# The autonomous interpretation method in international law with particular reference to the proposed European Sales Law I

by Maren Heidemann

## 1. INTRODUCTION

The proposed Common European Sales Law (CESL, COM (2011) 635 final) expressly includes an "autonomous" interpretation standard. The interpretation method is included in three places in the instrument: in the Preamble, Recital 29, the Regulation itself, Article 11, and in the actual sales law, Annex I, Article 4. The term autonomous is used in the Preamble and the Annex I. An autonomous interpretation standard is considered desirable in legal scholarship for the application of international instruments, both in private and public international law. The introduction of this standard in CESL could therefore be an important advancement for the theory and practice of international law. In the following, it will be analysed how this interpretation standard can be defined, how it has evolved in the context of existing international law instruments and what the standard is that CESL legislates.

From the first sales law conventions from the early 1960s to the more modern double taxation conventions concluded in the 1990s among European countries, this range of multilateral and bilateral treaties – and in some cases so-called model laws or soft law instruments – show different approaches to the question of how they should be applied and interpreted. Interpretation standards are included in each international instrument while the 1969 Vienna Convention on the Law of Treaties (VCLT) provides a general interpretation standard. The VCLT applies to most of the uniform instruments discussed below, as they are treaties regardless of the technique applied to their subsequent implementation or the legal matters they refer to. Some of these treaties regulate public law matters; others, unusually, contain rules of substantive private law for use in international trade. The question of the addressees of these instruments and their objective and purpose therefore plays a role and will be discussed below.

The uniform instruments to be discussed here are therefore divided by their subject matter into private and public law, and CESL is discussed separately in comparison with those two types of international legal instruments. Part I deals with private law and some public law issues, while Part II concludes the public law discussion and considers the application and interpretation rules in CESL.

## 2. CONTEXT WITH OTHER INTERNATIONAL LAW INSTRUMENTS

### (1) *Private law*

There are three important origins of modern uniform private law for international trade, displaying two different types of interpretation standards.We have to distinguish law created under the auspices of the Hague Conference of Private International Law, the UNIDROIT Institute in Rome and the United Nations, more specifically their trade law division, UNCITRAL.

The first relevant legal instrument was created with the Uniform Law for International Sales (ULIS) in 1964. This type of standard has been followed in the UNIDROIT Principles of Commercial Contracts (UPICC) of 2004 and 2010.

A second type of interpretation standard had been introduced by the time of the later conventions concluded under UNIDROIT in 1988, the so-called Ottawa conventions on financial leasing and on factoring. Finally, the 1980 Vienna Convention on the International Sale of Goods (CISG) displays elements of both types of interpretation standard.

The standards are composed of two elements – method, and interpretation in the narrower sense.

#### (a) Method

ULIS provides in its Article 17 that:

*Questions concerning matters governed by the present Law which are not expressly settled therein shall be settled in conformity with the general principles on which the present Law is based.*

This interpretation standard goes beyond the strict confines of the literal wording of the actual rules of the uniform instrument. It introduces the idea that there are "underlying principles" which will allow a meaningful resolution of questions arising in the course of its application to which no answer is immediately obvious. It invites the applying user to spend more time and effort on finding a solution to the problem in hand using the specific instrument. This interpretation standard includes the autonomous method of finding an answer as far as possible within the instrument itself. Implicitly, this method depends on a further step, that of conceiving the instrument as a comprehensive set of rules.

This latter aspect is not expressly included in Article 17 ULIS, and nor is it in any of the later uniform instruments. Its exclusion has significant consequences for international contract law, as can be illustrated by the following example.

Article 17 ULIS features almost identically in Article 1.6 (2) of the 2010 UNIDROIT Principles of Commercial Contracts (UPICC):

*Issues within the scope of these Principles but not expressly settled by them are as far as possible to be settled in accordance with their underlying general principles.*

*Isolated application of rules*

At the 1989 UNIDROIT conference in Basel to introduce the UPICC, one of the presenting scholars criticised the wording of Article 7.2.1, the payment rule, which reads:

*(Performance of monetary obligation) Where a party who is obliged to pay money does not do so, the other party may require payment.*

It was stated that the rule did not include express limitations like the immediately following rule on non-monetary obligations, Article 7.2.2:

*(Performance of non-monetary obligation)*

*Where a party who owes an obligation other than one to pay money does not perform, the other party may require performance, unless*

*(a) performance is impossible in law or in fact;*

*(b) performance or, where relevant, enforcement is unreasonably burdensome or expensive;*

*(c) the party entitled to performance may reasonably obtain performance from another source;*

*(d) performance is of an exclusively personal character; or*

*(e) the party entitled to performance does not require performance within a reasonable time after it has, or ought to have, become aware of the non-performance.*

It was then concluded that Article 7.2.1 provided an overly rigid right to performance and would therefore not be compatible with most European legal systems. The only "limitation" found in the UPICC was the mitigation duty of Article 7.4.8. (I Schwenzer, "Specific Performance and Damages According to the 1994 UNIDROIT Principles of International Commercial Contracts", 1 *European Journal of Law Reform* (1998/1999) 289).

