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ENFORCING TAX INDEMNITIES AND RIGHTS OF RECOVERY UNDER THE BRUSSELS AND LUGANO CONVENTIONS

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There is a well-settled principle that the courts of one country will not enforce the revenue laws of another. The purpose of this article is to examine whether the Brussels and Lugano Conventions defeat this rule in the light of the Court of Appeal's decision in *QRS 1 APS v Frandsen*.[2] It will be argued that the Conventions apply to the enforcement of tax indemnities and rights of recovery. Consequently, these indemnities and rights can be enforced against domiciliaries of Contracting States notwithstanding any domestic rule that the Contracting State's courts will not enforce foreign revenue laws.

The Brussels and Lugano Conventions

The Brussels Convention[3] aims to nurture the common market by securing the free movement of judgments within the European Community. The Contracting States are the present Member States: France, Germany, Italy, Belgium, Luxembourg, the Netherlands, the United Kingdom, Denmark, Ireland, Greece, Spain, Portugal, Austria, Finland and Sweden. The Lugano Convention[4] seeks to secure the free movement of judgments between the EC and the EFTA countries. The Contracting States are the Member States of the EC and the three EFTA countries: Iceland, Norway and Switzerland. The provisions of the Brussels and Lugano Conventions are virtually identical. However, there is an important

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2 [1999] STC 616, QBD and CA; [1999] 1 WLR 2169, CA.

3 Text at Schedule 1 to the Civil Jurisdiction and Judgments Act 1982.

4 Text at Schedule 3C.

procedural difference. National courts (other than a court of first instance) may ask the European Court of Justice for a preliminary ruling on the meaning of the Brussels Convention;[5] but there is no mechanism for references on the meaning of the Lugano Convention. The practical upshot of the Conventions is that foreign judgments are easily enforceable throughout most of Western Europe.

The Conventions achieve the free enforceability of judgments by harmonizing the jurisdiction rules of the Contracting States. The rationale is that agreement about where a dispute should be heard makes enforcement more straightforward: if all the Contracting States have the same jurisdiction rules, no Contracting State can refuse to enforce a judgment of another Contracting State on the ground that it had no jurisdiction to decide the dispute. Consequently, a Contracting State to either of the Conventions will have two distinct sets of rules for determining whether its courts have jurisdiction to hear an international dispute. If the Convention does not apply, the Contracting State must use its own domestic rules for determining jurisdiction. In contrast, when the Convention does apply, the Contracting State must use the Convention jurisdiction rules. The Convention has two basic rules.

Article 2: If the defendant is domiciled in a Contracting State, the defendant must (generally) be sued where he is domiciled.

Thus a defendant in a dispute to which the Convention applies who is domiciled in France must be sued in France.

Article 4: If the defendant is not domiciled in a Contracting State, the question whether a Contracting State has jurisdiction must (generally) be determined by its own domestic rules on jurisdiction.

Suppose the Convention applies to a dispute in which the defendant is domiciled in Brazil. An English court will have jurisdiction in three circumstances: if the defendant has submitted to being sued in England, the defendant has been served abroad under Order 11 of the Civil Procedure Rules, or the defendant has been served whilst present in the UK (and the plaintiff has successfully defended any application to strike out the proceedings on the ground that the UK is not the most appropriate forum).

The rule that the courts of one country will not enforce the revenue laws of another is part of that country's domestic rules of jurisdiction on recognizing foreign judgments. There is no equivalent rule under either of the Conventions.

5 Article 3 of Schedule 2.

Consequently, the question arises whether the rule against enforcement of foreign revenue laws survives the Conventions. It will be argued that the Conventions override the rule against the enforcement of foreign revenue laws when the defendant is domiciled in a Contracting State. The argument will be that there is no room for the rule because it impairs the effectiveness of the Conventions. However, the essential first step is to demonstrate that the Convention can sometimes apply to disputes involving foreign revenue laws. It is suggested that the Conventions apply to the enforcement of tax indemnities and rights of recovery. The application of the Brussels Convention to revenue disputes and the question whether it overrides the rule against enforcing foreign revenue laws were both considered in *QRS 1 APS v Frandsen.*[6].

