updated by Directive 2006/68/EC of the European Parliament and of the Council of 6 September 2006, 2006 O.J. (L 264) 32 and Directive 2009/109/EC of the European Parliament and of the Council of 16 September 2009, 2009 O.J. (L 259)14).

⁵⁶ See Second Council Directive, *supra* note 55, art. 25.

⁵⁷ *Id.* art. 25 para. 1.

⁵⁸ *Id.* art. 29.

⁵⁹ See generally CODICE CIVILE [C.C.] (It.).

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Italian law, the interests of existing shareholders receive a stronger protection *vis-à-vis* the interest of the corporation to maintain a flexible financial structure so as not to be diluted through a capital increase.

In addition, in light of the partially harmonized regulation at the European level, the Italian system has important similarities with the systems of other major continental European jurisdictions, therefore presenting a good illustration of the European regulatory model. For these reasons, the following pages concentrate on the Italian system first and then briefly examine other European countries, such as Germany, France, Spain, and the U.K.

A first crucial difference between the Italian and American regulation and practice of issuing new shares concerns the competence to decide the increase of capital. Under Italian law, pursuant to the Second Company Law Directive, the power is primarily in the hands of the shareholders.⁶⁰ The issuing of new shares for a consideration, in fact, represents an amendment to the corporate charter that can only be approved by the so-called “extraordinary” shareholders’ meeting with a supermajority.⁶¹ The matter can be delegated to directors by the shareholders’ meeting, pursuant to Article 2443 of the I.C.C.⁶² In this case, the situation is similar to the one in which a U.S. corporation has authorized but unissued shares. The delegation to directors, however, can only be given for a maximum period of five years, therefore limiting directors’ freedom to issue new shares.⁶³

Probably the most crucial difference concerns preemptive rights. In contrast to the U.S.—or, more precisely, in contrast to current U.S. rules, but similar to the traditional U.S. approach—the statutory and mandatory rule generally applicable is that, in any issuing of new shares for a consideration, all shareholders have a preemptive right to purchase the new shares proportionally to their stake in the corporation.⁶⁴ Another difference with U.S. law is that, in a closely-held corporation, the shareholders that exercise their preemptive right do not only have the right to buy the new shares *pro rata*, but they can also exercise an additional preemptive right on the shares that other shareholders have not bought.⁶⁵ Hence, if a corporation has two shareholders and only one of them exercises her preemptive right, she has the right to also buy the percentage of shares that the other share-

⁶⁰ See Second Council Directive, *supra* note 55.

⁶¹ See CODICE CIVILE [C.C.] (It.).

⁶² CODICE CIVILE [C.C.] art. 2443 (It.).

⁶³ See GIUSEPPE A.M. TRIMARCHI, *L'AUMENTO DEL CAPITAL SOCIALE* 337 (Iposa, 2007) (It.).

⁶⁴ CODICE CIVILE [C.C.] art. 2441, para. 1 (It.).

⁶⁵ *Id.* para. 3.

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holder refused, increasing her percentage of the corporation's capital.⁶⁶ Only if shareholders do not exercise this additional right of preference can directors sell the shares to third parties.

The scope of the preemptive right under Italian law is also broader with respect to the securities to which the right attaches. First, the law expressly states that the holders of bonds convertible into shares also enjoy preemptive rights and that preemptive rights can also be exercised on convertible bonds, when issued.⁶⁷ The rationale for this rule is straightforward: since holders of bonds convertible into shares can potentially become shareholders, not granting preemptive rights to or on these financial instruments would allow a dilution of the position of shareholders or bondholders. It should be noted, however, that according to a recent case involving Spain, the European Court of Justice has taken the position that granting preemptive rights to holders of convertible bonds is against European law, as it reduces the number of shares available to shareholders.⁶⁸

The law is not similarly clear with respect to preemptive rights when it comes to issuing different classes of shares. There is a specific rule for non-voting shares issued by listed corporations: Article 145 of the Consolidated Law on Finance.⁶⁹ This rule provides that, in the absence of a different option in the corporate charter, holders of non-voting shares have a preemptive right on shares of the same class.⁷⁰ If non-voting shares are not issued, holders of these shares have a preemptive right on the classes of shares that are issued. Most commentators have expressed the view that this rule is the expression of a more general principle, where preemptive rights include the right to subscribe to shares of different categories if the capital increase does not respect the proportion between the categories of shares already outstanding.⁷¹

⁶⁶ *But see supra*, Part I.

⁶⁷ CODICE CIVILE [C.C.] art. 2441, para. 1 (It.).

⁶⁸ The European Court of Justice, in Case C-338/06, *Commission of the European Communities v. Kingdom of Spain*, held that Article 29 of the Second Directive gives to shareholders priority over all other potential purchasers of new shares and convertible bonds. It follows, according to the court, that Spanish law, which gives preemptive rights to convertible bondholders, might jeopardize shareholders' preemptive rights. In this case, the Kingdom of Spain, which has a provision similar to the Italian one cited, was considered not having fulfilled its obligations under the Second Directive.

⁶⁹ Legislative Decree No. 58 of 24 February 1998 Consolidated Law on Finance, art. 145 (1998) (It.).

⁷⁰ *See id.*

⁷¹ *See generally* G.F. CAMPOBASSO, *DIRITTO COMMERCIALE: DIRITTO DELLE SOCIETA* 521, n. 44 (ed. M. Campobasso) (Utet, 2012) (It.).



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3. *Statutory Limitations to Preemptive Rights*

Preemptive rights can be limited or excluded only in four specific and narrow circumstances, listed in Article 2441 I.C.C.⁷² The first circumstance applies when the resolution approving the capital increase provides that the consideration for the new shares must be a contribution in kind.⁷³ The rationale is the same as that adopted by U.S. courts to limit contractual preemptive rights included in the corporate charter in the absence of a specific provision: the interest of the corporation to receive exactly the property it seeks to acquire trumps the interest of shareholders not to be diluted. The law suggests, however, that, even in this case, it is not sufficient that the resolution indicates a contribution in kind, but also that a specific business purpose for the contribution in kind be shown in order to not elude the right of shareholders to maintain their stake in the corporation.⁷⁴

The second case in which preemptive rights do not apply is, pursuant to Article 2441, Paragraph 5 of the I.C.C., where “the interest of the corporation requires it.”⁷⁵ The scope of this provision is clearly broader and more blurred, but a few examples can be derived from corporate practice. When a corporation is going public, it needs to have a minimum number of shareholders in order to be admitted to a stock exchange. The initial public offer must, therefore, be made to a broad range of investors, and preemptive rights would be an insurmountable obstacle to the creation of a widespread ownership structure.⁷⁶ In this case, the interest of the corporation to be listed arguably requires that preemptive rights be limited. This may occur, for example, when a corporation wants to attract a new shareholder in order to become part of a corporate group, or to exploit the business relationships and expertise of the new shareholder.

Similar to the U.S. model, a third possible exclusion of preemptive rights can be based on an intention to compensate employees with shares of the corporation. Pursuant to Article 2441, Paragraph 8 of the I.C.C., when new shares are offered to employees, a maximum of one-fourth of the new shares can be sold without granting existing shareholders a preemptive right.⁷⁷ It should be noted, however, that the limitation on preemptive rights can only affect 25% of the newly issued shares in order to curb the possible dilution of existing shareholders.⁷⁸

⁷² CODICE CIVILE [C.C.] art. 2441 (It.).

⁷³ CODICE CIVILE [C.C.] art. 2441, para. 4 (It.).

⁷⁴ See TRIMARCHI *supra* note 63, at 323 n. 259.

⁷⁵ CODICE CIVILE [C.C.] art. 2441, para. 5. (It.)

⁷⁶ See *generally* GEVURTZ, *supra* note 5.

⁷⁷ CODICE CIVILE [C.C.] art. 2441, para. 8 (It.).

⁷⁸ *Id.*

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The fourth and last situation in which preemptive rights can be limited applies only to listed corporations. This is a relatively recent innovation introduced in 2003 and inspired by German law.⁷⁹ Article 2441, Paragraph 4 of the I.C.C. provides that the charter of a listed corporation can opt for the possibility of increasing the amount of outstanding shares up to 10% of their number without granting preemptive rights.⁸⁰ The rationale of this rule is to give more flexibility to listed corporations in designing their financial structure by allowing the issuing and selling of new shares without the time-consuming offer to existing shareholders required by preemptive rights. In a listed corporation, when shares are traded on a liquid regulated market, the risk of shareholders' dilution is more limited: existing shareholders that want to maintain their position in the corporation can, in fact, easily buy additional shares on the market.

As mentioned above, these four exceptions to mandatory preemptive rights are the only ones allowed: contribution in kind, interest of the corporation, shares offered to employees, and 10% of the outstanding shares in listed corporations.⁸¹ Only in these cases can the stake of a shareholder in the corporation be diluted if the shareholders' meeting so decides. The law, however, provides for specific rules concerning the issuing price of the new shares in case of limitation or exclusion of preemptive rights, in order to avoid an economic damage to investors. The selling price of the shares cannot, in these cases, be lower than a fair price determined through specific procedures.