This result is only possible when Article 7.2.1 UPICC is looked at virtually in total isolation. The author is in the company of many domestic European courts who refer to uniform instruments in a similar way. An isolated rule is selected in order to illustrate or underline a point made in the reasons of the domestic judgment, for example to demonstrate that good faith is a standard of international trade, or a general principle. In the two UK cases referring to the CISG, *ProForce Recruit Ltd v Rugby Group Ltd* [2006] EWCA Civ 69 and *The Square Mile Partnership Ltd v Fitzmaurice McCall Ltd* [2006] EWCA Civ 1690 this is the way to refer to CISG in order to underline points about the "parol evidence rule" in the construction of contractual terms.

This technique makes such uniform instruments into a "toolbox", a term often used in the course of the European drafting projects in contract law, both the CESL and its predecessor, the CFR. It conceives of such instruments as a loose collection of rules that are on offer and can be used according to taste or opportunity.

The legal background for this "quarry technique" is of course the private international law status of the uniform law instruments. Under current conflict law in the EU and most European states, these instruments cannot be chosen as *lex contractus*, the governing or the proper law of the contract at present. In the case of the UK this also applies to CISG. In state court litigation, they are therefore used either as contractual terms or they are used as far their "persuasive force" reaches. Even the CISG is said to be subject to domestic mandatory rules despite it being directly applicable to international commercial contracts according to its scope (see P Mankowski, "Rechtswahl für Verträge des internationalen Wirtschaftsverkehrs", Recht der Internationalen Wirtschaft (RIW) (2003). For this reason one aspect of the autonomous interpretation method seems to have no firm root in the law – the comprehensive conception of the uniform instrument, comparable to any domestic codification.

*Comprehensive application of a uniform instrument*

If applied in its context Article 7.2.1 UPICC will yield satisfactory results. If the rule was part of a domestic codification it would not readily be viewed in isolation. Domestic pieces of legislation are not normally viewed as "toolboxes." Instead, lawyers learn over their several years of education how to apply codifications. Codifications being mainly assigned to so-called civil law jurisdictions, the civil law methods of applying law may serve as an example and a starting point.

As for the application of Article 7.2.1 UPICC, the wording shows that the rule does not actually establish the payment obligation itself, it presupposes it. In order to establish whether the obligee can actually require payment, the obligation would have to be valid, mature and enforceable. The first condition would have to be found in the contract and if necessary established by the rules of the UPICC on formation and validity of contracts. If an obligation has arisen according to those tests it would have to be asked whether the obligor had any defences against the obligation. These could also arise from the contract, aided by UPICC rules on mistake, defective goods, frustration, hardship or force majeure. Our hierarchy of defences would be categorised by the legal category they arise from, beginning with contract and then moving on to non-contractual obligations and tort (delict). In addition a civil lawyer, or particularly a German lawyer, would remark in view of the particular "limitations" listed in Article 7.2.2 that most if not all of those are deemed never to apply to monetary obligations, certainly in (a) to (d), while (e) if applied "analogously" would be expressed by way of delay provisions which would include stipulations of interest.

Article 7.2.2 (e) also represents the condition that a payment obligation must be due before it can be claimed and enforced. This again would usually be part of the contractual terms. This brief outline of an application method can be said to be taken directly from domestic law, say in this case German law, and brought to the UPICC. It also presupposes an "as if" status of the uniform international instrument, which has been treated as if it was a domestic codification, hypothetically using it as *lex contractus*.

So the question now arises whether this exportation of domestic methodology is useful and acceptable in an international context.

Application of this technique reveals that Article 7.2.1 UPICC does not provide an overly rigid right to performance and that its drafting is not defective. The rule must be applied in the context of the whole set, however, and according to a suitable method. Whether this method is an "agreed method", or a common method, or a shared one and as such is part of the instrument, is another question. The method may be taken from domestic law. It may differ according to the background of the applying user. Part of the method however, is contained in the interpretation rules of the uniform instrument as well as in other international law and ought to be observed.

*Theory of gaps*

The aforementioned Article 6 (2) UPICC describes part of this method, but excluding, as described above, the part which would entail using the instrument in its entirety, as a comprehensive set of rules. This latter part, however, seems to have found its way into the last sentence of Recital 29 of the Preamble of CESL.

Perhaps the authors of the UPICC and its forerunners and related instruments took it for granted that users would regard the instruments as comprehensive sets. In any case, Article 6 (2) UPICC as well as the *pendant* in ULIS, Article 17, refer to a later step in the methodology; the step that needs to be taken after all answers taken from the instrument have been exhausted. This takes us to the theory of gaps.

