Major Expropriation Case Decided by the Mexican Supreme Court of Justice, The Due Process Requirement and its Correlation with International Treaties

Alejandro Faya Rodriguez
Mexico Launches Immunity Program to Prosecute Antitrust Violations
By Jorge Jimenez
(López Velarde, Hefty y Soria)

Following the experiences of other countries with stronger and longer-standing traditions on antitrust law enforcement, Mexico’s Federal Competition Commission (Comisión Federal de Competencia), known by its acronym as Cofeco, has launched a program under which it will grant immunity to market participants that may have been involved in so-called “absolute monopolistic practices”, provided that they come forward and cooperate with the Cofeco in providing information on the illegal activities so that Cofeco may be able to stop the practice and prosecute others involved.

Private Equity Dealflow Inching Forward
Real Estate Dominates Market
By Alex Burgess

Private equity investors are speaking with more and more enthusiasm about investing in Mexico, but investment levels have not fully reflected such optimism. Deal flow into the country has increased only moderately over the past few years despite sharply increasing levels of fundraising during that same time. From 2003 to 2005, dealflow has gone from $149 million to $138 million to $176 million. Mexico’s economy as a whole was somewhat slow last year, with its GDP growing only about 3%. Even so, the lack of capital invested last year comes as somewhat of a surprise, given that fundraising levels devoted solely to investing in Mexico reached $347 million in 2004 and $676 million in 2005. With Advent’s $375 million regional fund, that 2005 number is even higher, as Advent has said that it will invest 65-75% of the fund in Mexico.
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MEXICO

Expropriations

Major Expropriation Case Decided by the Mexican Supreme Court of Justice

The Due Process Requirement and its Correlation with International Treaties

By Alejandro Faya Rodríguez

All States have the right to expropriate private property. It is a fundamental right, a natural expression of sovereignty, and a manner whereby States conduct public policy and pursue legitimate economic and other welfare objectives. However, what always must come into scrutiny is the manner States expropriate. Regardless of the content of domestic laws, the rules of customary international law for the treatment of aliens—forged primarily over the last century—require that any taking of property by States be for a public purpose, with observance to basic rules of legality or due process, in a non-discriminatory manner and accompanied by fair compensation. Some economic international treaties, confirming this criteria, have set forth such requirements at the conventional level (e.g. most International Investment Agreements as well as certain human rights conventions).

It remains clear that because of the strong impact of these kind of acts, States have to act upon a certain framework so as to guarantee that any expropriation serves its legitimate purpose, and is not an arbitrary, discriminatory or capricious act. Domestic laws must contain expropriation legislation that goes at hand with international standards.

Of course, such an exercise requires a case-by-case examination, but in essence, domestic laws should prescribe a straightforward legal procedure establishing how expropriations take place and effective means of defense and full access to the system of justice—in case the owner does not agree with the expropriation, as well as ensuring that the expropriation serves a public objective that clearly overweighs the negative impact imposed on the owner and that such owner gets fair compensation from his or her loss.

The Expropriation Law

Pursuant to the Mexican Expropriation Law, expropriations—at the federal level—take place by means of a decree issued by the Federal Executive (President), which has to be notified to the affected party and duly published at the Federal Register (“Diario Oficial de la Federación”). Expropriations must be for a public purpose, which modalities are expressly listed in the law. Article Five of the Expropriation Law states that the affected owners shall file, within fifteen days after they are notified of the expropriation decree, a revocation or annulment recourse against such decree. In certain cases, depending on the modality of

Should there be a right to a hearing before an expropriation?

“public purpose” we are talking about, seizure of the property may only occur when such recourse is not submitted within a certain timeframe or when it is settled adversely against the owner; but in other cases, seizure takes place immediately notwithstanding the expropriation is sub judice at the administrative level. This article may bring controversy, as it certainly had been the case, because it does not provide for a prior hearing; that is to say, the right of the affected party to know about the impending expropriation, prescribing that the affected party—in certain cases—may only defend himself or herself after the expropriation occurred and he or she is no longer the owner of the property nor has its physical possession. The latter clashed, for some, with Article 14 of the Mexican Political Constitution, which provides that no person may be deprived of its properties, possessions or rights, but by means of a trial conducted before previously established courts, observing the essential for-
malities of a proceeding, and pursuant to the laws enacted prior to the facts that gave rise to the dispute.

Do “essential formalities of a proceeding” include the right of prior hearing in expropriation cases according to the Constitution? Expropriations had been conducted otherwise, and when the constitutionality of such rule was contested, the Supreme Court, in 1997, confirmed the criteria: the Expropriation Law was to be applied in its terms. In support of the latter criteria, it may be said that Article 27 of the Constitution, when referring to Expropriation, does not mention the need for a prior hearing, and therefore its implementation may be regulated by federal law. Moreover, expropriation is a major constitutional institution of public order, which responds to situations of emergency or social need. Therefore, it is implicit that a right of prior hearing is not necessarily required, and that the due process requirement is fulfilled as long as the owner has effective legal means to challenge the expropriation and eventually revert it. I am of such an opinion, and consider that the Expropriation Law, as it stands, is not unconstitutional. It is just a matter – up to the Legislative or Judiciary – to decide between private property and legal certainty and procedural effectiveness, or a balance in between. The lack of prior hearing may be questioned of course, and it may not be seen as the best scheme under certain legal systems, but it may also be fairly said that such is a sovereign decision of States in the manner they do expropriations.