The plaintiffs were Danish companies; the defendant was the plaintiffs' owner, who was resident and domiciled in the UK. The plaintiffs' assets had been sold for cash and used to buy the defendant's shares. In consequence, the plaintiffs had been compulsorily wound up for breaching the Danish rule of company law that bans a company providing financial assistance for the acquisition of its own shares. The plaintiffs' only creditor was the Danish Revenue. The liquidator (funded by the Danish Revenue) brought proceedings against the defendant in the UK to recover the outstanding corporation tax. The defendant applied for the proceedings to be struck out under the English rule that an English court will not enforce a foreign revenue law.

The plaintiffs' accepted that their claim breached this rule because it sought to indirectly enforce a foreign revenue law.[7] The rule covers both direct and indirect enforcement. Direct enforcement arises when a foreign state (or its nominee) sues for money or property by relying on its own tax law. Indirect enforcement arises when a foreign state (or its nominee) sues for money or property, not in reliance on its own tax law, but in a way that gives its tax law extra-territorial effect. The plaintiffs' claim was not direct enforcement because it was for damages arising from the defendant breaching his statutory and fiduciary duties owed to the plaintiffs under Danish company law. However, the claim was indirect enforcement because any damages recovered would be used to meet the Danish revenue's unsatisfied claim for corporation tax. The plaintiffs argued that they should succeed notwithstanding the English rule against enforcing foreign revenue laws. The plaintiffs' principal argument was twofold: (1) the dispute fell within the Brussels Convention and (2) the Convention overrides the rule.

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6 [1999] STC 616, QBD and CA; [1999] 1 WLR 2169, CA.

7 *Peter Buchanan Ltd and Macharg v McVey (Note)* [1955] AC 516n.

When do the Conventions apply to disputes involving foreign revenue laws?

It is not obvious that the Conventions can ever apply to a dispute involving foreign taxes. This is because of Article 1:

> 'This Convention shall apply in civil or commercial matters whatever the nature of the court or tribunal. It shall not extend, in particular, to revenue, customs or administrative matters.'

In *QRS* both Sullivan J and the Court of Appeal held that the plaintiffs' claim was excluded from the Convention because it was a revenue matter.[8] The reasoning at first instance and on appeal was similar. Sullivan J noted that the rule against enforcing foreign revenue laws is a general principle found in most countries, so he saw 'no reason to restrict 'revenue matters' in the context of the Convention to direct, as opposed to indirect, enforcement of revenue claims.'[9] This reasoning suggests that the scope of 'revenue matters' under the Convention should mirror the rule against enforcing foreign revenue laws. According to Simon Brown LJ (with whom both Auld and Thorpe LJJs agreed) the absence of a Convention definition of 'revenue matters' or binding European authority means that the scope of the revenue exclusion must be established by asking what meaning the Contracting States would give to 'revenue matters'. Once again Simon Brown LJ noted that the rule against enforcing foreign revenue laws is a general principle and gave 'revenue matters' a meaning that mirrored the English rule against enforcing foreign revenue laws. This approach is fundamentally misconceived for two reasons.

First, the 'revenue matters' exclusion adds nothing to the basic principle that the Convention applies to 'civil and commercial matters'. The second sentence of Article 1 – which provides that the Convention 'shall not extend, in particular, to revenue, customs or administrative matters' – did not exist until the UK and Ireland became Contracting States. These specific exclusions were introduced because the meaning of 'civil' in the original contracting states excludes customs, revenue and administrative matters but these are included in the UK and Ireland meaning.[10] Thus, as the Court of Appeal recognised in *QRS*, the exclusion of

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8 [1999] STC 616 at 625c-d and 630f-g; [1999] 1 WLR 2169 at 2173H-2177C.

9 [1999] STC 616 at 625a.