The two instruments state what reference outside the actual uniform law should be made at this point, and they point to "general principles underlying it." Neither UPICC nor ULIS introduce any other external sources of law to complement the law finding exercise further, leaving it open what would be the next point of reference if no answer can be derived even from those principles. These two rules represent the oldest and original approach since the "unification movement" began in the second half of the 20th century.

Later codifications settled on this next step: next in line ought to be the law applicable by virtue of private international law. Effectively, *de lege lata,* this means the question should then be decided by a national domestic law.

Article 7(2) CISG is identical with Article 4(2) of the UNIDROIT Convention on International Factoring and Article 6(2) of the UNIDROIT Convention on International Financial Leasing, the so called Ottawa conventions of 1988:

> *Questions concerning matters governed by this Convention which are not expressly settled in it are to be settled … in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law.*

This means that no other international law, hard or soft, shall be considered in the settlement of the dispute at that point, and it should be referred to national law. This is the approach taken by the drafters of these conventions concluded under the auspices of UNCITRAL and which were then agreed upon on the political level in the 1980s.

The last component of the method expressed in these uniform instruments is the transition from the uniform instrument itself to its underlying principles and subsequently the external domestic law. This technique employs the theory

of gaps.

All the above-mentioned UNIDROIT conventions introduce this step with the wording "Questions concerning matters governed by this Convention which are not expressly settled in it..."

This choice of words combines aspects of all parts of the methodology and also implies an interesting possibility of integrating common law approaches to interpretation which may prefer to stop short at a more restrictive literal understanding of rules of law, rather than applying extended interpretation methods as is usual in civil law jurisdictions (see the interesting explanation by K Vogel and M Lehner (eds), *Doppelbesteuerungsabkommen der Bundesrepublik Deutschland auf dem Gebiet der Steuern vom Einkommen und Vermögen* (4th edn ,C H Beck, München 2003), 346 about the meaning of the "context" element in the interpretation rule of DTCs). It describes the so called internal gaps, the *lacunae praeter legem.*

Franco Ferrari commented on the role of the theory of gaps in uniform sales instruments in 1998 following the above-mentioned introductory conference in Basel (F Ferrari, "Das Verhältnis zwischen den Unidroit-Grundsätzen und den allgemeinen Grundsätzen internationaler Einheitsprivatrechtskonventionen", 1 *Juristenzeitung* (1998) 9). He sets out that under the established gap theories the instruments cannot be complemented by each other. The wording of the method articles does not permit recourse to a third external uniform instrument, but points the user back to national law after having established and exhausted general principles, or, more literally, after establishing the absence of underlying principles for the problem in hand. This means that in the case of questions that may arise in the course of applying CISG to an international contractual case, the UPICC cannot be consulted to continue the application process. The bridge from the first step to the second, ie from the actual text of the convention to its underlying principles, is provided by what is called the internal gap – a matter falling within the scope of the instrument but not expressly settled in it. How to establish a gap is subject to theoretical debate in legal scholarship.

Going back to the above-mentioned example of Article 7.2.1. UPICC, we could ask if this provision represents a gap. Professor Schwenzer could have conceived the absence of express limitations in the rule to be a gap, not expressly settling the question of limitations. In this case, limitations ought to have been sought in the principles on which the UPICC are based, which in the event was not done. Whether reference to other rules in the actual instruments, according to the above-described continental jurisprudential exercise, could be seen as referring to underlying principles is debatable. It appears to be a rather extreme viewpoint. Ferrari emphasises the role of the civil law and common law divide in jurisprudence. He points out that continental lawyers are more likely to seek an answer within the actual uniform instrument and therefore naturally resort to underlying principles, perhaps by analogy or teleological deductions, while a common lawyer prefers to resort to external sources and assume a gap earlier in the application of a body of law due to the preferred closeness to the literal wording.

This means that in applying uniform instruments, the lawyer has to be conscious of his or her choices. The uniform instruments have in fact been drafted and adopted in the awareness and with regard to the different legal traditions established by civil and common law traditions. Lawyers can use the instrument comprehensively as described above, but they may also identify gaps at an earlier stage, leaving out the possibility of resorting to the provisions on validity, mistake, frustration and hardship in the UPICC to consider the extent of the payment obligation in Art. 7.2.1, and seeking the answer in underlying principles which again may lead back to these rules in order to establish what these principles have to offer.

The UPICC, however, do not suggest reverting back to national law by way of applying conflict rules. This distinguishes them from the politically adopted UNIDROIT conventions. The most extensive politically accepted method is to resort to national law after having exhausted answers from the uniform instrument itself including all its provisions. This is *lex lata* as embodied in the "Rome I Regulation" ((EC) No 593/2008), the Rome Convention (1980 Rome Convention on the Law Applicable to Contractual Obligations) and relevant case law.