Worth noting is that, in the case of Mexico, Chapter XI of NAFTA, other Free Trade Agreements with similar provisions and eighteen Bilateral Investment Treaties in force require from the signing States that all expropriations against foreign investors be made, among other requirements, according to the principle of “due process of law” (or similar formulas), as international custom requires. Interesting would be to determine if such due process requirement would include the prior hearing, negated in the Expropriation Law, or if the above-mentioned procedure established at the Expropriation Law suffices and is compatible with such principle. In my opinion, it does not remain clear that the due process requirement set forth at the referred treaties indeed requires a prior hearing, as some Ministers – in the case described below - suggested. In fact, I consider that it does not, because the due process should be seen as a general principle that obliges States to have a procedure established in law (which is public and known by everyone), effective means of defense and of course the opportunity of the owner to be heard and defeated in trial, whether before or after the expropriation takes place. Moreover, there is no indicative that the customary international law on expropriation goes so specific as to require the prior hearing in this context, being therefore up to the State to decide on this matter.

Worth noting is that in the international context, the expropriation cases under International Investment Agreements (e.g. the NAFTA) have focused on whether there has been a direct or indirect expropriation, in the sense of the effects of the acts, and in whether there has been paid compensation to the foreign investor. The other elements have proved to be quite irrelevant because notwithstanding the expropriation was legal or illegal (i.e. it was for a public purpose or under due process of law), compensation must be paid anyway. That is the reason why there is not much jurisprudence on the due process requirement for expropriations (the same goes for “public purpose”); however, the argument that the absence of a right of prior hearing equals the lack of due process may of course be raised in the international context. In the case of Mexico, assuming arguendo that the due process contained in certain treaties indeed requires a prior hearing, then it comes (before the Supreme Court decision was issued) that under such instruments owners from abroad had the right of prior hearing, whereas Mexican nationals and foreigners not covered by investment international commitments had not.

**The Sugar Mills Cases**

In the major act of this sort during his tenure, President Vicente Fox expropriated 27 sugar mills in 2001 by reason of their economic and financial condition. Consequently, the owners filed lawsuits alleging that the expropriations were unconstitutional. The first victory came in 2004 to Grupo Azucarero Mexico; in such case, the tribunal stated that the government did not prove that the expropriation was for a public purpose. Worth noting is that GAMI, a US company holding an equity interest at such company, lost a claim under Chapter XI of NAFTA partially because of the success of Grupo Azucarero Mexico in the domestic courts. After that, the Attorney-General requested the Supreme Court to consider the remaining cases because they were of national interest and in order to have one decision setting all cases at the highest level.

The Supreme Court attracted five cases and resolved in plenary session. In question was the validity of the old precedent, which denied owners the right of prior hearing before an expropriation occurs, as well as the “public purpose” requirement – not proved before the Court -, although we will not refer to the latter issue (it remained as a casuistic assessment, contrary to the due process element, that was to set up a new rule). The big question was the following: should the owners have under the Expropriation Law the right to know about an impending expropriation,
so as he or she may take the requisite legal steps of defense? Or on the contrary, should the owner defend just after the expropriation took place? Constitutional articles 14 and 27, already mentioned, were the legal underpinning of the discussions.

Although the international investment agreements signed by Mexico were not the subject-matter of the dispute, some Ministers suggested that holding the old precedent firm and valid may led to unconstitutional considerations of such treaties, because their effect would be granting preferential rights on foreigners over nationals. The latter, based on the assumption that the due process requirement set forth in the treaties implied the need for a prior hearing (as previously mentioned, I do not share that opinion). Even if that were truth, that argument of illegal discrimination against nationals would be rather weak. International Investment Agreements (as part of Free Trade Agreements or as Bilateral Investment Treaties) may give in some way preferential treatment to foreign investors but just on a strictly reciprocal basis and because of their special condition as foreigners. In other words, there is equality in the sense that any preferential right given to a foreigner in Mexico is also granted to the Mexican national in the country of origin of that investor; moreover, foreigners are not in the same conditions than nationals, so certain differences may exist that do not necessarily amount to illegal discrimination against nationals. The investment protection given under treaties has to be assessed within its own context. The use of international arbitration (a procedural right a foreign investor has under an International Investment Agreement that a Mexican national does not have under local law), for instance, does not really imply an advantage for the investor or disadvantage to the Mexican national; moreover, it exists as a mechanism to settle treaty breaches and not ordinary claims, being therefore a scheme totally justified.

Those considerations, however, were not needed (they remain as mine), and the question was not whether to homologate national law to international law, nor to link domestic law to international treaties, but to assess the legality of the Expropriation Law and the old precedent under the Constitution. At the end of the day, the majority of the Ministers decided that the legality of an expropriation has to be forged before it actually occurs, and therefore, the prior hearing had to be duly respected, according to Article 14 of the Mexican Political Constitution. Hence, domestic law got changed on constitutional grounds, on the basis that expropriations should not be made with prejudice to the bill of rights established in the Mexican Political Constitution.