10 Paragraph 23 of the Schlosser Report, 1979 OJ C.59/1. Section 3 of the Civil Jurisdiction and Judgments Act 1982 provides that the Schlosser Report may be considered when interpreting the Brussels Convention. Similar Reports have been produced as new Contracting States accede to the Convention (Jenard Report, 1979 OJ C.59/1; Evrigenis and Kerameus Report, 1986 OJ C.298/1; Almeida Cruz, Desantes Real and Jenard Report, 1990 OJ C.189/35). There is also a report for the Lugano Convention (Jenard and Moller Report, 1990 OJ C.189/57).

'revenue matters' in Article 1 is purely declaratory: 'It did not purport to reduce the scope of Article 1, only to clarify it.'[11] Consequently, the Court of Appeal should have approached the plaintiffs' argument that its claim fell within Article 1 by asking whether it concerned a civil or commercial matter. This was the European Court's approach in *Sonntag v Waidmann*[12] where the question was whether the dispute was a civil matter or an administrative matter. Hence, the Court of Appeal should have considered the European authorities on the meaning of 'civil and commercial matters'.

The Court of Appeal's second mistake was that it gave the revenue exclusion a meaning peculiar to UK law. This is wrong because the ECJ has always stressed that Article 1 should have a Convention meaning independent of the domestic law of the Contracting States. The ECJ explained why in *LTU v Eurocontrol*[13] (the first European case to consider the meaning of 'civil and commercial matters'): 'As Article 1 serves to indicate the area of application of the Convention it is necessary, in order to ensure, as far as possible, that the rights and obligations which derive from it for the Contracting States and the persons to whom it applies are equal and uniform, that the terms of that provision should not be interpreted as a mere reference to the internal law of one or more of the States concerned'. Consequently, the Court of Appeal was wrong to decide whether the plaintiffs' claim fell within the Convention by asking whether it breached the English rule against enforcing foreign revenue laws. Although it is true that most countries have an equivalent of the rule, it is to be expected that the content of these rules varies. For example, in some countries the rule may cover indirect enforcement but in other countries it may not. If the rules do vary - and, like the UK, all the Contracting States interpret the revenue law exclusion in Article 1 to mirror their own domestic rule - the scope of the Convention will necessarily vary among the Contracting States. But this is the problem that *Eurocontrol* says should be avoided by giving Article 1 an independent Convention meaning. Thus, once again, the Court of Appeal should have resolved the question whether the plaintiffs' claim fell within the Convention by considering the European authorities that describe the scope of 'civil and commercial matters'. What conclusion should the Court of Appeal have reached if it had taken this approach?

The European case law on the meaning of 'civil and commercial' was summarized by Advocate General Darmon in *Sonntag v Waidmann*.[14]

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11 [1999] STC 616 at 628a; [1999] 1 WLR 2169 at 2174B.

12 Case C-172/91 [1993] ECR I-1963.

13 Case C- 29/76 [1976] ECR 1541 at 1551 para. 3.

14 Case C- 172/91[1993] ECR I-1963 at 1982 para. 43.

> 'It follows from the judgments in *LTU v Eurocontrol*[15] and *Netherlands v Ruffer*[16] ... that proceedings do not fall within the scope of the Convention:
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> - if their subject-matter is an act of a public authority acting in the exercise of public powers;
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> - if the right on which the proceedings are founded has its source in such an act.'

What sort of revenue disputes are civil or commercial matters for the purposes of the Convention? The enforcement of a foreign revenue law by a Contracting State (direct enforcement according to the English authorities) is excluded because the Contracting State is a public authority exercising its public powers. The enforcement of a foreign revenue law by a claimant other than a Contracting State (indirect enforcement according to the English authorities) is excluded because the right on which the proceedings are founded has its source in the act of a Contracting State exercising its public powers. Consequently, the Convention does not apply to proceedings brought by a liquidator to recover outstanding tax that will be paid over to a foreign tax authority. (Thus, the Court of Appeal in *QRS* achieved the right result by using the wrong analysis.) However, the Conventions will clearly apply to proceedings brought to enforce tax indemnities and rights of recovery. This is because in both cases the claimant is a private person exercising a statutory or contractual right. It cannot be said that the claimant's right has its source in the act of a public authority enforcing its public powers because what is recovered is paid to a private person not a public authority. However, this argument is practically uninteresting if the claimant's action is struck out by the court of a Contracting State for breaching its rule against enforcing foreign revenue laws.