Under the UPICC one could add other possible methods. ULIS and the UPICC are drafted after the traditional Hague model. They neither include nor exclude the "politically correct" method expressly, but they remain open to those methods actually employed in international commercial arbitration and more progressive legal doctrine. On reaching an internal or external gap in a given uniform instrument, and after having failed to find a solution in the underlying principles, the external norms to be consulted next could be simply those of a given *forum*. Alternatively they could be other international uniform instruments or "general principles of international commercial law" or those rules that are stipulated to be "the law applicable by virtue of the private international law."

This hierarchy of norms, which itself implies a method of law finding, is available as part of general customary and written international law (cf J Dalhuisen, "The Operation of the Modern Lex Mercatoria: The Hierarchy of Norms", guest blog on Opinio Iuris, April 3, 2012, http://opiniojuris.org/2012/04/03/the-operation-of-the-modern-lex-mercatoria-the-hierarchy-of-norms/ [8 April 2012]. Such law is among other sources embodied in the 1969 Vienna Convention on the Law of Treaties (VCLT).

Reverting to the actual identification of a gap, we distinguish between internal and external gaps, *lacunae praeter legem* and *lacunae intra legem*. Only the former are dealt with in the uniform instruments on private law, there is no provision on how to deal with external gaps. Internal gaps, however, receive the same treatment in all the above-mentioned uniform instruments. It is clear from the foregoing that it depends on the background training of a lawyer who applies such instruments at which point he or she will actually assume a gap.

In civil law doctrine, internal gaps can justify analogous application of norms. This could then be extended to underlying principles. Applying those underlying principles analogously may be criticised on the other hand as unduly creating such principles. Larenz submitted in his influential treatise on legal methodology that an internal gap can only be assumed where the legislator had the express objective to regulate a matter comprehensively (K Larenz, *Methodenlehre der Rechtswissenschaft* (6th ed, Enzyklopädie der Rechts- und Staatswissenschaft, Springer, Berlin etc. 1991), p 371). This is frequently not the case with uniform international instruments – often matters are left deliberately unaddressed due to a lack of political consensus. Typical examples are formation of contracts, validity, capacity, and agency.

German doctrine also maintains that a mere silence on a subject within a given codification should not immediately be taken as a "gap" but rather all possibilities of interpretation of the existing rules should be exhausted, ie the available "positive" law should be fully explored. Dealing with a uniform international instrument in the above described way "under German doctrine" could either be conceived as applying the accepted interpretation method of the UNIDROIT and Hague Conventions, or it could also be conceived as applying domestic law and its values to the international instruments by simply looking at them through the eyes of a national lawyer.

In my view this is the decisive question. If the lawyer brings his or her interpretation standard to the international table and exercises the same diligence in applying the uniform law and if he or she is aware of it, then this is an improvement to the above described isolated view of the international norm in the absence of any method whatsoever.

Continental lawyers spend their entire legal education learning how to the read codifications. It seems that this technique mysteriously goes missing when faced with international uniform instruments.

The problem to be addressed here is the unjustified application of a lesser standard to international uniform instruments, both in the areas of private and public law. Often, open textured terms or interpretation norms are mistaken for conflict rules in order to resort quickly to the more familiar territory of domestic law, most often for reasons of convenience (see S Gopalan, "Demandeur-centricity in transnational commercial law" in M Andenas and C Baasch Andersen (eds), *Theory and Practice of Harmonization* (Edward Elgar Publishing, 2011, p 168). The theory of mandatory laws is part of this arsenal of possibilities). An international legal doctrine, including the autonomous interpretation method, provides a basis to explore international instruments fully so that they reveal their full potential to resolve an international legal matter which is to be settled by them, be it of a public or private nature.

(b) **Interpretation**

*Individual criteria*

The interpretation of the individual rules of a uniform instrument is regulated in Article 7(1) CISG:

> *In the interpretation of this Convention, regard is to be had to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade.*

ULIS did not contain an interpretation standard, and the UNIDROIT (Ottawa) conventions following CISG contain an addition to the CISG standard. Article 6(1) of the UNIDROIT Convention on International Financial Leasing and Article 4(1) of the UNIDROIT Convention on International Factoring read:

> *In the interpretation of this Convention, regard is to be had to its object and purpose as set forth in the preamble, to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade.*

Article 1.6 of the UPICC contains a similar rule:

> *In the interpretation of these Principles, regard is to be had to their international character and to their purposes including the need to promote uniformity in their application.*

So while CISG sets out the international character of the convention, the need to promote uniformity in its application, and the observance of good faith as freestanding criteria and values, the Ottawa conventions add the "object and purpose" of the instrument as a criterion, as do the UPICC which in turn consider the need to promote uniformity as part of their purpose.

Interestingly, the UPICC, being the latest of the uniform contract law instruments developed by UNIDROIT, abstain from proclaiming the observance of good faith in international trade as an independent interpretation standard.