Final Remarks
The Executive acted under the lex lata; that is to say, under the law in force at the time. In that sense, it did not commit a mistake with respect to the due process requirement (although according to the Court, in another assessment, it did regarding the public purpose element), because it just followed a criteria that, in the opinion of the Supreme Court, had to be modified. It played in favor of private property and against the discretionary powers of the State regarding expropriation. Now, everybody will know and have the opportunity to take the requisite legal steps to challenge an expropriation before it occurs. Good news for private parties and investors. Nevertheless, the Supreme Court never clarified how this right of hearing was supposed to operate; nor did it try to establish clear rules on this matter. It may be a strong right as it also may well be just a formalistic step. The right to expropriate remains intact, at least legally speaking; however, it does not remain clear if the expropriation mechanism is damaged in its implementation aspect. Let us remind of the essence of such institution: to respond to emergencies effectively and make social welfare privileged over a private interest. The future shall tell, let us hope the outcome is just a proper balance.

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Clarifications for Mexico’s Thin Capitalization Rules
By Jose Ibarra
(Chevez Ruiz Zamarrripa y Cia)

Mexico is continuing to tinker with strict limits it imposed a year ago that were supposed to limit the ability of Mexican companies to deduct interest paid to related shareholders. (See discussion in 11/15/05 NAFTIR, p. 5).

The limits—called “thin capitalization” rules—prevent Mexican companies from deducting interest paid to anyone to the extent the companies have debt-equity ratios greater than three-to-one.

Thin capitalization limits took effect on January 1, 2005, but have been a source of controversy since then.

The new law should permit a Mexican tax deduction for interest on most project financing.

because key details about how to apply them remain vague. Suits are pending in the Mexican courts to have the limits declared unconstitutional. President Vicente Fox issued a decree on October 21, 2005 relaxing the restrictions by allowing money borrowed from financial institutions and spent on productive investments not to be counted as debt. Congress—at the request of the president—passed a new law in late November that broadens the exception. The new law, to be effective January 1, 2006, should permit a Mexican tax deduction for interest on most project financing notwithstanding the taxpayer’s debt-equity ratio.

Background

Mexican thin capitalization limits deny interest deductions on that portion of a taxpayer’s debt that exceeds a 3-to-1 debt-equity ratio.

Equity for purposes of the ratio is probably the shareholders’ equity as reported for financial statement purposes. The taxpayer’s debt for the tax year is determined by taking the average of its debt on the last day of every month during the year. However, the word “debt” is not defined, and it is unclear whether accrued liabilities and trade payables are to be counted in determining the debt-equity ratio.

There is a five-year transition period that may enable taxpayers to avoid having their interest deductions denied if they are able to reduce excess debt “proportionately in equal parts” over the five-year period. It is unclear what the consequences are if the taxpayer reduces its excess debt more quickly than “proportionately in equal parts” over the five years.

Application

Thin capitalization rules apply to all related-party loans and to third-party loans from creditors located in or outside of Mexico. Under the law as originally enacted, third-party loans are exempted from the 3-to-1 debt-equity ceiling only if the borrower obtains a ruling from Mexican tax authorities that all of its inter-company transactions are reasonably priced under approved transfer pricing methods.

The Fox administration proposed legislative amendments to the thin capitalization rules throughout 2005, concerned that the rules would impede the long-term financing needs of Mexican infrastructure projects and manufacturing operations. On October 21, 2005, the administration issued a decree that created an exception from interest deduction denial for debt incurred to finance qualifying projects.

Exempt Loans

The presidential decree allows debtors to exclude from their debt-equity ratios any financing obtained from the financial sector that can be allocated to the construction, operation or maintenance of productive infrastructure or the manufacturing of fixed assets. To qualify, at least 80 percent of the loan must be used in the acquisition or construction of fixed assets, land or engineering projects. There are some additional requirements that are designed to ensure that the financing is in the nature of a typical long-term infrastructure financing, one of which is the creditor must impose conditions on the borrower in order to conserve the borrower’s financial resources. To qualify for the decree exception, financing contracts must contain at least six of 16 specified creditor-friendly terms, such as a provision permitting the creditor to appoint a member of the borrower’s board of directors and a provision prohibiting the borrower from entering related-party transactions without creditor approval. If existing loans are refinanced to comply with these requirements, then they can qualify for the exception from the thin capitalization rules provided by the decree.

At the same time that the decree was issued, several legislative proposals to change the thin capitalization rules were being considered. On October 28, the lower house of the Mexican Congress approved a tax bill containing...
a broad exception from thin capitalization rules. The exception permitted the deduction of interest on third-party debt if it incorporated restrictions on borrower behavior that are typically imposed by unrelated creditors. The proposed legislation was more generous than the presidential decree because it did not limit the thin capitalization exception to infrastructure projects or to financing from the financial sector.

New Exception
Under the new rules, Mexican companies with debt-equity ratios above 3-to-1 will be permitted to deduct the interest paid or accrued on qualifying loans from third-party lenders. These qualifying loans are excluded from the calculation of the taxpayer’s debt for purposes of the debt-equity ratio.

The exemption applies to all financing from unrelated parties that restricts the borrower’s ability to do all of the following: sell fixed assets, reduce capital or issue new share capital, distribute dividends or profits, enter into new financing, and impede the lender’s rights under the financing agreement.