More precisely, in the first three cases listed above, the directors must present the shareholders with a proposal indicating the issuing price calculated on the basis of the actual value of the corporation, taking into account, in the case of listed shares, their market price in the last six months.⁸² The proposal also must be shared with the auditors of the corporation, who must issue an opinion on the fairness of the issuing price.⁸³ In the last case where preemptive rights can be limited, concerning 10% of the outstanding shares in listed corporations, the issuing price must be equal to the "market value" of the shares, and the auditing firm must confirm this equivalence.⁸⁴

In the four cases when preemptive rights can be excluded, directors are not free to issue the new shares to one or some of the ex-

⁷⁹ See Gaia Balp & Marco Ventoruzzo, *Esclusione del diritto d'opzione nelle società con azioni quotate nei limiti del dieci per cento del capitale e determinazione del prezzo di emissione*, 49 RIVISTA DELLE SOCIETÀ 795 (2004) (It.).

⁸⁰ CODICE CIVILE [C.C.] art. 2441, para. 4 (It.).

⁸¹ See generally *id.* art. 2441.

⁸² See *id.* art. 2441, para. 6.

⁸³ See *id.*

⁸⁴ See *id.* para. 4.

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isting shareholders, thus increasing their participation in the corporation. On the one hand, the statutory language relating to the circumstances under which preemptive rights can be excluded limits the ability of directors to sell the shares only to some shareholders. Consider the case of contributions in kind. Only if a business purpose justifies the acquisition of property owned by a specific shareholder can the new shares be sold only to this investor. The same is true in the few cases in which the interest of the corporation requires the exclusion of preemptive rights, or when preemptive rights are excluded for the benefit of employees.

In addition, general corporate law principles require equal treatment of all shareholders.⁸⁵ Pursuant to this principle, it is difficult to justify the exclusion of preemptive rights and the simultaneous sale of shares to a selected number of shareholders, leaving the other ones out in the cold.

Also under Italian law, as in the U.S., there are no preemptive rights in the case of merger. Unlike the U.S., however, Italian law, pursuant to European law, does not allow cash-out mergers. As a consequence, generally all shareholders of the corporations involved receive a proportionally identical percentage of shares in the corporation resulting from the merger, calculated on the basis of the exchange ratio.⁸⁶

Finally, in Italy there are no specific rules concerning the resale by the corporation of treasury shares, which in theory, could be sold to only some shareholders. This practice would however be subject to scrutiny based on the above-mentioned principle of equal treatment of shareholders.

In this section we have considered how shareholders are protected against possible dilutions caused by the issuing of new shares under Italian law. To sum up, we have seen that Italian law, in comparison to U.S. law, provides for more rigid rules against dilutions. First, the competence to issue new shares for a consideration is more firmly in the hands of the shareholders. Second, all shareholders have a mandatory preemptive right established in the corporate statute—a

⁸⁵ A general principle of equal treatment of shareholders under European company law has also been inferred by the European Court of Justice in the “Audiolux” case. See Federico M. Mucciarelli, *Equal Treatment of Shareholders and European Union Law*, 7 *EUR. CO. & FIN. L. REV.* 158 (2010). For a study of the principal of equal treatment of shareholders in Italy, see generally Carlo Angelici, *Parità di trattamento degli azionisti*, *RIVISTA DI DIRITTO COMMERCIALE* 1 (1987) (It.). In specifically listed corporations, see Marco Ventoruzzo, *Article 92. Parità di trattamento*, in *LA DISCIPLINA DELLE SOCIETÀ QUOTATE* (Vol. I, Giuffrè, 1999) (Piergaetano Marchetti & Luigi A. Bianchi eds.).

⁸⁶ See Marco Ventoruzzo, *Freeze-outs: Transcontinental Analysis and Reform Proposals*, 50 *VA. J. INT'L L.* 841, 887 (2010).

right that can be waived only in narrow circumstances. If the rights are waived, mandatory rules ensure that the issuing price is fair and specifically, not lower than the actual value of the shares.

4. *Italian Law: Directors' Fiduciary Duties*

Directors can be liable to the corporation or to a single shareholder for a violation of their duty of care and loyalty, which include the duty to act lawfully.⁸⁷ A violation of the mandatory rules concerning the procedures required for issuing new shares can therefore result in liability to the corporation and to single shareholders. Liability to the corporation occurs when the corporation suffers the damage, and shareholders can also act derivatively on behalf of the corporation. When the damage only affects shareholders and does not implicate damage to corporate assets, shareholders also have a direct cause of action against directors.

Not respecting the rules concerning preemptive rights can be a source of liability in at least two circumstances. For one, illegally excluding preemptive rights can damage shareholders by diluting their investment. Additionally, setting an issuing price below the fair value in the cases in which the preemptive right is excluded can damage both the corporation (which receives less than the actual value of the shares), and the shareholders (whose participation loses value).

This type of lawsuit is fairly rare, for at least two reasons. First, the procedure to issue new shares is tightly regulated, as are the cases in which the preemptive right can be limited. This regulatory approach leaves little room for directors' discretion. To incur liability, directors would have to blatantly disregard the law by, for example, denying preemptive rights when shareholders are entitled to them. In other words, director liability arises more easily when directors have more freedom to act, and a breach of the duty of care or of loyalty is possible; there is a direct relationship between discretion and accountability. When mandatory provisions govern an area of the law, violations of fiduciary duties tend to be more rare.

There is a second and more general reason why directors' fiduciary duties do not play the same role in Italy that they play in the U.S. The Italian system relies less on private litigation as an *ex post* mechanism to govern corporations, for a number of reasons, including procedural ones. The absence of a U.S. style class action and of discovery, the existence of a "loser pays" rule, the unavailability of contingency fees to retain lawyers, and the extremely long duration of civil

⁸⁷ For an overview of the concept of directors' fiduciary duties in Europe, see generally Holger Fleischer, *Legal Transplants in European Company Law—The Case of Fiduciary Duties*, 2 EUR. COMPANY AND FIN. L. REV. 378 (2005).

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litigation contribute to reduce the attractiveness of litigation as a means to protect preemptive rights of disgruntled shareholders.⁸⁸

5. *Germany*

Pursuant to the Second Company Law Directive under German law, an increase of capital for consideration must be decided by the shareholders' meeting and represents an amendment to the corporation's charter. There is a double majority requirement, because the resolution must be approved by a simple majority of the votes, representing at least three-quarters of the voting capital.⁸⁹ The corporate charter or bylaws can increase these percentages to further protect shareholders.⁹⁰ In addition, if the corporation has issued different classes of shares, any capital increase affecting the rights of a class of shares must also be approved by a class vote.⁹¹

Shareholders can delegate the power to increase the capital to directors generally, or for specific purposes.⁹² In the former case, the delegation can be given only for a maximum period of five years, similar to Italian law, and the capital increase cannot exceed 50% of the outstanding shares.⁹³ Rules concerning preemptive rights in Germany (*Bezugsrecht*) are particularly rigid. Generally, shareholders always have a mandatory preemptive right, both when the new shares are issued for cash and when issued for assets in kind.⁹⁴ Shareholders may waive their preemptive rights, but only through a resolution, voted on by three-quarters of the capital represented at the meeting and based on a report prepared by the executive board (*Vorstand*), stating the reasons why the exclusion of preemptive rights is in the company's best interest.⁹⁵ Courts also require managers to show that the corporation has a valid business purpose to limit preemptive

⁸⁸ For an excellent and recent analysis of these procedural elements, and an explanation of why they can limit the use of corporate litigation in European countries, including Italy, see Martin Gelter, *Why Do Shareholders Derivative Suits Remain Rare in Continental Europe?*, 37 *BROOK. J. INT'L L.* 843 (2012).

⁸⁹ Aktiengesetz [AKTG] [Stock Corporation Act], Sep. 6, 1965, BGBL. I at 1089, § 182 (1) (Ger.), translated in *STOCK CORPORATION ACT*, NORTON ROSE (1 Dec. 2011) [hereinafter *Stock Corporation Act*]; see also CAHN & DONALD *supra* note 3, at 197; see generally GERHARD WIRTH ET AL., *CORPORATE LAW IN GERMANY* 179 (C.H. Beck, 2nd ed., 2010).

⁹⁰ See *Stock Corporation Act*, *supra* note 89, at 1089, § 182 (1) (Ger.), translated in *STOCK CORPORATION ACT*, NORTON ROSE (1 Dec. 2011).

⁹¹ *Stock Corporation Act*, *supra* note 89, § 182 (2).

⁹² *Id.* §§202; 186.

⁹³ CAHN & DONALD, *supra* note 3, at 198.

⁹⁴ See *Stock Corporation Act*, *supra* note 89, at 1089, § 186(1) (Ger.), translated in *STOCK CORPORATION ACT*, NORTON ROSE (1 Dec. 2011).

⁹⁵ *Id.* § 186(3)-(4).