It is easy to find reflections of the two original criteria, promotion of uniformity and regard to the international character of the instrument, in the case law – case law passed by domestic courts, collected in a database at the Pace Law School and at UNIDROIT. When domestic courts refer to those decisions they are promoting uniformity in the application of CISG and UPICC. The international character of the instruments is observed by developing interpretation criteria that suit the special circumstances of international trade.

*The general standard: Vienna Convention on the Law of Treaties of 1969*

The VCLT deals with the interpretation of treaties in Articles 31-33. Other than the uniform instruments on contract law it does not contain a separate rule on method. However, its rules contain tools to clarify some of the questions raised above.

The general rule of interpretation is contained in Article 31. Its subject is the terms of the treaty. The ordinary meaning of these terms "in their context and in the light of the object and purpose" of the convention in question is the starting point for the interpretation. Therefore interpreting Article 7.2.1 UPICC in context with other rules of the UPICC in order to balance the right to performance seems perfectly justified. The addition of the "object and purpose" of the legal instrument as a criterion exceeds the guidelines given by both ULIS and CISG. Both criteria play an important role in the application of international treaties, however, as will be shown below.

The following rules contained in Articles 31(2), 32 and 33 add a large range of additional materials and procedures to be taken into account for the correct establishment of meaning in an international convention. Article 31(2) VCLT confirms the architecture of most European Regulations and Directives, but especially CESL which relies on all elements listed there – a preamble, a text and two annexes. The difficulty is of course that CESL is meant to be national law and not an international instrument (see Part II of this article for further discussion). The character of EU secondary law is generally unclear in this respect. This is an important factor in the assessment of CESL. The answer becomes clearer after looking at the interpretation of treaty law with a public law content.

The VCLT confirms the wide ranging method of consulting external materials – such as preparatory work, the parties' intentions, subsequent agreement and practices for the application of uniform law – and helps to overcome reservations common law jurisdictions might have to such an approach. Clearly, this method is justified on an international level where negotiations play a greater role than in parliamentary debates because the "if" of the instrument will be much more questioned that in a domestic setting with a permanent legislator. This is true despite a certain continuity provided within a permanent platform like the UN, the WTO or indeed the EU. The method opens ways to find tools to establish the aforementioned "principles on which the instrument is based" by taking a look at the full context of its existence.

Under Article 32 VCLT however, the predominant criterion remains the "ordinary meaning in its context" as set out in Article 31(1) VCLT.

***(ii) Public law***

An example of a treaty with a public law subject is the double taxation convention (DTC). There are a great number of bilateral DTCs concluded among many nations of the world. Many of these are modelled after the OECD Model Tax Convention on Income and on Capital which was first drafted in 1992 and has been updated six times since then, most recently in 2008.

With regard to the application of these conventions, postulations for a "treaty specific" interpretation of their norms have been made by practitioners and scholars for decades. The biggest obstacle to achieving this is the interpretation standard contained in many of the DTCs and most prominently in the OECD Model Tax Treaty. More specifically, it is the way in which this clause is understood, interpreted and applied, particularly in the rather small community of tax law scholarship.

**(a) Article 3 of the OECD Model: method or interpretation?**

Article 3 of this Model is entitled "general definitions." The first paragraph contains a list of definitions of eight individual terms such as "person", "enterprise", "company" and so forth.

Article 3(2) contains the interpretation rule:

> *As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.*

This article has not been changed by any of the updates and has found its way into most DTCs currently in force in identical or similar wording. In the following it will be shown how this wording can lead to discrepancies and possible failure of the convention.

The rule contained in Article 3 of the Model Tax Convention appears in the German-British Double Tax Convention of

1964 (Convention of 26 November 1964 between the Federal Republic of Germany and the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion – DTC D-UK) in its Article II:

> *(3) In the application of the provisions of the present Convention by one of the Contracting Parties any term not otherwise defined in the present Convention shall, unless the context otherwise requires, have the meaning which it has under the laws in force in the territory of that Party relating to the taxes which are the subject of the present Convention.*

This rule not only precedes the current OECD Model but also the VCLT of 1969 and, incidentally, the EU membership of the UK. It is clearly not compatible with Art 31 VCLT and has not been subject to renegotiation in the recent round. The rule must be given some credit for originating from an era of pioneering work being done on this subject matter in the absence of the legal and political infrastructure now present in the EU. At the same time this could justify a call for reform. The wording of this article, and indeed in comparison with the slightly expanded OECD Model article, is far from self-explanatory. Why does the application "by one of the Contracting Parties" need a special mention? Is it not self-evident that a treaty will in most cases be applied by one of two parties and what is the opposite or the complementary situation – the application by both parties simultaneously in the same case?