The new legislation also spares taxpayers with excess debt who cannot deduct all their interest payments from having to include the excess debt in computing inflationary income (defined as the inflation effect for the year on average liabilities), thus eliminating a double hit to those taxpayers.

Clarifications Needed
Unfortunately the new legislation fails to clarify some aspects of thin capitalization rules that are not well understood. As originally enacted, the rules contained a five-year transition rule under which the interest expense on debt in excess of the 3:1 ratio does not become nondeductible unless the taxpayer’s debt-equity ratio remains excessive for the five years. There is no penalty if the taxpayer is able to reduce excess debt “proportionately in equal parts” over the five years, but there is no guidance as to what this requires or whether a failure to reduce debt sufficiently in one year can be rectified by extra reductions in a subsequent year.

The new legislation also fails to clarify whether general trade payables and other accrued liabilities—for example, court-ordered damages—are “debt” for purposes of computing the debt-equity ratio.

Taxpayers can choose to apply the new tax legislation retroactively to January 1, 2005.

Meanwhile, a significant number of Mexican companies have taken legal action against the thin capitalization rules in general, going to the courts and filing amparo suits. The courts have yet to rule, but there is a strong feeling among tax litigation experts that there are enough grounds for the courts to rule for taxpayers.

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➤ Antitrust, from page 1

In commencing this immunity or leniency program, Cofeco has recognized that although it has been able in some cases to sanction this type of monopolistic practices, illegal conduct of this type is extremely difficult to prove because of the utmost secrecy in which it is typically undertaken, and the indirect means used to effectuate the relevant actions. Likewise, Mexico’s antitrust authority lacks many prosecution powers and broad investigation rights available to other antitrust regulators in other jurisdictions. This, added to the formalistic nature of Mexico’s administrative litigation statutes, has limited Cofeco’s ability to effectively prosecute illegal conduct.

Following the school of U.S. antitrust laws, Mexico’s Federal Law of Economic Competition (Ley Federal de Competencia Económica) describes two types of antitrust violations or monopolistic practices: the absolute monopolistic practices, and the relative monopolistic practices. While the former is a set of limitative conducts that are per se illegal, relative monopolistic practices are a group of economic actions or conducts which are only determined as illegal if the parties involved have a substantial power in the relevant market so as to create an anti-competitive effect as a result of their conduct (i.e. conducts that a U.S. court would analyze under its antitrust laws under the so-called “rule of reason”. Absolute monopolistic practices, on the other hand, are considered illegal no matter who are the parties involved, what their market power is and what is the effect of their conduct in the market.

The list of absolute monopolistic practices for which the new Cofeco immunity program applies are:
(1) **Price Fixing**, i.e. the act or series of acts through which competitors in the same market agree on the terms and conditions for the sale of their products or the provision of their services.

(2) **Horizontal Market Allocation**, which is the distribution of markets between competitors, whether in terms of geographic areas, types of consumers, or otherwise, so that competitors do not interfere within each other in their areas so allocated.

(3) **Restraints on Trade**, where competitors agree to limit the availability or supply of goods or services to certain quotas or amounts; and

(4) **Bid Rigging**, which is the coordination of efforts or sharing of information of two or more parties involved in a government procurement process or public bid in order to manipulate the terms and conditions under which such parties bid with the government agency or instrumentality.

Because of the extensive nature of the government procurement market in Mexico (particularly considering crucial sectors of the economy where because of their monopolistic structure – such as the oil and gas sector with Pemex being the state monopoly, and the electricity sector with Comisión Federal de Electricidad as the state monopoly – a vast majority of the business in such sectors, and a considerable portion of the Mexican economy, depends on public bids. Due to this circumstance, bid rigging has been one of the most important concerns of the Cofeco, and is one of the lines in which it both intends and may expect to have an ability to pursue actions under this immunity program.

Because of the seriousness of the actions that constitute violations to the absolute monopolistic prohibitions of the Competition Law, sanctions contemplated by such statute are among the harshest under Mexican law, exceeding $1.5 million dollars. With the immunity program, companies or entities cooperating with and providing information to the antitrust regulator in the investigation may only be imposed symbolic or nominal sanctions.

The program will try to emulate similar actions undertaken by the antitrust authorities of other OECD members, in addition to the U.S. and the European Union, such as Canada, Brazil, Switzerland, Australia and Japan, and is also intended to provide additional international cooperation tools to authorities of such countries undertaking investigations of this type. Mexico’s antitrust laws have very much followed international experience, since enactment in 1993 as a result of the negotiation of the North American Free Trade Agreement. In this specific matter, they also follow OECD Council Recommendations concerning effective action against the so-called “hard core cartels.”

Upon formal commencement of an investigation, additional participants coming forward and wishing to cooperate in the investigation may also see a benefit in the reduction of their respective sanctions and penalties.

Needless to say, the success of this program will depend to a large degree on two elements: the ability of the Cofeco to maintain the secrecy of its source during the litigation and investigation process, as well as any judicial appeals of such process, and the success of the Cofeco in effectively taking advantage of the cooperation and information provided.

Apart from the elements affecting this process, Cofeco will need to continue its struggle towards a more effective and efficient enforcement of the Mexican antitrust laws. Born relatively recently –back in 1993 – Cofeco still has a long way to go in conveying an antitrust culture in the Mexican economy, and for that it requires a more pro-active role and a policy of better enforcement. Cofeco has been lobbying for months for a series of amendments to the Competition Law that would strengthen the commission. These amendments, however, are likely to have to wait until the next legislature takes seat and after the 2006 presidential elections.