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rights.⁹⁶ When preemptive rights are waived, the issuing price of the new shares must be appropriate, and shareholders have an explicit cause of action to challenge the price in court.⁹⁷

In the 1990s, the German corporate statute was amended to allow the exclusion of preemptive rights in listed corporations if the new shares are paid in cash.⁹⁸ In this case, the capital increase cannot exceed 10% of the outstanding shares, and the issuing price cannot be lower than the market price.⁹⁹ This ground for limiting preemptive rights is, as previously discussed, similar to one of the four grounds for exclusion under Italian law.¹⁰⁰

6. France

Under French law, issuing new shares for a consideration is subject to specific formalities designed to protect shareholders against the risk of dilution. The power to decide the capital increase is, as in other European jurisdictions, in the hands of the so-called extraordinary shareholders' meeting and is subject to supermajority requirements (two thirds of the votes cast).¹⁰¹ The shareholders can, however, delegate the power to the directors pursuant to Article L. 225-129 of the Commercial Code and, in listed companies, the delegation can also be given to the CEO.¹⁰²

When France introduced mandatory preemptive rights in 1935,¹⁰³ the legislature allowed preemptive rights to be waived by the

⁹⁶ See Bundesgerichtshof [BGH] [Federal Court of Justice] Mar. 13, 1978, II ZR 142/76 ENTSCHEIDUNGEN DES BUNDESGERICHTSHOFES IN ZIVILSACHEN [BGHZ] 71 (40) (Ger.); Bundesgerichtshof [BGH] [Federal Court of Justice] Apr. 19, 1982, II ZR 55/81 ENTSCHEIDUNGEN DES BUNDESGERICHTSHOFES IN ZIVILSACHEN [BGHZ] 83 (319) (Ger.); CAHN & DONALD, *supra* note 3, at 201-02; see also HERIBERT HIRTE, BEZUGSRECHTSAUSSCHLUSS UND KONZERNBILDUNG 58 ff. (Heyman, 1986).

⁹⁷ Stock Corporation Act, *supra* note 89, at 1089, § 255(2)-(3) (Ger.), translated in STOCK CORPORATION ACT, NORTON ROSE (1 Dec. 2011). Veil, in Schmidt and Lutter (2008: § 182 mn. 23).

⁹⁸ *Id.* § 186(3).

⁹⁹ *Id.* § 255(2)-(3).

¹⁰⁰ WIRTH ET AL., *supra* note 89, at 179.

¹⁰¹ MAURICE COZIAN ET. AL, DROIT DES SOCIETES 457 (LexisNexis, 25th ed., 2012) (Fr.).

¹⁰² CODE DE COMMERCE [C. COM.] art. L.225-129-1 (Fr.); see also *id.* n. 61.

¹⁰³ See Frédéric Serpoul, *Beyond Legal Origins: Shareholder Protection and Stock Market Development in France (1852-2007)* 19 (London School of Economics and Political Science, Working Paper, June 15, 2013) ("Shareholder rights improved significantly in the mid-1930's through changes initiated by the Laval government [. . .]. In particular, as a result of the 1935 laws which granted preemptive rights to shareholders in order to prevent majority shareholders abuses (dilution), LLSV shareholder right index rose to 2.").

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shareholders' meeting, not dissimilarly from what was happening in some U.S. States.¹⁰⁴ France still provides for mandatory preemptive rights in Article L. 225-132 of the Commercial Code.¹⁰⁵ The extraordinary shareholders' meeting can, however, waive preemptive rights. In this case, the resolution must indicate the persons that will subscribe to the shares, or the criteria that the subscribers must meet.¹⁰⁶ In listed corporations, the indication of the beneficiary of the shares is not necessary.¹⁰⁷ Also in listed corporations, the Commercial Code provides that when preemptive rights are waived the shareholders' meeting can give existing shareholders a term during which they can subscribe the shares before third parties.¹⁰⁸ Preemptive rights also do not apply when the extraordinary shareholders' meeting approves an increase of capital paid with consideration in kind.¹⁰⁹ It can be observed, therefore, that France also views preemptive rights as the default rule, and that preemptive rights can only be waived with the consent of the controlling shareholders.

Specific rules apply to the determination of the issuing price when preemptive rights are waived. The general rule, applicable when the shareholders' decision indicates the beneficiaries acquiring the new shares, is that the price can be determined by the shareholders' meeting.¹¹⁰ In listed corporations, when the beneficiaries of the new shares are not indicated, the price must be in line with the trading price in order to avoid a prejudice to the value of the existing shareholders' shares.¹¹¹

7. *Spain*

Under the Spanish *Ley de Sociedades de Capital*, the competence to increase the capital is primarily in the hands of the shareholders' meeting. The shareholders can, however, delegate this power to the board of directors for a period of five years, although in this case the amount of the increase is limited to fifty percent of the outstanding capital.¹¹²

¹⁰⁴ Katharina Pistor et al., *The Evolution of Corporate Law: A Cross-Country Comparison*, 23 U. PA. J. INT'L ECON. L. 791, 825 (2002).

¹⁰⁵ Sofie Cools, *The Real Difference in Corporate Law Between the United States and Continental Europe: Distribution of Powers*, 30 DEL. J. CORP. L. 697, 729 (2005).

¹⁰⁶ CODE DE COMMERCE [C. COM.] art. L.225-138 (Fr.).

¹⁰⁷ MAURICE COZIAN ET AL., *supra* note 101, at 459.

¹⁰⁸ CODE DE COMMERCE [C. COM.] art. L.225-135-5 (Fr.); MAURICE COZIAN ET AL., *supra* note 101, at 459.

¹⁰⁹ MAURICE COZIAN ET AL., *supra* note 101, at 462.

¹¹⁰ CODE DE COMMERCE [C. COM.] art. L.225-138 (Fr.).

¹¹¹ *See* CODE DE COMMERCE [C. COM.] art. L.225-136 (Fr.).

¹¹² Corporations Act art. 297 (B.O.E. 2010, 161) (Spain).

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As a general rule, when new shares are issued, existing shareholders have a preemptive right (*derecho de preferentia*). After a 2008 decision of the European Court of Justice, bondholders no longer have preemptive rights when new shares are issued.¹¹³ This right can be totally or partially waived by the shareholders when the interest of the corporation requires it. In this case, the directors must prepare a report to the shareholders indicating the value of the shares, the reasons for the exclusion of the preemptive right, and the investors that will subscribe the new shares. An independent appraiser appointed by the Office of the Corporate Register must calculate the value of the shares and of the preemptive rights that are excluded, and must assess the soundness of the value of the shares included in the directors' report. The issuing price cannot be lower than the fair value of the shares.¹¹⁴

8. *United Kingdom*

In the U.K., pursuant to European law, directors may issue new shares only if authorized by the corporate charter or by the shareholders; the authorization must specify the maximum number of shares that can be issued and can only be given for a period of five years.¹¹⁵ U.K. law gives, however, more extensive powers to directors in the case of a close company with only one class of shares. In this case, the directors are free to issue new shares unless there is an explicit prohibition in the articles of incorporation.¹¹⁶

The English corporate law statute introduced preemptive rights (also called "rights issue") to comply with European Union law.¹¹⁷ The relevant provisions can be found in the Companies Act, Part 17, Chapter 3, § 560.¹¹⁸ It is interesting to point out that, different from the U.S. and even other European systems, preemptive rights also apply in the case of a sale of treasury shares held by the company.¹¹⁹

U.K. law distinguishes between exceptions, exclusions, and disapplication of preemptive rights. Exceptions include the case in which shares are paid other than in cash¹²⁰ and when the shares are des-

¹¹³ The European Court of Justice declared this provision in violation of the Second Directive because granting preemptive rights to convertible bondholders limits the number of shares available for shareholders, contrary to the provision of the Directive; see Case C-338/06 *supra* note 68.

¹¹⁴ MANUEL BROSETA PONT & FERNANDO MARTINEZ SANZ, *MANUAL DE DERECHO MERCANTIL* 460 (19th ed., 2012) (Sp.).

¹¹⁵ Companies Act, 2006, c. 2, §551 (U.K.).

¹¹⁶ BRENDA HANNIGAN, *COMPANY LAW* 460 (3d ed. 2012).

¹¹⁷ Pistor et al., *supra* note 104, at 825.

¹¹⁸ Companies Act, 2006, c. 3, § 560 (U.K.).

¹¹⁹ *Id.* § 573.

¹²⁰ *Id.* § 565.

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ted to an employees' share scheme.¹²¹ The articles of incorporation of a close corporation can exclude preemptive rights pursuant to § 567 of the Companies Act, which provides an opt-out mechanism. In addition, the directors of a private company that has only one class of shares outstanding can be given, by the articles of incorporation or by the shareholders, the power not to apply preemptive rights.¹²²

PART III: CONCLUSIONS

This overview of the rules governing issuing of new shares in the U.S. and in some European jurisdictions has shown a few basic, but important, comparative differences. In the U.S., within the limit of authorized shares, directors have significant freedom to increase capital. This freedom is enhanced by the practice of authorizing a number of shares significantly higher than the number of outstanding shares, but is partially curbed by rules requiring shareholders' approval when the issuing of new shares might determine a shift in control. In terms of competence, the differences with European jurisdictions are not particularly profound.

It is true that, in Europe, the competence to issue new shares is generally attributed to the shareholders' meeting, while in the U.S., the powers of directors are original and undelegated.¹²³ However, it is also true that in Europe shareholders can delegate their power to issue new shares to directors, even if there are some limitations to this power, such as the fact that the delegation is only valid for five years. Through a delegation, therefore, European directors can also be entrusted with a meaningful degree of freedom in issuing new shares.

