Doing Business in the United States

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Pillsbury Winthrop Shaw Pittman LLP

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Pillsbury Winthrop Shaw Pittman LLP

1540 Broadway | New York, NY 10036-4039

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PREFACE

Pillsbury Winthrop Shaw Pittman LLP is pleased to present *Doing Business in the United States*, an introductory guide for non-U.S. businesses that may be interested in doing business in the United States. We intend this to be a practical guide rather than a technical treatise; we have also tried to keep the length of the book manageable. Therefore, we have only covered the main topics that may be considered by a non-U.S. investor who intends to enter the U.S. market. This book is not an exhaustive guide to doing business in the United States and you should not rely on the information in the book as legal advice. The information in this book is based on conditions in place as of 2012.

Heartfelt thanks to Joseph J. Kaufman for numerous helpful editorial comments throughout the project.

Woon-Wah Siu, Editor

CHAPTER 1

CHOICE OF A BUSINESS ENTITY

By Woon-Wah Siu and Qiaozhu Chen

Introduction

An important question that a non-U.S. business faces before doing business in the United States is the selection of an optimal business structure. Selecting the best type of entity helps maximize the chances of financial and operational success.

There are four main types of business entities in the United States, namely: corporations, limited liability companies (LLCs), partnerships and sole proprietorships (a form used exclusively by natural persons). A non-U.S. investor may choose among any of them, but in most cases the corporation is preferred and recommended. The non-U.S. investor may also join forces with one or more other businesses to create a joint venture, which can take the form of a corporation, a partnership or a limited liability company. Finally, a non-U.S. investor may conduct business in the United States through a branch.

This chapter provides a brief introduction of each type of business structure and discussion of the factors to consider in choosing a business structure and the mechanics of organization for each structure.

Major Types of Business Entities in the United States

Corporations

Corporations protect their owners from business-related liabilities. They are easy to finance, and operate separately from their owners. Ownership of corporations is represented by shares of stock, and owners are called "stockholders" or "shareholders." Generally, shareholders of a corporation are not personally liable for the liabilities and debts of the corporation. As independent legal entities, corporations can enter into contracts, own properties and sue and be sued in their own names. Except for certain regulated industries (e.g., insurance, banking, telecommunications and defense), there are no restrictions on non-U.S. ownership of corporations. Generally, non-U.S. persons may own U.S. corporations, but non-U.S.-owned corporations may not qualify as "S" corporations. Corporations that elect to be treated as "S" corporations under U.S. federal tax law are generally taxed only at the shareholder level, whereas non-U.S.-owned corporations must be taxed both at the level of corporate earnings and at the level of dividends.

Advantages and Disadvantages of Corporations

The following chart listed the major advantages and disadvantages of corporations. Note that some advantages may be reduced if the corporate charter documents are drafted improperly.

CORPORATION	
Pros	**Cons**
• Most common, well-understood and tested business structure • No personal liabilities of the owners for the debts and actions of the corporation, except in exceptional circumstances • No minimum capitalization requirements • Perpetual life • Easy transfer of ownership • May authorize multiple classes of stock • Generally easiest structure for raising capital • Division between management and ownership • Favorable tax treatment for employee benefits expenses • No limit on number of shareholders (except in the case of "S" corporations)	• Double taxation of income (taxed at the corporate level and at the shareholder level when dividends distributed to shareholders) • Higher requirements for formal record keeping and associated costs for corporate maintenance, such as board and shareholder meetings • Higher cost of maintenance of corporate formalities, e.g., shareholder meetings, and board meetings, etc. • Dividends must be distributed to each class of shareholders in proportion to their shares

Forming a Corporation

Corporations are created under state laws. The existence of a corporation begins upon the acceptance of filing of the Articles or Certificate of Incorporation (referred to as "articles" in this chapter) in the selected state of incorporation.

Apart from the information required by applicable state laws, the organizers of a corporation are free to include in the articles other provisions relating to the corporation, such as preemptive rights applicable to the shareholders, rights and obligations of the board of directors and officers, or certain matters that may be and normally are included in the bylaws.

Following the filing of the articles, an organizational meeting must be held at which the board of directors is elected and the bylaws adopted. Bylaws are required by state law, and they contain the rules for the internal functioning of the corporation. They must conform to the various provisions of state corporation law in areas such as procedures for regular and special meetings of shareholders and of the board of directors, the composition and responsibilities of the board of directors, the officers and their duties, and other basic corporate governance matters.