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More than likely, it is simply taking time for new funds in Mexico to start investing their money. 2005 deal flow is still a reflection of the low levels of fundraising that Mexico saw a few years ago ($127 million in 2003). With fundraising for the country reaching over a billion dollars in 2005 (including portions of regional funds dedicated to Mexico), fund managers remain confident that deal flow will start to reflect the higher levels of fundraising that is taking place.

Exactly when these massive increases in funds will start to translate to similar increases in equity invested into the country is unclear, especially given upcoming political elections. Many funds are somewhat hesitant to invest heavily in Mexico because Andrés Manuel López Obrador, who has somewhat of a populist background, is the frontrunner in the July presidential elections. Many fund managers are bullish on Mexico for 2006, but others forecast that the current election year means that we won’t see a dramatic increase in activity until 2007.

Real Estate Still Hot

Most of the attention devoted to Mexico continues to revolve around the country’s real estate market, as 13 of the 23 deals recorded over $1 million in 2005 are related to real estate. The largest deal of the year was Advent International’s $50 million acquisition of Mexican housing mortgager Hipotecaria Casa Mexicana. At the very end of the year, another significant real estate acquisition came about with the sale of Pulte Homes’ Mexico operations to a group of investors led by Walton Street Capital. Pulte built roughly 7,000 homes in Mexico last year, and the new investors reportedly want to make Pulte the biggest homebuilder in Mexico. Terms of the deal were not disclosed.

### Deals Monitor: Mexico

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<td>NA</td>
<td>Mexico</td>
<td>Real estate</td>
<td>Greenfield</td>
<td>NA</td>
<td>September 2005</td>
</tr>
</tbody>
</table>
Hines was also active in Mexico, developing two significant greenfield industrial projects last year, neither of which had an investment price disclosed. Prudential Real Estate Investors also pumped significant equity into the Mexican real estate market, mostly through its residential program. Once again, financial details for the year were not disclosed. It seems that part of the reason that deal flow has not matched up with funds’ “bullish on Mexico” mentality is that financial terms of most major real estate transactions have not been disclosed.

O’Connor Capital Partners made another industrial acquisition in Mexico in the beginning of 2006- this time for $30 million. Industrial Global Solutions was also very active in 2005 with six industrial real estate investments totaling $21.5 million of equity financing. The investments were made out of IGS’ $75 million Mexico Real Estate Investment Fund, which has roughly $25 million of remaining capital to be invested in 2006.

A great deal of activity has gone on in Mexico’s real estate industry, not only with private equity funds. Various REITs from Germany and the US, pension funds from the US and other international institutional investors are also trying to take advantage of the housing market. According to Ricardo Zuñiga, managing director at O’Connor,
the market is beginning to get somewhat crowded, driving up prices to some extent.

Gary Garrabrant, CEO of Equity International, agrees: “I wouldn’t go so far as to say that the real estate market in Mexico is overcrowded, but there are certainly some areas where we won’t look into again, such as the industrial market,” he said. As for the housing market, the large population of Mexicans under the age of 25 and the increasing number of married couples is appealing to investors and should spark more investment in housing development companies and mortgage lending institutions.

As the real estate market gets more and more crowded in Mexico, there will be two results: Brazil will see more activity from real estate funds, and Mexico will see more investment in other sectors from general private equity funds.

Other Sectors

The giants of Latin American private equity have a different approach than real estate-focused investing. Darby Overseas Investments made an $11 million investment in housing developer GEMet last year, but will likely not invest again in Mexican real estate for purposes of diversification. Darby and Advent are looking to the consumer and services sector as being some of their main investment targets.

“As interest rates continue to come down and the economy gains sustainability, we should see increased consumer demand and a bigger role played by the consumer,” said Julio Lastres, a Managing Director of Darby. Energy will also be a focus of several funds—Conduit Capital Partners and FE Clean Energy Group were both active in making energy investments in Mexico in 2005 and BBVA Proyectos Empresariales will devote a fair amount of its new $190 million fund to energy in Mexico.

More Deals to Come

Though dealflow has hovered between $138 and $175 million for the past three years, numbers should become more substantial in the next year or two. The drastic increase in funds is not the only indicator of such an increase. The new Securities Law promises to attract both smaller investors and investments in bigger companies because it better protects minority shareholder rights. Investors are also more convinced of profitable exit possibilities because of the improved access to public markets as a result of the Securities Law and because of the success of two recent exits on the Mexican stock exchange. New local venture funds will likely form because of the new trust framework approved by the Mexican government at the end of 2005.

Alex Burgess is the editor of Venture Equity Latin America, also published by WorldTrade Executive, Inc.
A Tax Paradigm Shift from Canadian Supreme Court
By Guy Du Pont and Nicolas X. Cloutier
(Davies Ward Phillips & Vineberg LLP)

The judicial approach to the interpretation of tax legislation has fundamental implications for the Canadian tax system. It is of a paramount importance for taxpayers and their professional advisors for purposes of devising transactions which may withstand the evermore aggressive assaults of the tax authorities and has an undisputed impact on the result of tax litigation, both in avoidance and other cases.