The real and profound difference concerns preemptive rights. Generally speaking, most American statutes, including the M.B.C.A. and Delaware law, do not provide for preemptive rights. These rights are only available through a specific option in the articles of incorporation, and virtually no listed corporations make such an option. Shareholders are protected against the risk of unfair dilution primarily through directors' fiduciary duties. In Europe, as the Italian example clearly shows, shareholders' preemptive rights are mandatory and can only be waived in limited circumstances when the interest of the corporation requires it. When shareholders waive their preemptive rights, the issuing price generally cannot be lower than the fair market value of the shares. Comparatively, directors' fiduciary duties play a more limited role in protecting shareholders.

What does this difference tell us about the forces that shape corporate law on the two sides of the Atlantic? How does this compari-

¹²¹ See *id.* § 566.

¹²² *Id.* § 569.

¹²³ See *Manson v. Curtis*, 119 N.E. 559, 562 (N.Y. 1918).

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son reflect on the structure of corporate law? It is tempting to characterize the European approach, and the Italian approach in particular, as more regressive when compared to its U.S. counterpart. After all, with some differences, the U.S. adopted mandatory preemptive rights in the past but abandoned them in favor of a more flexible rule that allows corporations, and their directors, to follow a more expeditious and efficient procedure to sell new shares. To simply dismiss the European approach as a relic of the past would not, however, be a satisfactory conclusion.

A second and more compelling explanation of the diverging approaches might be based on the degree of separation between ownership and control. In the U.S., at an earlier stage, the separation between ownership and control became more profound, resulting in managers and directors becoming key players in shaping corporate laws. Directors and managers, selecting the state of incorporation, can put pressure on the legislatures to adopt the rules that they favor. This was probably one of the driving forces that induced state legislatures to abolish mandatory preemptive rights.¹²⁴

In Europe the situation is radically different. Notwithstanding the recent developments of the jurisprudence of the European Court of Justice,¹²⁵ in Europe there is not, and probably never will be, a market for corporate charters as developed as the American one. In addition, prevailing ownership structures are profoundly different from the U.S. In most continental systems, controlling shareholders are still very influential both within the corporation and *vis-à-vis* policy makers. In the U.K., while ownership structures of public corporations are more

¹²⁴ John Armour and David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers, and Why? – The Peculiar Divergence of U.S. and U.K. Takeover Regulation*, 95 *Geo. L. J.* 1727 (2007) advances a fascinating public choice explanation for the differences in takeover regulation in the U.K. and in the U.S. The former system seems to favor managers and directors against hostile acquisitions, while the latter favors institutional investors through the use of the mandatory tender offer rule and the passivity rule. In short, they advocate that this difference can be explained in the light of the influence of institutional investors on the development of U.K. rules, and of directors and managers in the U.S. A similar argument could be used for the regulation of preemptive rights: in the U.S., stronger managers and directors managed to shift the regulatory approach to greater flexibility in the issuance of new shares, while in Europe institutional investors and controlling shareholders pushed for a stronger protection of their investment through mandatory preemptive rights.

¹²⁵ See Marco Ventrizzo, “Cost-based” and “Rules-based” Regulatory Competition: Markets for Corporate Charters in the U.S. and in the E.U., 3 *N.Y.U. J.L. & Bus.* 91, 133-35 (2006); Veronika Korom & Peter Metzinger, *Freedom of Establishment for Companies: The European Court of Justice Confirms and Refines its Daily Mail Decision in the Cartesio Case C-210/06*, 6 *EUR. COMPANY AND FIN. L. REV.* 125 (2009).



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widespread than in continental Europe, institutional investors are particularly strong. As a result, it is more difficult for directors and managers to obtain a legislative departure from preemptive rights that protect the interests of existing shareholders. The Second Directive and the regulatory approaches of the Member States reflect this situation: mandatory preemptive rights are still considered a cornerstone of corporate law, and shareholders play a more crucial role in controlling the issuing of new shares.

The explanation based on ownership structure is not completely satisfactory. It might be argued that in listed or publicly held corporations, where the separation between ownership and control is more profound in the U.S., directors and managers influenced the development of corporate law toward the abolition of mandatory preemptive rights. But the shift in the U.S. also affected close corporations, in which the degree of separation between ownership and control is lower. Also in these corporations, as we have seen, directors have broader, non-delegable powers to issue new shares, and preemptive rights are generally not available unless the governing documents of the corporation provide for them. The prevailing ownership structures of the firms do not, therefore, seem to fully capture the reasons that led the U.S. to substantially abolish mandatory preemptive rights in all types of corporations.

An alternative theory might be that the diverging development of U.S. and European laws on preemptive rights reflects a more general "cultural" difference concerning the function of corporate law. In the U.S., shareholders are considered investors able to contract the basic rules of the corporate contract among themselves and with other corporate actors. From this point of view, it makes sense to provide for preemptive rights only on an optional basis. Freedom of contract is considered a sufficient protection for shareholders, as they are able to maximize efficiency. If shareholders want preemptive rights, they will include them in the charter of the corporation.

In Europe, by contrast, there is not a similar trust in the virtues of contractual liberty: property rights of shareholders are more strongly protected through mandatory rules, at the expense of a more flexible financial structure that would allow directors and managers to obtain fresh financial resources from new investors more quickly. The greater discretion of directors in the U.S. is balanced in this area, by the policing role of litigation for breaches of fiduciary duties, while litigation in Europe plays a lesser role.

**COMMENT: EMINENT DOMAIN:
THE SOLUTION TO THE FORECLOSURE CRISIS OR
OVERSTEPPING GOVERNMENT BOUNDARIES?**

*By: Anne T. T. Jensen**

I. INTRODUCTION

In the summer of 2012, the relatively unknown county of San Bernardino, California made national headlines when its CEO announced that he would entertain a venture fund's proposal to use the county's power of eminent domain to seize mortgages and sell them for restructuring in an effort to assist the county's struggling homeowners. While many, including California Lieutenant Governor Gavin Newsom, backed the county's resourcefulness in desperate times,¹ others have questioned whether the county could be overstepping its constitutional bounds and causing more harm than good. Is this the long-awaited solution to America's floundering housing market?

Unfortunately, it seems a revival of the market through eminent domain is unlikely. While the San Bernardino proposal would be within the limits of the power afforded to states and municipalities by the U.S. and state constitutions, it may have a long-term cooling effect on the lending market that would greatly outweigh any short-term relief it may offer.

This article will provide both an analysis of the legal concept of eminent domain and its likelihood of success in resuscitating real estate markets in towns like San Bernardino. Sections Two and Three will explore the background of the mortgage crisis and provide an in-depth description of the eminent domain proposal by the Mortgage Resolution Partners ("MRP"). Section Four takes a deeper look into the state and federal precedent on a municipality's power to use eminent domain, revealing that the definition of "legitimate public purpose" would likely apply to the seizing of mortgages. Finally, Section Five will focus on the predicted effect this proposal, if enacted, would have on lenders and borrowers, proving that San Bernardino should refrain from using eminent domain to seize private mortgages.

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¹ Sam Forgione, *FHFA Raises Concerns About Eminent Domain Plan*, REUTERS (Aug. 8, 2012, 3:16 PM), <http://www.reuters.com/article/2012/08/08/us-mortgages-restructuring-idUSBRE8771C420120808>.

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II. THE MORTGAGE CRISIS

The mortgage crisis, which began in 2007, has had a crippling effect on the country's housing market over the last six years. As of January 2012, there were approximately 12 million underwater homeowners nationwide,² with sources estimating that they collectively owed \$1.2 trillion more than their homes are worth.³ Moreover, of the 12 million underwater homeowners, approximately 28 percent were behind on their payments, putting them at a higher risk of default.⁴ Such defaults typically result in lengthy and expensive short-sale or foreclosure proceedings⁵ (totaling upwards of 3.9 million in 2011⁶), during which both lenders and homeowners suffer. While refinancing the loan for lower interest rates is an option for some, many homeowners owe as much as twice what their house is currently worth.⁷ For those borrowers, a principal modification, a special form of debt relief offered by the lender, is the only thing that will save their homes.⁸

So why, in the face of a national financial crisis of this scale, is it so difficult for homeowners to obtain loan modifications? One of the biggest problems is that while homebuyers initially sign a mortgage with a bank or financial service company, most of those firms only service, or manage, the loan.⁹ Many loans are then bought and sold to investors on the secondary market as mortgage-backed securities.¹⁰ Unfortunately, it is where the loans end up, not where they originate,

² BD. OF GOVERNORS OF THE FED. RESERVE SYS., *THE U.S. HOUSING MARKET: CURRENT CONDITIONS AND POLICY CONSIDERATIONS* 21 (2012), available at <http://www.federalreserve.gov/publications/other-reports/files/housing-white-paper-20120104.pdf>.

³ Ben Hallman, *San Bernardino Eminent Domain Fight Closely Watched By Other Struggling Communities*, HUFFINGTON POST (Sept. 25, 2012, 3:29 PM), http://www.huffingtonpost.com/2012/09/01/eminent-domain-mortgages_n_1836710.html.