The default rule in this treaty is that "if the term is not otherwise defined" in it and "unless the context otherwise requires," the meaning of that term in national taxation law of the applying state prevails. This is not a conflict rule and not a method to refer to an external regime upon the encounter of a gap in the treaty, but it describes an interpretation standard (cf M Schönhaus, *Die Behandlung der stillen Gesellschaft im Recht der Doppelbesteuerungsabkommen unter besonderer Berücksichtigung des OECD-Partnership-Reports* (Europäische Hochschulschriften, Peter Lang, Frankfurt etc 2005), 42).

Article 3 of the Model DTC is often referred to in scholarship as the "method article" (*Methodenartikel)* – see J M Mössner, R Waldburger and M Lang, Die Auslegung von Doppelbesteuerungsabkommen in der Rechtsprechung der Höchstgerichte Deutschlands, der Schweiz und Österreichs (Schriftenreihe zum internationalen Steuerrecht, Linde Verlag, Wien 1998), 433 where he uses the term *Methodenstreit* , dispute about methods to describe different interpretation methods. This may be where the expression derives from.

It is hard to see how Article 3 provides a method in the above established sense. It is clearly concerned with the terms of the convention and their meaning, hence with interpretation. It should therefore be referred to as an interpretation rule, *Auslegungsregel.* Unfortunately, this rule is often understood as instructing the user to subject the whole case to national law, ie to apply national law if a term is not defined in the convention, a method in the above described sense, despite the clear limitations through the reference to the context and the tax law specific meaning. Current user preference in Germany is clearly for the national meaning of the term, not for the development of treaty specific meaning and interpretation. If applied diligently, it is possible to derive an appropriate interpretation standard from this rule, as the example of a case in silent partnership set out below will show.

**(b) Qualification conflicts**

This interpretation rule never prevented so-called qualification conflicts, where a situation falls into different categories defined in the DTC under each of those national interpretations and thereby leads to contradictory results and double taxation. The accepted and practised solution here is not to resolve the conflict arising from the interpretation and attempt to reconcile the conflicting meanings, but to refer to the provisions about crediting tax paid in one country to the dues in the other country, see below. The taxpayer has the possibility of referring to the authorities in his country of residence (under the DTC D-UK) in order to seek taxation in line with treaty provisions by way of the mutual agreement procedure as described below. Clearly, this raises questions about the relationship of Article II(3) and Article 3(2) of the Model with the objectives and purpose of the treaty. It would be interesting to ask if the OECD Model DTC has a model purpose.

*The silent partner in English and German double taxation law*

A good example of a qualification conflict is provided by the treatment of the silent partnership in English and German double taxation law. The silent partnership is dealt with under Article VI(4) of the DTC-D-UK:

> *…; in a case of the Federal Republic the term includes income arising from participation in the capital and profits of a company resident in the Federal Republic, and the income derived by a sleeping partner from his participation as such.*

In the *Memec* case series (*Memec Plc v Inland Revenue Commissioners* [1998] STC 754 (CA); *Memec Plc v Inland Revenue Commissioners*[1996] STC 1336 (Ch D)) a "sleeping partner" in a German private limited company (Memec GmbH) claimed a deduction of trade tax under UK taxation law in the UK paid in Germany by the subsidiaries of the German outfit. The courts decided that this was not possible because the income derived from this was dividends under the DTC and the partnership

with the German GmbH was to be regarded as transparent (in Germany) and not giving rise to "business profits" in the sense required for the UK Income Tax Act. In Germany however, the very same case of Memec plc would have given rise to business profits both under the DTC and domestic tax law (albeit not necessarily to the desired set-off). Memec plc's partnership agreement was what under German law amounts to a so-called "atypical" silent partnership. Those types of participation are seen as giving rise to business profits under the prevailing view in German scholarship and current case law.

Interestingly, this fact was not raised by counsel in the *Memec* cases even though it would have made for an argument in favor of the claimant's case. For more detail on this subject see M Heidemann and A Knebel, "Double Taxation Treaties: The Autonomous Interpretation Method in German and English Law; as Demonstrated by the Case of the Silent Partnership", 38 I*ntertax* (2010) 136.

The most recent leading case on this subject in Germany is from 1999 (Urteil vom 21.7.1999 BStBL (*Bundessteuerblatt, Federal Tax Bulletin)* II 1999, 812 = FR 1999, 1361 (Bundesfinanzhof)). The Supreme Tax Court, *Bundesfinanzhof* (BFH) decided a case concerning the German-Swiss DTC. A German resident was an atypical silent partner in a Swiss enterprise, meaning there was an element of participating not only in capital and profits but also in the potential losses of the company as well as the "goodwill" and market value of the company. This element is classed as "income derived from entrepreneurial activity" under the six sources enumerated in the German income tax Act (the others being income from capital assets, employment, rental and agricultural income, income from professional services and "other income", *Einkommenssteuergesetz*, EStG, section II. 8. (§§13-23)).