Does the Convention Override the Rule Against Enforcing Foreign Revenue Laws?

In *QRS* Sullivan J held that the English rule against enforcing foreign revenue laws survives the Brussels Convention because the Convention 'does not seek to regulate the details of the procedure to be followed in the courts of the contracting parties.'[17] The Court of Appeal disagreed. Simon Brown LJ pointed

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15 Case C- 29/76 [1976] ECR 1541 at 1551 para. 4.

16 Case C- 814/79 [1980] ECR 3807 at 3819 para. 8.

17 [1999] STC 616 at 624e; [1999] 1 WLR 2169 at 2177E.

out that not all procedural rules are compatible with the Convention. The circumstances in which a domestic procedural rule violates the Convention were set out by the ECJ in *Hagen v Zeehage*.[18]

A Dutch hotel was suing Hagen for breach of contract. The dispute arose when Hagen cancelled a large number of reservations made for its German principal. Hagen wanted to claim an indemnity from its principal and therefore sought to join them as a third party under Article 6(2): 'A person domiciled in a Contracting State may also be sued ... as a third party ... in the court seized of the original proceedings'. However, the domestic Dutch rules would not permit joinder in these circumstances. On its face Article 6(2) applies subject to one condition only: that the third party is domiciled in a Contracting State. However, the ECJ decided that Article 6(2) created a power to join, not an obligation. In doing so, it applied a twofold test for whether a domestic rule is compatible with the Convention. First, the rule must be procedural not a rule of jurisdiction, because the Convention is concerned with jurisdiction but not procedure. Second, 'national procedural rules may not impair the effectiveness of the Convention'.[19] The question of joinder was to be settled by the Dutch law on joinder because these rules were procedural and did not impair the Convention. Does the rule against enforcing foreign revenue laws satisfy the test in *Hagen*?

The first question is whether the English rule against enforcing foreign revenue laws is procedural. Dicey & Morris say that the rule is 'framed in terms of lack of jurisdiction'.[20] However, as Simon Brown LJ pointed out in *QRS*, this statement is contrary to authority: in *In re State of Norway's Application*[21] Lord Goff explained 'that the rule does not affect the jurisdiction of the court, but is concerned rather with circumstances in which the court declines to exercise its jurisdiction.' Thus, the rule is procedural, so the first condition in *Hagen* is satisfied. The second question is whether the rule impairs the effectiveness of the Convention. Simon Brown LJ held that applying the rule under the Convention would not merely be to impair the Convention's effectiveness 'but indeed substantially to derogate from it'.[22] This must be right. The Convention contains mandatory rules of jurisdiction – for example, that defendants in Contracting States shall be sued in the courts of that State – which would be undermined by the rule against enforcing foreign revenue laws. Hence, the Convention defeats

18 Case C-365/88 [1990] ECR 1845.

19 Above, at para. 21.

20 Dicey and Morris, *The Conflict of Laws* (2000), p. 90.

21 [1990] 1 AC 723 at 808F.

22 STC [1999] 616 at 631h-j; [1999] 1 WLR 2169 at 2178E-F.

the rule. On its face this is a startling conclusion. However, in *Pearce v Ove Arup Partnership Ltd*[23] Laddie J held that a similar rule relating to intellectual property was defeated by the Convention for the same reasons.