The Canadian approach has now, at best, reached a heightened stage of confusion or, at worst, in rebuffing at least a decade of jurisprudence, hints at a newfound focus on context and purpose when the legislative provisions at issue are otherwise clear and unambiguous.

This must not go unnoticed, since, as mentioned by Mr. Justice Estey in Stubart in more than two decades ago, liberal rules of interpretation generally “reduce[s] the attraction of elaborate and intricate tax avoidance plans, and reduce[s] the rewards to those best able to afford the services of the tax technicians”.

Statutory interpretation is, mainly, the province of the judiciary. Hence, approaches to statutory interpretation are largely a reflection of judicial attitude, more particularly in tax cases, and the potential paradigm shift now hinted at by the Supreme Court of Canada may reflect the different judicial philosophy of its members.

What follows is a brief description of the current judicial approach to statutory interpretation of tax legislation in Canada, as reflected by recent decisions of the Supreme Court, preceded by an overview of its genesis.

Genesis

In 1984, the Supreme Court’s decision in Stubart heralded a fundamental departure from the prior doctrine of strict interpretation of tax legislation, in the historic sense. In Stubart, the taxpayer had transferred income producing assets to a related company in order to offset profits therefrom against the transferee’s losses and had thereafter continued to run its own business as the transferee’s agent. Interestingly, the decision did not revolve around the interpretation of any specific provision of the Income Tax Act.

Stubart stands for the general proposition that: “Courts today apply to this statute the plain meaning rule, but in a substantive sense [...]”. This excerpt exemplifies the tension inherent to the “modern rule” of interpretation that: (a) “the words of an Act are to be read in their entire [textual] context and in their grammatical and ordinary sense”; and (or but) (b) “harmoniously with the scheme of the Act, the object of the Act and the intention of Parliament”.

Three years later, this tension was noted in Bronfman Trust, where the shift away from strict interpretation, and the study of “scheme, object and intention”, were approved conditionally by Chief Justice Dickson, i.e. only: “provided it [the result] is consistent with the text and purpose of the taxation statute”, provided also that the text and purpose are consistent, and; we can only assume, giving precedence to the text if they are not. Interestingly, the issue of consistency between text and purpose was also noted in the most recent Supreme Court case on statutory interpretation.

Importantly, Stubart also stands for the proposition that the study of “scheme, object and intention” is a prerequisite for determining whether a legislative provision is applicable in a given case: “[...] when the clause in question is contextually construed, is clear and unambiguous, and there is no prohibition in the Act which embraces the taxpayer, the taxpayer shall be free to avail himself of the beneficial provision in question”.

In other words, after Stubart, strict interpretation without due and prior study of the “scheme, object and intention” of the provision at issue should no longer have had a place in the canons of construction of tax statutes, unless the broader interpretation of the provision did not lead to a workable conclusion compatible with its purpose.

Ten years later, in Antosko, Mr. Justice Iacobucci quoted Stubart but apparently discounted the requirement that the provision at issue must be “contextually construed” to determine whether it is clear and unam-
biguous and, to the contrary, the Supreme Court restricted the study of “scheme, object and intention” to cases where the provision at issue is unclear: “While it is true that the courts must view discrete sections of the Income Tax Act in light of the other provision of the Act and of the purpose of the legislation [...] such techniques cannot alter the result where the words of the statute are clear and plain and where the legal and practical effect of the transaction is undisputed.”

This was viewed to reflect a judicial concern that the qualification of clear legislative provisions by unexpressed (unwritten) notions of policy or principle would introduce intolerable uncertainty into the application of the Income Tax Act.

At that juncture, although the import of “scheme, object and intention” in interpreting “clear and plain” provisions clearly varied in degree, the interpretative canon for resolving ambiguities had changed. Before, resort was often made to the maxims that an ambiguity in a taxing provision was to be resolved in the taxpayer’s favor, while an ambiguity in an exempting provision was to be resolved in favor of the tax authorities. By then, it was clear that ambiguities were to be resolved openly by reference to the “scheme, object and intention” of the provision.

In 1998, Canderel, in the guise of distinguishing between the role of the judiciary and that of Parliament, added an express limitation to the “modern rule”, in that: “The law of income tax is sufficiently complicated without unhelpful judicial incursions into the realm of lawmaking [...] it is trite law to say that the promulgation of new rules of law must be left to Parliament”.

One year later, Shell Canada represented, as plainly as possible, an explicit departure from the Supreme Court’s teachings in Stubart and, to a lesser extent, from the Stubart progeny:

40. Second, it is well established in this Court’s tax jurisprudence that a searching inquiry for either the “economic realities” of a particular transaction or the general object and spirit of the provision at issue can never supplant a court’s duty to apply an unambiguous provision of the Act to a taxpayer’s transaction. Where the provision at issue is clear and unambiguous, its terms must simply be applied [...]

45. [...] The courts’ role is to interpret and apply the Act as it was adopted by Parliament. Obiter statements in earlier cases that might be said to support a broader and less certain interpretive principle have therefore been overtaken by our developing tax jurisprudence.

The above excerpts clearly reject the study of “scheme, object and intention”, at least when the provision at issue is found, on the basis of its wording alone, to be unambiguous.