⁴ BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 2; Ted Gayer, *How Many Borrowers Might Qualify for Principal Reduction Under the Mortgage Settlement?*, BROOKINGS INSTITUTE (Mar. 1, 2012, 3:24 PM), <http://www.brookings.edu/blogs/up-front/posts/2012/03/01-mortgage-agreement-gayer>.

⁵ Estimates from 2008 suggest that a foreclosure costs approximately \$77,000, a cost that is split between the lender, homeowner, neighborhood, and local government. Glenn Setzer, *Foreclosures Cost Lenders, Homeowners, the Community Big Bucks*, MORTGAGE NEWS DAILY, (June 2, 2008), http://www.mortgagenewsdaily.com/622008_Foreclosure_Costs.asp.

⁶ *Home Foreclosure Statistics*, STATISTIC BRAIN (Oct. 15, 2012), <http://www.statisticbrain.com/home-foreclosure-statistics/>.

⁷ Hallman, *supra* note 3.

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

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that matters for the homebuyers seeking to qualify for principal reduction.¹¹

Underwater homeowners with loans at the largest banks are currently receiving the most assistance. Five banks, including Bank of America and JPMorgan Chase, reached a settlement agreement with state attorney generals in early 2012 to offer debt forgiveness of at least \$10 billion.¹² While it is questionable whether this assistance will reach a significant number of homeowners,¹³ the banks must reach the \$10 billion target or face financial penalties.¹⁴

The second and largest pool of loans are those owned or controlled by Fannie Mae and Freddie Mac, government-owned mortgage companies. In early 2012, it was estimated that approximately 3.3 million of those loans were underwater.¹⁵ Unfortunately, those homeowners do not currently qualify for any type of principal reduction.¹⁶

Private investors, including pension funds like California Public Employees' Retirement System and the bond fund Pacific Investment Management Co., own much of the remaining approximately ten percent of all loans.¹⁷ These mortgages are the most likely to be deep underwater (three times as likely as Fannie Mae or Freddie Mac loans), and are thus at the highest risk of failing.¹⁸ The banks managing these loans typically point to their contracts with private investors as the barrier to principal reduction.¹⁹ Their loans are often divided into bonds that are owned by many different investors, so there are usually no single entities that the banks can approach for revisions of the agreements.²⁰ Thus, millions of upside down homeowners are unlikely to see any relief in the form of principal reduction from their lenders.

III. EMINENT DOMAIN PROPOSAL

When MRP, a self-described community advisory firm,²¹ formulated its theory that the power of eminent domain could revitalize the housing market, San Bernardino County seemed like the perfect

¹¹ *Id.*

¹² *Id.*; Gayer, *supra* note 4.

¹³ *See* Gayer, *supra* note 4.

¹⁴ Hallman, *supra* note 3.

¹⁵ Gayer, *supra* note 4.

¹⁶ Hallman, *supra* note 3.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ MORTGAGE RESOL. PARTNERS, <http://mortgageresolution.com/> (last visited Dec. 2012).

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place to test the concept. The recession had hit San Bernardino's homeowners harder than most. In late 2012, the County's 11.9 percent unemployment rate was one of the nation's highest,²² and housing prices had plummeted as a result. Unsurprisingly, every second homeowner in San Bernardino was underwater by the summer of 2012.²³

MRP sought out the county CEO, Greg Devereaux, and presented its CARES theory (Community Action to Restore Equity and Stability²⁴) to use eminent domain to help county homeowners.²⁵ Eminent domain is the authority of the government "to take private property for a public use" so long as the owner receives "just compensation" for the property taken.²⁶ This authority is available to the federal government under the Fifth Amendment to the U.S. Constitution.²⁷ Every state government has also inherently been granted this authority as an attribute of sovereignty, subject to limitations found in each state's constitution or statutory law.²⁸ Eminent domain is, in theory, applicable to any type of property, including mortgages.

²² GOOGLE PUBLIC DATA EXPLORER, http://www.google.com/publicdata/explore?ds=z1ebjgk2654c1_&ctype=l&strail=false&bcs=d&nselm=h&met_y=unemployment_rate&fdim_y=seasonality:U&scale_y=lin&ind_y=false&rdim=country&idim=county:CN060710&iifdi=country&tstart=631861200000&tend=1336536000000&hl=en&dl=en&ind=false&q=san+bernardino+county+unemployment+rate#!ctype=l&strail=false&bcs=d&nselm=h&met_y=unemployment_rate&fdim_y=seasonality:U&scale_y=lin&ind_y=false&rdim=country&idim=county:CN060710&iifdim=country&tstart=1290747600000&tend=1359176400000&hl=en_US&dl=en&ind=false (last visited Jan. 20, 2013).

²³ *Realtors, Banks Warn Plan To Seize Distressed Homes May Backfire: Half of San Bernardino County Homeowners 'Underwater'*, CBS LOS ANGELES (July 6, 2012, 8:31 AM), <http://losangeles.cbslocal.com/2012/07/06/realtors-banks-warn-plan-to-seize-distressed-homes-may-backfire/>.

²⁴ MORTGAGE RESOL. PARTNERS, *supra* note 21.

²⁵ Joe Nocera, Op-Ed., *Housing's Last Chance?*, N.Y. TIMES, Jul. 9, 2012 at A21, available at http://www.nytimes.com/2012/07/10/opinion/nocera-housings-last-chance.html?_r=0.

²⁶ See, e.g., *Landgraf v. USI Film Prod.*, 511 U.S. 244, 266 (1994) (noting that the Fifth Amendment allows the government to take private property for a "public use" and upon payment of "just compensation"); *Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1004-05 (1984) (distinguishing between a taking when the government "deprive[s] the owner of all or most of his interest in a subject matter" and mere "regulation," not requiring just compensation).

²⁷ U.S. CONST. amend. V.

²⁸ *Gober v. Stubbs*, 682 So. 2d 430, 433 (Ala. 1996) (explaining that "[t]he power of eminent domain does not originate in [the constitution, i]nstead, it is a power inherent in every sovereign state"); see also *Calmat of Ariz. v. State ex rel. Miller*, 859 P.2d 1323, 1326 (Ariz. 1993); *Mt. San Jacinto Cmty. Coll. Dist. v. Super. Ct.*, 11 Cal. Rptr. 3d 465, 469 (Cal. Ct. App. 2004).

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In this case, the idea is that a municipality could buy underwater mortgages using its power of eminent domain and then write the homeowner a new, reduced mortgage.²⁹ Proponents argue it would be an effective avenue to get around the roadblock of securitization contracts that prevent people from modifying loans.³⁰ MRP maintains that it could be a way to prevent future foreclosures.³¹ Ultimately, the goal would be a stabilization of housing prices.³²

The plan calls for the county to buy mortgages at a large, but fair, discount to their face value,³³ and then offer to refinance the homeowner into a new mortgage with a “sustainable” balance.³⁴ The plan would take associated fees and costs out of the spread.³⁵ The money to buy the mortgages would come from investors whom MRP has already started to secure.³⁶

In addition to San Bernardino, about a dozen other communities have voiced some level of interest in the eminent domain plan, including Chicago, Sacramento, New York’s Suffolk County, and Detroit.³⁷

IV. LEGITIMATE PUBLIC PURPOSE?

In order for the use of eminent domain to be legal under the U.S. Constitution and the majority of state constitutions, the government must take the property for a “public use” and the owner must receive “just compensation” for the acquired property.³⁸ Since San Bernardino would be offering a fair price for the property, the more frequent objection to MRP’s plan is that the taking of private mortgages would not be a legitimate public use, in violation of the U.S. and most state constitutions. In fact, the Federal Housing Finance Agency (“FHFA”) launched a formal investigation into the proposal in late 2012, issuing a request for input from industry groups.³⁹ In an open letter to the FHFA, the California Association of Realtors expressed its apprehension at the idea, stating:

²⁹ Nocera, *supra* note 25; MORTGAGE RESOLUTION PARTNERS, *supra* note 21.

³⁰ Nocera, *supra* note 25.

³¹ *Id.*

³² *Id.*

³³ *Id.*

³⁴ MORTGAGE RESOL. PARTNERS, *supra* note 21.

³⁵ Nocera, *supra* note 25.

³⁶ *Id.*

³⁷ Hallman, *supra* note 3.

³⁸ See, e.g., Landgraf v. USI Film Prod., 511 U.S. 244, 266 (1994); Ruckelshaus v. Monsanto Co., 467 U.S. 986, 1004-05 (1984).

³⁹ Notice of Input Accepted on Use of Eminent Domain to Restructure Performing Loans, 77 Fed. Reg. 154 (Aug. 9, 2012), available at http://fhfa.gov/webfiles/24147/77_FR_47652_8-9-12.pdf.

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While we applaud local officials' efforts to continually search for innovative solutions to expedite a full economic recovery, we cannot support this proposal . . . The use of eminent domain to seize underwater performing loans, alter their loan terms, and then resell them to another investor is . . . a violation of the "public use" requirement of eminent domain.⁴⁰

However, the critics of MRP's plan are unlikely to find much support for their challenge under either the federal or state law. The definition of what constitutes a valid public use has been greatly expanded by the majority of both state and federal courts over the years so that, now, almost any acquisition will satisfy the test.