The defendants were accused of copying the plaintiff's plans for a town hall in Rotterdam. One of the defendants was domiciled in the UK, so the plaintiff brought proceedings under Article 6(1): 'A person domiciled in a Contracting State may also be sued ... where he is one of a number of defendants, in the courts for the place where any of them is domiciled'. The defendants sought to strike out the proceedings, because of the English rule that claims for breach of foreign intellectual property rights are not justiciable before an English court. Laddie J held that the courts of Contracting States are both entitled and obliged to exercise the jurisdiction conferred on them by the Convention. The English rule that made the proceedings inadmissible undermined this jurisdiction. Hence, just as in *QRS*, the rule impaired the Convention and was inapplicable under it. This reasoning will apply in all Contracting States. Consequently, the Convention will defeat every Contracting State rule against enforcing foreign revenue laws. Perhaps it is not so surprising that the Convention can defeat such long-established rules: the Convention seeks to achieve the free movement of judgments – but this objective is not furthered by domestic rules that undermine its own rules on jurisdiction.

One question remains: do the Conventions defeat the rule when the Contracting State has jurisdiction under Article 4. It has been explained that the Conventions have two basic rules of jurisdiction: (1) under Article 2 defendants domiciled in a Contracting State must (generally) be sued in that state; and (2) under Article 4 defendants not domiciled in a Contracting State may be sued in a Contracting State according to that State's domestic rules on jurisdiction. In *QRS* the UK court had Article 2 jurisdiction because the defendant was domiciled in England. Would the rule against enforcing foreign revenue laws be defeated by the Convention if the UK court (potentially) had Article 4 jurisdiction because the defendant was not domiciled in a Contracting State? The answer must be that the Convention would not defeat the rule: Article 4 tells the UK Court to apply its domestic rules to decide whether it has jurisdiction – but these rules would not be truly applied if they were applied without the rule against enforcing foreign revenue laws. Consequently, the Conventions only defeat the rule when the Contracting State has Article 2 jurisdiction.

[23] [1997] 2 WLR 779.

What is the Practical Significance of this Argument?

The argument has been that the Conventions defeat the rule against enforcing foreign revenue laws and that the Conventions apply to the enforcement of tax indemnities and rights of recovery. Consequently, tax indemnities and rights of recovery are enforceable against domiciliaries of Contracting States notwithstanding any domestic rule that the Contracting State's courts will not enforce foreign revenue laws. There are three major areas in which this argument will be significant for UK taxpayers.

(1) The right of personal representatives to be repaid inheritance tax under section 211(3) of the Inheritance Tax Act 1984. The personal representatives of a foreign domiciliary who is deemed to be domiciled in the UK for inheritance tax purposes are liable for UK inheritance tax on the deceased's foreign assets. If there is no UK property to discharge this liability, the UK executors may have to pay the inheritance tax personally. Under section 211(3) the personal representatives have a right to be repaid by the beneficiary of the foreign asset. There will be problems enforcing this right if the beneficiary's assets are situated in a country that has a rule against enforcing revenue laws. However, the right is enforceable if the beneficiary is domiciled in a Contracting State and has assets situated in a Contracting State.

(2) The right of the settlor of non-resident trusts to recover capital gains tax under paragraph 6(2) of Schedule 5 of the Taxation of Chargeable Gains Act 1992. This right is useless if the trust's assets are in a country with a domestic rule against enforcing foreign revenue laws. However, the right is enforceable if the trustees are resident in a Contracting State and the trust's assets are in a Contracting State.

(3) The right of a UK buyer under a tax indemnity negotiated as part of a company sale. Suppose a UK taxpayer buys a UK resident company from foreign shareholders. The UK buyer should negotiate an indemnity from the foreign seller against unexpected tax liabilities arising from the seller's period of ownership. There may be problems enforcing this indemnity if the seller has no UK assets and the country in which it does have assets has a domestic rule against enforcing foreign revenue laws. However, the indemnity can be enforced under the Conventions if the seller is domiciled in a Contracting State and has assets in a Contracting State. (The UK buyer may even be able to sue the seller in the

UK under Article 5(1) of the Special Jurisdiction rules on the ground that the contract is to be performed in the UK.)