The question arises whether it is appropriate to give this meaning to the silent partnership under the DTC. The argument maintained by mainstream scholarly opinion is that the term is not defined in the DTC and therefore Article 3(2) of the Model Tax Treaty and the respective articles of the bilateral DTCs allow the application of the German interpretation of this term, and the classification of these proceeds as business profits. Therefore the provision about business profits which allocate those to the state in which the business has a permanent establishment (PE) after Articles 5 and 7 Model DTC could be applied.

In the Swiss case of 1999 the tax authorities themselves had taken the opposite view. They argued that the involvement of the silent partner in the business was not active enough to justify the classification of his income as business profits. Their hope was obviously to have them classed as dividends, which would have channelled the tax to Germany. There had been decisions where it was maintained that the question had to be decided by looking at the individual case rather than assuming business profits as a matter of course which gave rise to this argumentation. In that last decision on the matter from 1999, the BFH considered a view taken in scholarship that the income from the atypical silent partnership must be seen as capital gains. Taking the individual contractual agreement into account but not any individual involvement of the silent partner the judges eventually concluded that under the specific German-Swiss tax treaty the assumption of business profits was acceptable and they insisted on this traditional rather technical view which made the proceeds business profits despite a still passive role of the silent partner (BStBL II 1999, 812, 813). The entrepreneurship is seen in the mere fact that the silent partner participates in the losses as well as the profits and the occasional clause in such contracts that the silent partner has inspection rights towards the company or indeed only one of its partners regarding his share or sub-share.

This type of involvement is clearly not seen as sufficient to make for entrepreneurship under English law and such participation is not seen as a partnership – and therefore a commercial activity – in the *Memec* case. It would be classed as private asset management. In the Court of Appeal Henry LJ in *Memec plc* v *Inland Revenue Commissioners* [1998] STC 754 stated (at 756):

> *The position of Plc was that of a purchaser who, for a consideration consisting of the contribution of a capital sum and an undertaking to contribute to losses of the owner of a business up to the amount of the contribution, purchased a right to income of a fluctuating amount calculated as a share of the annual profits of the business. Neither in English nor in Scottish law would that have left Plc a partner with GmbH.*

This is in line with other continental jurisdictions, including Switzerland, which traditionally call this arrangement a participatory loan, *partiarisches Darlehen*. They do however tend to treat those proceeds in a similar way as the German fiscal authorities – sharing the same company law traditions – and a clause in the German-Swiss DTC which made the view taken by the BFH in the 1999 case convincing.

The judges however also included a passage pointing out that this solution was right for the German Swiss DTC but not necessarily for others. This passage is stubbornly overlooked by leading scholars and tax authorities in subsequent decisions. So far, no other case involving other DTCs, namely the German UK DTC, has come before the courts.

Regarding the German-British DTC, this solution leads to contradictory results. Memec plc should have paid taxes on business profits to the German authorities but seems to have paid taxes on dividends to the UK authorities. Or so it ought to have been under the respective views of the two judicial bodies.

Double taxation would clearly be the consequence. This seems to contradict the object and purpose of the convention according to its title.

*Elements of the interpretation standard in Article II (3)*

Article II (3) DTC D-UK and its relative in the Model DTC provide the basis to arrive at a treaty specific interpretation if intended. The 1999 decision of the BFH clearly respects the role of the "context" mentioned in the interpretation standard which after all is part of the now binding 1969 VCLT.

The most enigmatic element of this rule appears to be that of the absence of a definition. What shape or form should a definition for the purposes of the DTC have? Is the term atypical silent partnership defined in the treaty? It is not included in the list of definitions in its Article II (1). A strictly literal understanding of the notion of definition can therefore lead to the conclusion that a definition is missing and that the meaning given to the term in the income tax law of the applying state is therefore decisive. This rule resembles the method articles in the UNIDROIT conventions. The "absence of a definition" could be read as corresponding to an internal gap, a "matter not expressly settled" by the instrument. However, the article does not refer to national law as an external regime, and allows a meaning to be derived from national law to a term contained in the DTC. It cannot be inferred that heads of taxation should be created under this mechanism, or that the case should be treated as a domestic case without a cross border element.

The result is highly unsatisfactory for the tax payer. But is his position protected by the DTC? To what extent is his interest subject to the objectives and purpose of the DTC? The avoidance of double taxation is certainly a value that is solely in the interest of the tax payer. The intended procedure to resolve conflicting practice and understanding of the DTC is the mutual agreement procedure under Article XVIII A DTC D-UK. This can be invoked by the tax payer, and his or her argument is not limited to the avoidance of double taxation, but he or she can ask the authorities in the state of his or her residence to check if the convention has been properly applied:

> *(1) Where a resident of one of the territories considers that the actions of one or both of the Contracting Parties result or will result for him in taxation not in accordance with this Convention, he may, notwithstanding the remedies provided by the national laws of those territories, present his case to the taxation authority of the territory of which he is a resident.*

An atypical silent partner of a German business who is resident in the UK could therefore refer the question to the IRC. This has not been done by any party as yet.