In Will-Kare, on determining whether an asphalt plant was being used primarily for manufacturing or processing goods for sale, the Majority of the Supreme Court indicated that: “Referring to the broader context of private commercial law in ascertaining the meaning to be ascribed to language used in the Act is also consistent with the modern purposive principle of statutory interpretation”. However, in an interesting twist of judicial terminology, and perhaps further to Shell, this approach was also referred to in Will-Kare as the “principle of plain meaning”.

In the 2001 case of Ludco, the Supreme Court restated the “modern rule”, in referring to the admonition expressed in Canderel that: “judicial innovation is undesirable”, and added another, which further restricted the influence of “scheme, object and intention”: “In addition, given that the Income Tax Act has many specific anti-avoidance provisions and rules, it follows that courts should not be quick to embellish the provisions of the Act in response to concerns about tax avoidance [...]”. The first admonition was reiterated in Stewart, against the creation of a judicial test of “reasonable expectation of profit” for the deduction of expenses. The second admonition, which originated in Neuman, was reiterated in Walls.

In Markevich, on determining whether the Income Tax Act constituted a complete code for the collection of taxes, the Supreme Court rejected the Crown’s appeal in large part because it would have required adding the expression “at any time” in section 222 of the Income Tax Act. Interestingly, the Supreme Court nonetheless considered the scheme of the Act and conducted a “purposive analysis” to conclude that the collection provisions

**Overall, the Supreme Court has shown a clear focus on text when interpreting tax legislation in a way which amounts, at least in our view, as a flirtation with the plain meaning rule.**
of the Income Tax Act did not, “by implication”\textsuperscript{28}, exclude the operation of the general legislation on the collection of debts. Then, on the interpretation of the expression “proceedings by or against the Crown in respect of a cause of action”, the Supreme Court first studied the grammatical and ordinary sense of the words in French and English, including dictionary definitions, and concluded that: “It is then necessary, in this case, to conclude that the common meaning of the English and French version of the provision is unclear and that resort to other rules of statutory interpretation is necessary in order to discern Parliament’s intent”\textsuperscript{29}. Only then, the Court referred to the purpose and history of the provision, to hold ultimately, that the six years limitation period from the general legislation applied to the collection of tax debts.

Overall, the Supreme Court has shown a clear focus on text when interpreting tax legislation in a way which amounts, at least in our view, as a flirtation with the plain meaning rule. In other words, notwithstanding some doctrinal statements to the contrary, at least a decade of jurisprudence from the Supreme Court of Canada has reflected a fairly conservative approach to the judicial interpretation of tax legislation which, more often than not, has proved to be favorable to taxpayers.

A Paragigm Shift or the Musings of a New Court?

In Canada Trustco\textsuperscript{30}, one of the recent and much heralded decisions of the Supreme Court of Canada on the general anti-avoidance rule found in section 245 of the Income Tax Act, the Supreme Court presented, only in apparent conformity with its own jurisprudence, what may constitute a paradigm shift in statutory interpretation as significant today as Stubart was two decades ago. In that case, in what appears to be no more than a terminological twist to Stubart’s “scheme, object and intention”, the Court referred to statutory interpretation according to a “textual, contextual and purposive analysis”, including the usual limitations with respect to ambiguity:

The interpretation of a statutory provision must be made according to a textual, contextual and purposive analysis to find a meaning that is harmonious with the Act as a whole. When the words of a provision are precise and unequivocal, the ordinary meaning of the words play a dominant role in the interpretive process. On the other hand, where the words can support more than one reasonable meaning, the ordinary meaning of the words plays a lesser role. The relative effects of ordinary meaning, context and purpose on the interpretive process may vary, but in all cases the court must seek to read the provisions of an Act as a harmonious whole.\textsuperscript{31}

Then, on the basis of Shell and 65302, the Supreme Court restated, in the paragraphs immediately following the above excerpt, that the clear language of a detailed provision cannot be qualified by “unexpressed exceptions derived from a Court’s view of the object and purpose of the provision”, that the Income Tax Act invites a largely textual interpretation, and that the role of the courts is “to interpret and apply the Act as it was adopted by Parliament”.

However, and much to the surprise of Court observers, in what appears to be an about-face with at least a decade of jurisprudence on statutory interpretation, the Supreme Court indicated that: “In order to resolve any latent ambiguities in the meaning of provisions of the Income Tax Act, the courts must undertake a unified, contextual and purposive approach to statutory interpretation.”\textsuperscript{32} Or, more elegantly: “In some cases, a contextual and purposive interpretation may add nuance to the well-established legal meaning of the statutory language.”\textsuperscript{33}

In other words, as the law currently stands, a textual, contextual and purposive legislative analysis must be conducted in interpreting any provisions of the Income Tax Act, even where its meaning appears unambiguous, in order to reveal and/or resolve any latent ambiguities. The disturbing assumption underlying that requirement is that a legislative provision can be ambiguous even when its wording is not. Ultimately, it appears that the textual, contextual and purposive analysis is required to ensure that the interpretation is compatible with the intention of the legislator, as it appears from the text, context and purpose of the provision.

The Supreme Court did not elaborate on the contextual and purposive parts of the analysis in Canada

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Trustco. Generally, it stems from common sense that “textual” refers to the ordinary or literal meaning of the words, “contextual” refers to how the wording of the provision relates to other provisions of the statute and, “purposive” refers to the object, spirit or policy behind the provision, and may require a court to resort to extrinsic aids to interpretation.