A. *Federal Law*

As early as 1954, the United States Supreme Court faced the issue of whether a taking that involves sale to a private party could fulfill the requirement for legitimate public purpose under the U.S. Constitution. In *Berman v. Parker*, the Court held that Washington D.C.'s use of eminent domain for the public use of acquiring commercial property was constitutional.⁴¹ The Court found that the taking of property for slum clearance and the removal of urban blight was a legitimate public purpose within the police powers of the state.⁴² The Court based its decision on an expanded definition of public use that allows private enterprises to be involved in the taking of private property for its redevelopment and resale.⁴³ To elaborate on this point, the Court stated that:

[T]he means of executing the project are for Congress and Congress alone to determine, once the public purpose has been established. The public end may be as well or better served through an agency of private enterprise than through a department of government—or so the Congress might conclude. We cannot say that public

⁴⁰ Open Letter from Arnold LeFrancis, President, California Association of Realtors, to Alfred M. Pollard, General Counsel, FHFA on the Use of Eminent Domain to Restructure Performing Loans (Sept. 7, 2012) (on file with the FHFA), *available at* http://www.fhfa.gov/webfiles/24290/16_California_Association_of_REALTORS.pdf.

⁴¹ *Berman v. Parker*, 348 U.S. 26 (1954).

⁴² *Id.* at 32.

⁴³ *Id.* at 33 (noting that the public welfare may include "spiritual . . . physical, aesthetic . . . and monetary" values).

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ownership is the sole method of promoting the public purposes of community redevelopment projects.⁴⁴

As a result, an early standard was set for allowing private party involvement in valid eminent domain takings under the U.S. Constitution.

The U.S. Supreme Court again opted for a broad definition of public use in *Hawaii Housing Authority v. Midkiff*.⁴⁵ At issue in this case was the constitutionality of Hawaii's Land Reform Act, which aimed to reduce the social and economic evils caused by large land estates that dated back to the high chiefs of the pre-statehood Hawaiian Islands.⁴⁶ To reduce the concentration of inland ownership, the Act created the Hawaii Housing Authority, whose mission was to take title to the real property from lessors of large land estates, condemn the land, then sell the property to the lessees inhabiting the land at the time that it was condemned.⁴⁷ Lessees could file to have the land they lived on condemned, but the process would only be instituted once the Authority determined through a public hearing that the "acquisition of the tract would promote the public purposes of the Act."⁴⁸

In *Midkiff*, lessors who had refused to comply with the Authority's condemnation process had filed suit in federal court claiming that the Act was unconstitutional.⁴⁹ On appeal, the U.S. Supreme Court held that a "literal requirement" of general public use of property is not necessary to meet the conditions of eminent domain.⁵⁰ Thus, the Court disagreed with a lower court decision that the government must possess and use the property at some point during the condemnation process.⁵¹ Justice O'Connor, writing for the unanimous Court stated that:

The mere fact that property taken outright by eminent domain is transferred in the first instance to private beneficiaries does not condemn that taking as having only a private purpose. The Court long ago rejected any literal requirement that condemned property be put into use for

⁴⁴ *Id.* at 33-34; David Schultz, *Economic Development and Eminent Domain After Kelo: Property Rights and "Public Use" Under State Constitutions*, 11 ALB. L. ENVTL. OUTLOOK J. 41, 47 (2006).

⁴⁵ *Haw. Hous. Auth. v. Midkiff*, 467 U.S. 229 (1984).

⁴⁶ HAW. REV. STAT. § 516.1-516.56 (1993) (granting the housing finance and development corporation the power to use eminent domain or purchase land with the threat of eminent domain); *Midkiff*, 467 U.S. at 232-33; Schultz, *supra* note 44, at 48.

⁴⁷ *Midkiff*, 467 U.S. at 233-34.

⁴⁸ *Id.*

⁴⁹ *Id.* at 234-35.

⁵⁰ *Id.* at 244.

⁵¹ *Id.* at 243.

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the general public. "It is not essential that the entire community, nor even any considerable portion . . . directly enjoy or participate in any improvement in order [for it] to constitute a public use . . . "[W]hat in its immediate aspect [is] only a private transaction may . . . be raised by its class or character to a public affair."⁵²

Thus, in *Midkiff*, the U.S. Supreme Court endorsed the use of eminent domain for redistribution of private resources within a community if it accomplishes a widely drawn public purpose.⁵³

As recently as 2005, the U.S. Supreme Court has yet again ruled in favor of an expanded interpretation of public use, this time expanding it to economic development. In *Kelo v. City of New London*, the Court affirmed a Connecticut Supreme Court decision that held the taking of unblighted private property with the goal of economic development constituted a valid public use under both the state and federal constitutions.⁵⁴

In this case, the City of New London, a municipal corporation, and the New London Development Corporation, a private nonprofit entity, planned to use the authority granted to them under a state law⁵⁵ to take unblighted land in the waterfront area known as Fort Trumbull to build a residential and commercial development in an effort to revitalize the city's downtown area.⁵⁶ The development plan was divided into seven parcels, with most of the parcels planned for use in projects such as waterfront walkways or museums.⁵⁷ However, one parcel, known as Lot 3, was designated for sale to Pfizer Pharmaceutical Company for construction of a \$300 million research and development office complex and parking facility.⁵⁸

Nine owners of Fort Trumbull homes, four of which were located in Lot 3, brought suit, claiming that the taking of their unblighted land for economic development purposes was in violation of the Fifth Amendment.⁵⁹ They contended that using eminent domain for economic development "impermissibly blurs the boundary between public and private takings."⁶⁰ The U.S. Supreme Court granted certio-

⁵² *Id.* at 243-44 (quoting *Rindge Co. v. Los Angeles*, 262 U.S. 700, 707 (1923); *Block v. Hirsch*, 256 U.S. 135, 153 (1921)); *Schultz*, *supra* note 44, at 50.

⁵³ *Schultz*, *supra* note 44, at 50.

⁵⁴ *Kelo v. City of New London*, 545 U.S. 469, 490 (2005); *Schultz*, *supra* note 44, at 59.

⁵⁵ *Kelo*, 545 U.S. at 475 (citing CONN. GEN. STAT. §§ 8-188, 8-193 (2005)).

⁵⁶ *Id.* at 474; *Schultz*, *supra* note 44, at 59.

⁵⁷ *Kelo*, 545 U.S. at 474; *Schultz*, *supra* note 44, at 59.

⁵⁸ *Kelo*, 545 U.S. at 473-74. *See generally* *Schultz*, *supra* note 44, at 59.

⁵⁹ *Kelo*, 545 U.S. at 475.

⁶⁰ *Id.* at 485.

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rari to the federal question of whether a city's decision to take private property for economic development purposes, when it involved the transfer of land from one private owner to another, satisfied the public use requirement under the Fifth Amendment.⁶¹

The Supreme Court ruled that the taking was not a violation of the public use requirement of the Fifth Amendment.⁶² The Court reasoned that it was not a private taking because the decision to acquire the property was part of a "carefully considered' development plan" and there was no motive by the county to convey a private benefit on a "particular class of identifiable individuals."⁶³

Additionally, the Court rejected the homeowners' argument that the plan did not satisfy the public use requirement because the property was going to be sold to and used by a private party.⁶⁴ Justice Stevens, writing for the majority, stated that "this 'Court long ago rejected any literal requirement that condemned property be put into use for the general public,'"⁶⁵ and, instead, this narrow reading of public use had been rejected in favor of a broader "public purpose" reading of the public use doctrine.⁶⁶ The main issue then became whether the seizure of Lot 3 served a valid public purpose,⁶⁷ and the court looked to the precedent in *Berman*⁶⁸ and *Midkiff*,⁶⁹ both of which deferred to legislative determinations of what is considered a public purpose. Thus, since the City of New London had acted within its state statutory power in using eminent domain, the *Kelo* court held that the taking of private property for economic development purposes was a valid public use under the Fifth Amendment.⁷⁰

B. State Law

Several state supreme courts have also ruled in favor of a broad interpretation of public use in their own state constitutions. In the early 1980s, the Michigan Supreme Court, in *Poletown Neighborhood Council v. City of Detroit*, upheld the City of Detroit's use of its eminent domain authority to level an entire neighborhood, relocate over 1300 households, and acquire over 150 private businesses to

⁶¹ *Id.* at 477; Schultz, *supra* note 44, at 60.

⁶² *Kelo*, 545 U.S. at 485.

⁶³ *Id.* at 478 (quoting *Kelo v. City of New London*, 843 A.2d 500, 536 (Conn. 2004)); *Haw. Hous. Auth. v. Midkiff*, 467 U.S. 229, 245 (1984); Schultz, *supra* note 44, at 60.

⁶⁴ *Kelo*, 545 U.S. at 478-80; Schultz, *supra* note 44, at 60-61.

⁶⁵ *Kelo*, 545 U.S. at 479 (quoting *Midkiff*, 467 U.S. at 244).

⁶⁶ *Id.* at 479-80; Schultz, *supra* note 44, at 60-61.

⁶⁷ *Kelo*, 545 U.S. at 480.

⁶⁸ *Berman v. Parker*, 348 U.S. 26, 26 (1954); Schultz, *supra* note 44, at 61.