Managing a Corporation

A corporation is typically managed by a board of directors and officers who may or may not be owners. Nevertheless, shareholders retain certain key management powers such as election of directors, approval of major transactions, dissolution of the corporation, and amendment of the Articles.

The ultimate power of management and control rests with the board. The board of directors has the responsibility to set the strategic goal of the company and oversee the management of the company's business. The board selects corporate officers who are responsible for executing the decisions of the board and conduct the business on a day-to-day basis. Traditional officers are a president or chief executive officer, one or more vice presidents, a secretary and a treasurer or chief financial officer. Under most state corporation law, a corporation must at least have a president and a secretary. An individual may hold more than one office (e.g., the individual who holds the office of the president can also serve as the secretary). An officer may also serve on the board of directors.

The corporation is generally required to hold meetings of shareholders and directors at least annually under state law, although most states permit the taking of shareholder and board actions by written consent. A corporation must maintain a formal corporate minute book in which all meetings of shareholders and of the board and the resolutions adopted by them at meetings or by written consent are recorded. The corporate minute book is important for purposes of showing the separate legal existence of the corporation. Being able to show the separate legal existence of the corporation is important as it helps reduce the risk of allegations by creditors or other parties that the corporation is not a separate entity from the owners and thus the owners should be personally liable for the corporation's debts.

Choosing a State to Set Up a Corporation

A corporation may be formed in any state regardless of its principal place of business. The most common states in which businesses are incorporated are where the corporation law is flexible, and business-friendly, such as Delaware. non-U.S. businesses may also choose their state of incorporation in a state containing important commercial centers, such as New York, California or Illinois.

A corporation formed under the law of one state may establish its principal office and conduct substantially all of its business in other states. A corporation organized in one state is required to qualify as a "foreign" corporation in any other state before it can conduct business there. Failure to qualify can lead to penalties and/or restrictions on the corporation's ability to utilize local courts. The corporation's legal counsel can advise on what constitutes "doing business" for the purpose of having to qualify to do business under the corporation laws of a state, for state tax purposes or for purposes of liability under the state's business laws. The test for each purpose may be different.

Partnerships

Partnerships are formed by agreements between two or more partners. In contrast to corporations, which are subject to the formal governance requirements of state corporation laws, a partnership operates according to the partnership agreement, and it has relatively simple rules of governance. A partnership is not a legal entity fully separate from its general partners, but it can enter into contracts, own property and sue or be sued. The partnership agreement may address matters such as capitalization, allocation of profits and losses, governance, transfer restrictions and exit strategies. A partner may be an individual or any type of entity, U.S. or non-U.S. Except for certain regulated industries (e.g., insurance, banking, telecommunications and defense) there are no restrictions on foreign ownership in partnerships.

There are three main kinds of partnership in the United States: general partnership, limited partnership and limited liability partnership. General partnerships allow all members of the partnership to participate in the management of the business but also give all partners joint and several liabilities for partnership debts. A limited partnership allows some partners (general partners) to manage the business and other partners (limited partners) to merely invest. General partners are personally liable for the debts and actions of the partnership; limited partners are only liable to the extent of their investment. A general partnership may register as a limited liability partnership in most states, which allows the general partners to have limited liability for partnership debts and actions if they meet the standards prescribed in state law governing limited liability partnerships. This form is usually used by partnerships of professionals, such as lawyers and accountants.

ADVANTAGES AND DISADVANTAGES OF PARTNERSHIPS	
Pros	**Cons**
• The formation is simple and flexible • The minimum number of partners is two; no maximum number of partners • No minimum capital requirement, except in the case of general partners in certain circumstances • Earnings taxed at the individual partner level—no double taxation • Profits and losses may be distributed to owners in any proportion in accordance with the partnership agreement • Fewer formal record keeping requirements	• General partners have unlimited personal liability for all business actions and debts except in the case of limited liability partnerships • In the case of a general partnership, joint governance and decision making with other partners • No tax deductions for employee benefits

Forming a Partnership

Partnerships are formed under state law. A general partnership may be formed by two or more parties agreeing to begin a commercial venture and no further legal registration or filing is required. On the contrary, a limited partnership is treated as a separate legal entity, distinct from its members. It is created by the filing of a certificate of limited partnership with the Secretary of State of the selected state of organization. Similar to limited partnerships, state filings are required for limited liability partnerships, and usually written partnership agreements are also required.