A few weeks after Canada Trustco, the Supreme Court discussed at some length the “textual, contextual and purposive” approach, also referred to as “judicious interpretation”, in City of Montreal v. 2952-1366 Quebec Inc. In that case, the main issue before the Court was whether a municipal by-law prohibiting “noise produced by sound equipment” had the effect of prohibiting inoffensive sounds and, as a result, exceeded the power of the municipality to define and regulate nuisances. At the outset, the Supreme Court addressed the issue of latent ambiguity in unequivocal language:

10. Words that appear clear and unambiguous may in fact prove to be ambiguous once placed in their context. The possibility of the context revealing a latent ambiguity such as this is a logical result of the modern approach to interpretation. The fact that a municipal by-law is in issue rather than a statute does not alter the approach to be followed in applying the modern principles of interpretation.

[...]

12 In our view, although it appears to be clear, the provision is in fact ambiguous. In interpreting legislation, the guiding principle is the need to determine the lawmakers’ intention. To do this, it is not enough to look at the words of the legislation. Its context must also be considered.

However, it is clear that the Majority revealed an ambiguity in the by-law by a textual analysis alone, mainly on the basis that the word “noise” is “very general” and has an “open texture”, and thus considered the context and purpose of the provision only to resolve such ambiguity.

With respect to context, the Majority presented a distinction between the “overall context”, which is determined by reviewing legislative history and purpose, and, of equal importance, the “immediate context”, which is determined by analyzing the legislation itself.

In a strong dissent, Mr. Justice Binnie stated that the “textual, contextual and purposive approach” can have the effect of “going beyond what a court is authorized to do by way of interpretation and amounts to impermissible judicial amendment”. For the Minority, in upholding the validity of the by-law, and under the guise of statutory interpretation, the Majority has used “judicious interpretation” to remedy the wrongs in the provision at issue instead of ascertaining the underlying intention:

112 The provision in question is found in art. 9(1) of the by-law and reads as follows:

9. In addition to the noise referred to in article 8, the following noises, where they can be heard from the outside, are specifically prohibited:

(1) noise produced by sound equipment, whether it is inside a building or installed or used outside.

113 As my colleagues interpret article 9(1) in paras. 29-33 of their judgment it should read:

9. The following noises, where they can be heard from the outside, are specifically prohibited:

(1) disruptive noise emitted by sound equipment located inside a building or installed or used outside the building that stands out over other environmental noise and that interferes with citizens’ peaceful enjoyment of public spaces.

In the context of tax legislation, this combination of “reading expressions ‘up’, reading expressions ‘down’, reading words ‘out’ and reading words ‘in’”, now condoned, at least implicitly, by the textual, contextual and purposive approach advocated by the Supreme Court, could, unless it is applied with the utmost discernment by the courts below, encourage arbitrary decisions by the tax authorities and the courts, two evils that taxpayers and their advisors could do without, and add an additional layer of uncertainty to the interpretation and application of the core provisions Income Tax Act in an era where, until recently, it was thought that the general anti-avoidance rule was the ultimate sword of Damocles.

It can now only be hoped that these evils will be avoided and that the Supreme Court’s traditional approach to statutory interpretation, which had generally favoured Canadian taxpayers after the demise of strict interpretation in Stubart in 1984, will not be rapidly eroded.

1 Stubart Investments Ltd. v. Canada, [1984] 1 S.C.R. 536, 84 DTC 6305.
2 Stubart, p. 6322.
3 Five Justices of the Supreme Court of Canada have been nominated in the year 2000 or after (Charron, Abella, Fish, Deschamps and Lebel JJ.)
R.S.C. 1985, c.1 (5th Supp.). No section of the Income Tax Act was isolated as authorizing the assessments against the taxpayer (Stubart, p. 6308).


8 Bronfman Trust, pp. 5066-5067.

9 In City of Montreal v. 2952-1366 Quebec Inc, 2005 SCC 62, the Majority of the Supreme Court stated: “The contextual approach to interpretation has its limits. Courts perform their interpretative role only when the two components of communication converge toward the same point: the text must lend itself to interpretation, and the lawmakers’ intention must be clear from the context.” (par. 15)

10 Stubart, p. 5324.


12 Antosko, p. 6350.


15 Canderel, p. 6107. The Supreme Court commented against judicial interpretation which required the insertion of extra wording in Friesen v. The Queen, [1995] 3 S.C.R. 103, 95 DTC 5551, par. 27.


17 Will-Kare Paving & Contracting Ltd v. Canada, [2000] 1 S.C.R. 915; 2000 DTC 6467

18 Will-Kare, par. 32.

19 Will-Kare, par. 33.


21 Ludco, par. 38.

22 Ludco, par. 39.


27 Markevich, par. 15.

28 Markevich, para. 18 and 21.

29 Markevich, par. 32.

30 Canada Trustco Mortgage Co. v. Canada, 2005 SCC 54.

31 Canada Trustco, par. 10.

32 Canada Trustco, par. 47.

33 Canada Trustco, par. 54.

34 City of Montreal v. 2952-1366 Quebec Inc., 2005 SCC 652.

35 Montreal, para. 16, 24.

36 Montreal, par. 110.

37 Montreal, par. 110.

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