⁶⁹ *Midkiff*, 467 U.S. at 229; Schultz, *supra* note 44, at 61.

⁷⁰ *Kelo*, 545 U.S. at 489-90.

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make room for a General Motors assembly plant.⁷¹ The City exercised its eminent domain authority pursuant to the Michigan Economic Development Corporations Act.⁷² A neighborhood association and several residents of the Poletown area, including the owners of ten non-blighted businesses, opposed the taking because the land would be sold to GM.⁷³ They brought suit, challenging the taking as not constituting a valid public use under the Michigan Constitution because the land would be immediately transferred to a private party.⁷⁴ The residents also claimed that there was a difference between what constituted a valid “public use” under the Michigan Constitution versus what was a public purpose.⁷⁵ The City, however, contended that the proposed condemnation was for a valid public use because it would benefit the public by alleviating and preventing unemployment and “fiscal distress.”⁷⁶ Thus, the court faced the issue of whether the Michigan Constitution recognized a narrow or broader conception of public use.⁷⁷

The Michigan Supreme Court upheld the taking as a valid public use under the state constitution, contending that the public would be the primary beneficiary and the private benefit was merely incidental.⁷⁸ It reasoned that the needs served by this use of eminent domain included providing an economic boost and supporting the revitalization of local industry.⁷⁹ As a result, the Court said that it could not narrow the definition of public use, pointing to Court precedent that “public use changes with changing conditions of society . . . [and] [t]he right of the public to receive and enjoy the benefit of the use determines whether the use is public or private.”⁸⁰

⁷¹ *Poletown Neighborhood Council v. City of Detroit*, 304 N.W.2d 455 (Mich. 1981), *overruled by* *County of Wayne v. Hathcock*, 684 N.W.2d 765, 787 (Mich. 2004); Schultz, *supra* note 44, at 51.

⁷² Economic Corporations Development Act, MICH. COMP. LAWS § 125.1602 (2001) (“There exists in this state the continuing need for programs to alleviate and prevent conditions of unemployment . . . it is accordingly necessary to assist and retain local industrial and commercial enterprises, including employee-owned corporations, to strengthen and revitalize the economy of this state and its municipalities . . . Therefore, the powers granted in this act constitute the performance of essential public purposes and functions for this state and its municipalities.”); Schultz, *supra* note 44, at 51-52.

⁷³ *Poletown*, 304 N.W.2d at 457; Schultz, *supra* note 44, at 52.

⁷⁴ *Poletown*, 304 N.W.2d at 457.

⁷⁵ *Id.* at 457; Schultz, *supra* note 44, at 52.

⁷⁶ *Poletown*, 304 N.W.2d at 458.

⁷⁷ Schultz, *supra* note 44, at 52-53.

⁷⁸ *Poletown*, 304 N.W.2d at 459.

⁷⁹ *Id.*

⁸⁰ *Id.* at 475 (quoting *Hays v. City of Kalamazoo*, 25 N.W.2d 787, 790 (1947)).

The Court also set an unmatched, and widely criticized, precedent for a state court defining the judiciary's role in the determination of what qualifies as public use under the state constitution.⁸¹ Quoting state precedent and *Berman v. Parker*, the Court held that “[t]he determination of what constitutes a public purpose is primarily a legislative function”⁸² and a determination made by the legislature regarding a public interest is “well-nigh conclusive.”⁸³ Thus, *Poletown* became an unprecedented expansion of eminent domain power and government control over private property.⁸⁴

The next year the California Supreme Court upheld the right of a municipality to use the eminent domain power under the California constitution to acquire the property rights, including “intangible contractual rights,” of a sports franchise contemplating relocation in *City of Oakland v. Oakland Raiders*.⁸⁵ In this case, the City used its eminent domain power to seize all of the business assets of the Oakland Raiders’ football franchise.⁸⁶ The team owners had been leasing their stadium from a public nonprofit for fifteen years and, when negotiations to renew the lease failed, the team announced its intention to relocate to Los Angeles.⁸⁷ The City then commenced an eminent domain action to acquire the team’s property rights,⁸⁸ “including players’ contracts, team equipment, and television and radio contracts.”⁸⁹ In response, the franchise owners brought suit on two grounds: (1) that eminent domain could not be used to take “intangible property not associated with realty,”⁹⁰ and (2) that the “taking contemplated by the City cannot, as a matter of law, be for any ‘public use’ within [the] City’s authority.”⁹¹

The Court first faced the issue of whether the City had the power to acquire intangible property to serve municipal uses.⁹² It noted that “in contrast to the broad powers of general government . . . a municipal corporation has no inherent power of eminent domain and can exercise it only when expressly authorized by law.”⁹³ However,

⁸¹ Schultz, *supra* note 44, at 54.

⁸² *Poletown*, 304 N.W.2d at 459 (quoting *Gregory Marina, Inc. v. City of Detroit*, 144 N.W.2d 503, 516 (1966)).

⁸³ *Id.* at 633 (quoting *Berman v. Parker*, 348 U.S. 26, 32 (1954)).

⁸⁴ Schultz, *supra* note 44, at 54.

⁸⁵ *City of Oakland v. Oakland Raiders*, 646 P.2d 835 (Cal. 1982).

⁸⁶ *Id.* at 837.

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ Schultz, *supra* note 44, at 55.

⁹⁰ *Oakland Raiders*, 646 P.2d at 837; Schultz, *supra* note 44, at 55.

⁹¹ *Oakland Raiders*, 646 P.2d at 837.

⁹² Schultz, *supra* note 44, at 56.

⁹³ *Oakland Raiders*, 646 P.2d at 838.

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California's eminent domain statutes provided that "a city may acquire by eminent domain *any property* necessary to carry out any of its powers or functions" (emphasis added).⁹⁴ Thus, the Court found that the City of Oakland did have the power to acquire the Oakland's Raiders property, establishing the precedent that "intangible assets are subject to condemnation" under eminent domain.⁹⁵

The Court then focused on whether the City's actions were within the state constitutional requirement that eminent domain acquisitions serve a "public use."⁹⁶ It defined public use as "a use which concerns the whole community or promotes the general interest in its relation to any legitimate object of government."⁹⁷ However, the Court also noted state precedent, asserting that "[i]t is not essential that the entire community, or even a considerable portion thereof, shall directly enjoy or participate in an improvement in order to constitute a public use."⁹⁸ The City argued that the acquisition of the assets served a public use because of "the factual circumstances surrounding the construction of the Oakland Coliseum and the integration of the past use of the stadium with the life of the City of Oakland in general."⁹⁹ In considering the City's argument for its untraditional use of eminent domain, the Court noted the broad common law application of public use and its evolving nature in California.¹⁰⁰ Thus, the Court held that the "acquisition, and . . . operation of a sports franchise may be an appropriate municipal function."¹⁰¹ The City met the public use requirement because the community as a whole could benefit economically and culturally from the acquisition.¹⁰²

However, not all state courts have agreed with a broad interpretation of public use. In the recent landmark case of *County of Wayne v. Hathcock*,¹⁰³ the Michigan Supreme Court held that a more narrow construction of public use was necessary under the Michigan State Constitution.¹⁰⁴ At issue in *Hathcock* was a plan by Wayne County to condemn several parcels of private property near the Metro-

⁹⁴ *Id.* at 838 (quoting CAL. GOV'T CODE § 37350.5 (West 1975)).

⁹⁵ *Id.* at 840, 843; Schultz, *supra* note 44, at 56.

⁹⁶ Schultz, *supra* note 44, at 55.

⁹⁷ *Oakland Raiders*, 646 P.2d at 841 (quoting *Bauer v. County of Ventura*, 289 P.2d 1 (1955)).

⁹⁸ *Id.* at 841.

⁹⁹ *Id.* at 844; Schultz, *supra* note 44, at 57.

¹⁰⁰ *Oakland Raiders*, 646 P.2d at 842 (noting that the commission revising California's eminent domain laws had specifically recommended against the retention of the list of possible public uses in the new law).

¹⁰¹ *Id.* at 843; Schultz, *supra* note 44, at 55.

¹⁰² Schultz, *supra* note 44, at 56.

¹⁰³ *County of Wayne v. Hathcock*, 684 N.W.2d 765 (2004).

¹⁰⁴ *Hathcock*, 684 N.W.2d at 780; Schultz, *supra* note 44, at 73.

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politan Airport.¹⁰⁵ As part of the expansion of the airport and the construction of a nearby business and technology park, the County sought to obtain several properties that would be subject to increased noise and traffic.¹⁰⁶ When the owners of nineteen parcels refused to sell, the county initiated condemnation proceedings under Michigan's Uniform Condemnation Procedures Act.¹⁰⁷ The owners then brought a claim in Michigan state court, contending that the condemnation violated both Michigan Compiled Laws section 213.23, and Article 10, Section 2 of the Michigan Constitution.¹⁰⁸

On appeal, the Michigan Supreme Court held that "the taking of property from one private owner and transferring it to another private owner to encourage economic development or alleviate unemployment was not a valid public use under . . . the Michigan Constitution."¹⁰⁹ The Court stated that transfer of condemned private property from one owner to another private owner was only permitted in three situations.¹¹⁰ First, it recognized condemnations in which private land was constitutionally transferred by the condemning authority to a private entity that involved "public necessity of the extreme sort otherwise impracticable."¹¹¹ The second circumstance was when the private entity remains accountable to the public in its use of that property.¹¹² Lastly, condemned land could be transferred to a private entity when the selection of the land to be condemned is itself based on "facts of independent public significance."¹¹³ By narrowing the public use definition in this manner, the Court also overruled *Poletown*,¹¹⁴ invalidating a major legal precedent cited in many jurisdictions to support the use of eminent domain for economic development purposes.¹¹⁵

Opponents of the San Bernardino proposal have cited similar concerns to the court in *Hathcock* with regards to municipalities seiz-

¹⁰⁵ *Hathcock*, 684 N.W.2d at 769.