Managing a Partnership

Generally, partnerships are managed by the general partners. Each general partner is an agent for the partnership and, therefore, can hire employees, borrow money, enter into contracts and deal with third parties on behalf of the partnership. Limited partners of a limited partnership may not participate in the management of the business or act on behalf of the partnership.

Limited Liability Companies (LLCs)

LLCs combine many of the attributes of a corporation and a partnership. Like corporations, LLCs have the advantage of limited liability for their owners. Like partnerships, LLCs are more flexible in their organization and governance compared to corporations. LLCs are independent legal entities, and they have the power to enter into contracts, to hold property, and to sue and be sued in their own name. LLCs have become a popular ownership vehicle, particularly for small U.S. businesses. Except for certain regulated industries (e.g., insurance, banking, telecommunications and defense), there are no restrictions on non-U.S. membership in LLCs.

Advantages and Disadvantages of LLCs

As a hybrid business model, LLCs combine the advantages of corporations and partnerships. However, they also have some disadvantages.

LIMITED LIABILITY COMPANY	
Pros	**Cons**
• No personal liabilities of owners for the debts and actions of the LLC, except in exceptional circumstances • No limitation on the number of members; it is possible to have a single member LLC, while a partnership must have at least two partners • No requirement for a minimum amount of capital • Single taxation of income (income "passes through" to owners and is not taxed at the company level) • No ownership restrictions • Much less administrative paperwork and record keeping than a corporation • Profits and losses may be distributed to owners in any proportion in accordance with the LLC agreement	• Transfer restrictions are typical, making it harder to buy or sell ownership in the entity • Because it is a relatively new business structure, the law around LLCs is not as developed as corporate law • It may be more difficult to raise capital for an LLC as some investors are more comfortable investing funds in the better-understood corporate form • The management structure of an LLC is not as well-understood as for corporations • The principals of LLCs use many different titles—e.g., member, manager, managing member, managing director, chief executive officer, president and partner. As such, it can be difficult to determine who actually has the authority to enter into a contract on the LLC's behalf. • LLC members sometimes must pay Social Security and Medicare taxes on all LLC profits, not just those distributed to members

Forming an LLC

In order to organize an LLC, generally a Certificate of Formation (or Articles of Organization) must be filed with the Secretary of State of the selected state of organization.

The main document governing the rights and obligations of the members of an LLC is the limited liability company agreement or operating agreement. This document is substantially similar to the partnership agreement of a partnership, or the combination of the articles, bylaws and any shareholder agreement of a corporation and covers areas such as:

- Identity of the members and their rights and obligations;
- Capital contribution;
- The admission of new members;
- Rights and limitations on transfer or sale of ownership interest;
- Preemptive rights with respect to the issuance of additional membership interests;
- The expulsion of members;
- Preemptive rights and put and call rights upon the sale of membership interests;

- Allocation of profits and losses;
- Decision-making process; and
- The authority of the managing member or nonmember manager.

Although not strictly required, it is good practice and will avoid future questions on certain company actions in future transactions (e.g., bank borrowing and capital raising) for the members to hold an organizational meeting to approve the certificate of formation or articles of organization, appoint officers (if any) and approve other company actions.

Managing an LLC

An LLC is managed by either the members or managers (who need not be members). For a member-managed LLC, the members may designate one or more managing members. A manager or a managing member exercises authority that is broadly similar to those exercised by the general partner in a partnership. LLCs often adopt corporate management models, with a board of directors (or board of managers) that oversees the management of the overall business and sets strategic goals, and officers who manage the day-to-day operations. Invariably, members of a manager-managed LLC retain the right to vote on fundamental decisions and other protective rights.

Sole Proprietorships

Sole proprietorships are the simplest form of business entity. A single individual owns and operates the business. It requires no legal action or documentation to establish and offers no legal protection to the owner for business-related liabilities. Sole proprietorships are generally unsuitable for use as a vehicle for doing business in the United States.

Branches

A non-U.S. company may establish a branch in a state in the United States by qualifying in that state as a non-U.S. business entity in the same manner as entities organized in other states in the United States. Generally, the branch is permitted to conduct the same types of activities under the same conditions as a subsidiary company that is incorporated under the laws of the state concerned. The branch subjects the non-U.S. company to claims, possible lawsuits and direct liability in the United States, for the acts and business of the branch. In contrast, when the non-U.S. company establishes a subsidiary corporation in the United States, the subsidiary can serve in most cases to insulate the non-U.S. parent from liability for the subsidiary's acts and business. For this reason, most non-U.S. investors prefer to do business in the United States through a U.S. corporation rather than through a branch.