The wording of Article VIIIA shows that the object and purpose of the DTC may extend beyond its title. An application of the interpretation rule of both the DTC and the VCLT could therefore lead to the following results.

The starting point should be the term used in Art VI DTC D-UK, sleeping partner. Even under the German "reading" the atypical silent partner is still a silent partner, a sleeping partner. His or her profits are classed as dividends in the convention. The term may be undefined in the convention but the qualification assigned to it is defined in Article II DTC D-UK. Drawing on a variation of the term in order to reach a different qualification may mean an unauthorised diversion from this rule. The *Memec* cases present an excellent example of establishing an appropriate understanding of the term and convincing qualification of the proceeds by way of the thorough interpretation of the term business profits, or dividend respectively, in the decisions. The judges perform an interpretation in three steps. They first establish the understanding of an ordinary businessman, then the meaning under domestic tax law and finally the meaning under the DTC. They put the contractual arrangement between the British Memec plc and its German partner GmbH to the test under these three aspects. All three of them reveal that neither the ordinary businessman, nor the British income tax Act (ICTA), nor the DTC would conceive of the proceeds from this arrangement as business profits. This is quite contrary to the prevailing German practice, but very much in line with Article II (3) of the DTC and Art 31 VCLT.

The first test establishes the ordinary meaning of the term, the second puts in in its domestic tax law context as prescribed in Article 31 VCLT and in Article II (3) DTC, and the third combines the second test with the international aspect. This third test is in my view what sets the British decision apart. This third test is not expressly prescribed by the VCLT or by the DTC, and yet it seems to be the most important step to take in an international convention. It is the so-called treaty specific interpretation technique. The model for this test can be found in the House of Lords decision of *Fothergill* v *Monarch Airlines Ltd* [1981] AC 251. Here, it was established that a term can have different meanings in a domestic and an international setting. For the purposes of the DTC, it is therefore possible to assign a different meaning to the term "business profits" or "dividends" from that an ordinary businessman would understand from domestic tax law. To arrive at this meaning, the judges in *Memec* compared German law on the subject and concluded that German law considered the arrangement to be a "partnership" and therefore "transparent", so that the taxes were raised from the proceeds of the (silent) partner, not the body corporate. Other than the German case law, the House of Lords decided that those proceeds were not business profits, and also denied that the arrangement amounted to a "partnership" under English or Scots law, obviously not knowing the German take on this question.

It can be queried whether the requirements of the

interpretation rule in the VCLT are satisfied by this exercise. Certainly, the judges interpreted the term "dividends" in the DTC in the context of the international instrument. This context included the foreign law, in particular the law of the partner state with which the bilateral instrument was concluded. It can be said that the German case law does this in so far as it is acknowledged that the solution in the 1999 case was derived from the specific bilateral treaty with Switzerland and was not necessarily universally applicable to all other DTCs.

The terms to be interpreted in these two cases that only indirectly correspond to each other are the "sleeping partner" and his proceeds, the "dividends." The problem is posed by the absence of a separate rule for the "atypical sleeping partner" and the interpretation rule of Article II (3) DTC D-UK.

Does the fact that the atypical silent partner is not expressly mentioned in the DTC mean that it is not "defined" in the DTC and that therefore German law can decide about the qualification of the proceeds in a German case if Germany applies the DTC according to Article II(3)? A German Federal Supreme Tax Court (*Bundesfinanzhof,* BFH) decision of 1965 (BFH of 5 February 1965, VI 338/63U) does in fact deny this. It said that the mere silence of the subject is not an indication that expanding the meaning or creating a new head is acceptable in order to reach the desired result.

With regard to the "sleeping partner" of Article VI(4) of the German-British DTC, it is therefore highly questionable if the solution developed and confirmed under the German-Swiss DTC would be justified under this finding. The argument is in line with the above described German doctrine of the theory of gaps – the mere silence of the legislator should not be taken as a gap unless it is clear that the matter was intentionally left unregulated.

This would mean that Article II(3) DTC D-UK, and with it the German domestic tax law interpretation, would only apply if the atypical silent partner was deliberately left unmentioned.

It should be noted that "atypical silent partner" is a term of German civil law, and has no specific meaning in taxation law. In order to establish why the atypical silent partner is not mentioned in the DTC, recourse can be taken to the preparatory materials, according to the VCLT. However, the first step under the VCLT is to consider the relevant norms in the context with objectives and purpose of the convention.

- This article is based on a lecture at the IALS given in October 2012

**Dr Maren Heidemann**

*PhD, LLM (Nottingham); Assessor Iuris (Germany); Visiting Fellow 2011-12, IALS; Lecturer in Commercial Law, University of Glasgow*