¹⁰⁶ *Id.* at 769-70.

¹⁰⁷ *Id.* at 771.

¹⁰⁸ *Id.*

¹⁰⁹ Schultz, *supra* note 44, at 73-74.

¹¹⁰ *Hathcock*, 684 N.W.2d at 773.

¹¹¹ *Id.* at 781.

¹¹² *Id.* at 782.

¹¹³ *Id.* at 782-83.

¹¹⁴ *Id.* at 786 ("To justify the exercise of eminent domain solely on the basis of the fact that the use of that property by a private entity seeking its own profit might contribute to the economy's health is to render impotent our constitutional limitations on . . . eminent domain. *Poletown's* 'economic benefit' rationale would validate practically any exercise of the power of eminent domain on behalf of a private entity.").

¹¹⁵ Schultz, *supra* note 44, at 75.

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ing private loans and selling them to another private party.¹¹⁶ While those opponents may have *Hathcock* precedent on their side in questioning the constitutionality of the proposal, the overwhelming majority of both federal and state courts have agreed that a broad interpretation of public use is constitutional. Furthermore, *Hathcock* applied only to the Michigan State Constitution, and, while it did overrule the existing precedent of broad interpretation in that state, *Poletown* had already been recognized by many as an overzealous expansion of eminent domain power.¹¹⁷

Kelo, *Midkiff*, *Berman*, and other federal court decisions,¹¹⁸ on the other hand, illustrate the wide-ranging interpretation now given to the public use requirement on the federal level.¹¹⁹ As the court in *Kelo* pointed out, it no longer matters if property is taken from one private party and given to another, as long as there is no motive for private benefit.¹²⁰ These courts have also all suggested that the judiciary should have a limited role in questioning the advisability of eminent domain decisions by legislatures.¹²¹ Though these decisions have not been without their critics,¹²² if the proposal was challenged in federal court, a court would be likely to follow precedent and rule in favor of San Bernardino County. The County could easily argue that the taking of mortgages is intended to bestow an economic benefit on the citizens of San Bernardino by lowering the foreclosure rates.

Furthermore, the analogous facts in the *Oakland Raiders* case demonstrate that a mortgage taking under eminent domain would probably not be in violation of the California Constitution. The seizure of business assets, despite their intangible quality, was found to be

¹¹⁶ California Association of Realtors Letter, *supra* note 40.

¹¹⁷ See generally Timothy Sandefur, *A Gleeeful Obituary for Poletown Neighborhood Council v. Detroit*, 28 HARV. J.L. & PUB. POL'Y 651, 661-65 (2005) (summarizing numerous criticisms of the *Poletown* decision).

¹¹⁸ See, e.g., *People of Puerto Rico v. E. Sugar Assocs.*, 156 F.2d 316, 325 (1st Cir. 1946) (upholding an agrarian reform measure that broke up large tracts of land and redistributed it into smaller parcels to private individuals); Schultz, *supra* note 44, at 50.

¹¹⁹ Schultz, *supra* note 44, at 50.

¹²⁰ *Kelo v. City of New London*, 545 U.S. 469, 478-79 (2005).

¹²¹ *Id.* at 482-83.

¹²² See Kristi M. Burkard, *No More Government Theft of Property! A Call to Return to A Heightened Standard of Review After the United States Supreme Court Decision in Kelo v. City of New London*, 27 HAMLINE J. PUB. L. & POL'Y 115 (2005) (reasons that the *Kelo* Court misconstrued the public use requirement under the Fifth Amendment and wrongly applied the legislative deference standard of judicial review to disputes over fundamental private property rights when it requires a strict scrutiny standard of review.).

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valid in *Oakland Raiders*,¹²³ so seizing securitized mortgages, which are tangible, would likely be considered lawful in this case as well. Additionally, the *Oakland Raiders* court ruled that public use is a “use which concerns the whole community or promotes the general interest.”¹²⁴ So, even though the entire county of San Bernardino may not be under water on their mortgages, a large percentage are, and it would benefit the general interest (i.e. the home values) of the entire community to have less foreclosures.¹²⁵ Thus, a California court would almost certainly find in favor of the County on the state constitutionality of its use of eminent domain.

V. EFFECT ON BORROWERS AND LENDERS

Constitutional implications aside, the proposal also has its fair share of critics in the mortgage industry. Those opponents to the proposal predict that, not only will it not result in a market revitalization, it may actually have a negative effect on the housing market going forward. Many argue that this type of debt relief for a select group of borrowers would threaten the relationship between borrowers and lenders.¹²⁶ They believe other borrowers who were making their payments on time may find defaulting to be a more attractive option if they can have the principal of their loan reduced.¹²⁷

Other industry specialists have argued that the use of eminent domain in this situation could result in reduced access to credit for borrowers. The Securities Industry and Financial Markets Association (“SIFMA”) issued a statement to that effect, writing, “We believe using eminent domain would reduce access to credit for borrowers and

¹²³ *City of Oakland v. Oakland Raiders*, 646 P.2d 835, 843 (Cal. 1982).

¹²⁴ *Oakland Raiders*, 646 P.2d at 841 (quoting *Bauer v. County of Ventura*, 289 P.2d 1, 1).

¹²⁵ See generally Mary Ellen Podmolik, *A New Take on Impact of Foreclosures on Home Values*, CHICAGO TRIBUNE (Aug. 23, 2012), http://articles.chicagotribune.com/2012-08-23/classified/ct-mre-0826-podmolik-homefront-20120824_1_distressed-home-values-distressed-property (discussing the adverse effect that numerous homes in foreclosure can have on neighboring property values); Daniel Hartley, *The Impact of Foreclosures on the Housing Market*, FEDERAL RESERVE BANK OF CLEVELAND (Oct. 27, 2010) <http://www.clevelandfed.org/research/commentary/2010/2010-15.cfm> (noting that foreclosed properties add to the supply of homes on the market and diminish the desirability of a neighborhood resulting in lower property values).

¹²⁶ Hallman, *supra* note 3.

¹²⁷ “Edward DeMarco, the acting director of the Federal Housing Finance Agency, has said that giving debt relief to some borrowers would threaten the covenant between borrowers and lenders, and encourage those making their payments on time to default and cash in.” *Id.*

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would, at a minimum, result in lengthy and costly litigation.”¹²⁸ The FHFA has echoed those concerns, stating that it “has significant concerns with programs that could undermine and have a chilling effect on the extension of credit to borrowers seeking to become homeowners and on investors that support the housing market.”¹²⁹

Mortgage investment groups also believe that San Bernardino’s use of eminent domain could have an adverse effect.¹³⁰ Investment analysts have predicted that this type of precedent could push national mortgage interest rates up as much as 10 percent.¹³¹ There is also concern that the ability of the government to seize underwater mortgages means that mortgage investors would view new loans as only partially secured,¹³² creating a domino effect on the rest of the mortgage industry.

Thus, while an end to the housing crisis would be a welcome relief for many, the MRP proposal would likely only exacerbate the problem by deepening the rift between lenders and borrowers.

VI. CONCLUSION

In conclusion, the San Bernardino proposal would likely be upheld by courts as a valid use of the power afforded to municipalities by the Fifth Amendment and state constitutions, because it serves a legitimate public purpose through its potential to economically benefit over half of the County’s homeowners. In spite of this, the long-term risks of the plan may prevent it from ever getting off the ground. Experts on both sides of the issue can see that government interference may have a negative effect on the lending market, and that the risks likely outweigh the possible benefits¹³³ of immediate relief for San Bernardino. Thus, the San Bernardino proposal would simply be applying a band-aid to a broken bone - providing no lasting solution to the housing crisis.

¹²⁸ *Id.*

¹²⁹ Notice of Input Accepted on Use of Eminent Domain to Restructure Performing Loans, 77 Fed. Reg. 154 (Aug. 9, 2012), available at http://fhfa.gov/webfiles/24147/77_FR_47652_8-9-12.pdf.

¹³⁰ “We think it’s a disastrous idea and would be a horrible precedent for the market,” Stephen Walsh, [said] chief investment officer of Western Asset Management Co. . . . ‘What might bring isolated benefit to a particular city across the board could be very negative for housing financing going forward in the United States,’ he said.” Forgione, *supra* note 1.

¹³¹ Hallman, *supra* note 3.

¹³² *Id.* (quoting Edwin Groshans, analyst at investment advisory group Height Analytics).

¹³³ Forgione, *supra* note 1 (quoting Edward DeMarco, acting director of the FHFA).