Considerations in the Choice of Entity

As discussed above, each type of entity has its own advantages and disadvantages. Generally speaking, several factors affect a non-U.S. business's decision in choosing an entity form for its U.S. operations. The major ones include:

The Nature of the Business

Certain types of business entities are more common in certain industries than in others. Corporations are commonly used by manufacturers, technology companies and virtually all publicly traded companies. LLCs have also become popular investment vehicles in the industrial sectors such as technology, telecom and biotech. Partnerships are commonly used by professionals like lawyers, accountants, doctors, designers and architects. Sole proprietorships are commonly used by day care providers, freelance writers and other small service providers.

The Ability to Expand and Grow

Due to their more open and generic nature, corporations generally have a greater capability to expand and grow than other types of entities. As a result, a non-corporate business entity may eventually need to change to a corporate form later in the business's development. Non-U.S. investors should keep in mind the potential tax consequences of a change in the form of entity as not all conversions may be accomplished tax free.

Liability Protection

The U.S. legal system is known for its litigious nature and the willingness of U.S. courts to render damage awards substantially higher than those awarded in most other countries. Therefore, it is advisable for a non-U.S. business to take steps to insulate itself from liabilities that might arise in the United States. To achieve this goal, it is generally recommended, among other things, that non-U.S. businesses conduct their operations in the United States through subsidiaries that have limited liability such as corporations or limited liability companies, rather than a general partnership.

Tax Treatment and Consequences

Taxes play an important role in the selection of the form of business entity in the United States. There is a distinction between "corporate" tax treatment and "partnership" tax treatment under U.S. tax laws.

A corporation is a separate tax-paying entity. It pays taxes on its taxable income. It then may pay dividends from its after-tax income to shareholders. Dividends received by the shareholders will be income to the shareholders and are subject to income tax. This is the "double taxation" characteristic of "corporate" tax treatment. (As noted above, "S" corporations are not subject to double-taxation, but these corporations may not be owned by non-U.S. persons.)

Unless the partners of a partnership affirmatively elect to be treated as a corporation, a partnership is not a separate taxpayer (although there are some limited state law exceptions). The tax obligations of a partnership are "passed through" to the partners, who are the only taxpayers. Limited liability companies generally receive the "partnership" tax treatment and their members are treated like limited partners of a partnership. A corporation's shareholders are generally not taxed until a corporation issues dividends. A non-U.S. person who is a partner of a U.S. partnership or a member of a U.S. LLC will be subject to taxes in the United States on any profits, even if not distributed, and will have to file tax returns in the United States. Since most non-U.S. persons do not want to file tax returns in the United States, this may make the LLC and partnership less attractive than a corporation.

Conclusion

The proper choice of business entity for an American venture is an important means of protecting the international business owners from liability. Although the above discussion provides a basic overview of some of the considerations that should go into this matter, other questions must be addressed as well, including whether and how to make appropriate modifications to the entity's default structure. We urge you to consult with experienced U.S. corporate counsel and tax and accounting advisors to assist in making these determinations.

CHAPTER 2

INTRODUCTION TO FEDERAL SECURITIES LAWS

By Louis A. Bevilacqua and Joseph R. Tiano, Jr.

Introduction

This chapter provides a very general introduction to U.S. federal securities laws. Almost every aspect of federal securities laws that is touched upon in this chapter has been the subject of multivolume treatises, and books on each topic fill up walls of bookshelves in law libraries. Anything more than a high-level summary of U.S. federal securities laws is beyond the scope of this chapter.

The principal U.S. federal securities laws were enacted as a legislative response to the Wall Street Crash of 1929. Prior to the crash, few laws governed the purchase and sale of securities or regulated companies who had sold or proposed to sell securities to the investing public. After a series of congressional hearings pinpointing the precipitating factors giving rise to the 1929 Wall Street Crash, Congress passed the Securities Act of 1933, which governs the offer and sale of securities, and one year later enacted the Securities Exchange Act of 1934. Subsequent legislation, such as the Sarbanes-Oxley

Act of 2002 (or SOX) and the Jumpstart Our Business Startups Act, and rulemaking by the U.S. Securities and Exchange Commission (SEC), has followed the initial core pieces of securities legislation.

The SEC is the principal agency that administers and enforces the federal securities laws. The SEC's responsibilities include: (1) interpreting and enforcing federal securities laws; (2) rulemaking; (3) regulation of issuers, securities firms, brokers, investment advisers and ratings agencies; (4) oversight of private regulatory organizations in the securities, accounting, and auditing fields; and (5) interacting with other federal, state and foreign agencies and bodies. The SEC is charged with investor protection and the regulation and oversight of public companies—companies required to file reports under federal securities laws.

The remainder of this chapter will highlight the most critical aspects of the federal securities laws and discuss the interplay between those laws, the SEC and companies that offer and sell securities.

Foreign Private Issuer

The regulatory burden on a public company that qualifies as a foreign private issuer is smaller than that on domestic public companies. A foreign private issuer is exempt from the federal securities laws' requirements to file quarterly reports and financial statements, proxy statements for shareholder meetings, Section 16 filings and liability, and Regulation FD, all of which are discussed below. Not every foreign-incorporated company will qualify as a "foreign private issuer." If, at the relevant measurement date, (i) more than 50% of the foreign-incorporated company's outstanding voting securities are directly or indirectly held of record by U.S. residents and (ii) any one of the following exists: (a) the majority of the company's executive officers or directors are U.S. citizens or residents; (b) more than 50% of the company's assets are located in the United States; or (c) the company's business is mainly administered in the United States, then the company will fail to qualify as a foreign private issuer.

Securities Act of 1933

Generally speaking, the Securities Act of 1933 (1933 Act) governs the offer, sale and issuance of securities by companies. The 1933 Act, which is often referred to as the "truth in securities" law, seeks to fulfill two overarching goals. First, it seeks to ensure that all information, financial and otherwise, concerning securities being offered for public sale that may be material to an investor's investment decision has been disclosed to prospective investors. Second, the 1933 Act seeks to prohibit deceit, misrepresentations and other fraud in the sale of securities.

The 1933 Act requires any offer or sale of securities using the means and instrumentalities of interstate commerce to be registered under it unless an exemption from registration exists under the law. In practice, registration is the mechanism designed to ensure truthful offers and sales of securities by issuers to the investing public. Essentially, any person seeking to offer or sell securities must register the securities under the 1933 Act or find an available exemption from registration.

The registration process is commenced when a company files with the SEC a registration statement that contains a prospectus through which the securities are marketed to potential investors. Section 10 of the 1933 Act, together with rules promulgated by the SEC, establish guidelines for content and information that must be included in a registration statement. The SEC has prescribed a variety of forms which are used depending on the nature of the issuer and the transaction in which securities are being offered and sold. The most comprehensive form of registration statement is a Registration Statement on Form S-1. The equivalent form for foreign private issuers is Form F-1. Form S-1 or Form F-1 is most typically used to register primary offerings of securities or resales of previously sold securities that have never been registered. Both these forms require extensive information about an issuer and its financial and operational attributes, and about the nature and terms of the security that is being registered and offered and sold to investors. Some of the major items required to be included in Form S-1 or Form F-1 include:

- Description of the business of the issuer;
- Risk factors specific to the issuer's business and industry, the securities offered by the issuer and to the offering itself;
- The proposed use of the proceeds raised from the sale of securities;
- Historical audited financial statements together with management's discussion and analysis of financial results; and
- A description of the securities and the legal rights of holders of those securities.

Unlike regulatory regimes in many other countries, the registration process in the United States does not involve a merit-based regulatory review. The SEC does not pass upon the qualifications of an issuer to sell securities or approve or disapprove of the issuance of securities. Instead, the registration process with the SEC focuses on fulsome disclosure where, after a back-and-forth comment and response process between the SEC and an issuer, the SEC will issue an order declaring a registration statement to be "effective" if sufficient information and disclosure is provided. The registration process usually takes approximately four to eight months; thereafter, registered shares of stock can be issued and sold in a primary offering, usually through investment bankers or in a secondary offering by investors whose previously unregistered shares become registered and freely tradable.

As noted above, Form S-1 and Form F-1 are the most comprehensive registration statement forms prescribed by the SEC. Other forms of registration statements, which are more streamlined and less cumbersome, can be used to register securities in special situations. For example, Form S-3 and Form F-3 can be used to register securities that are being offered and sold in a qualified offering transaction by a mature issuer that meets certain financial requirements. Form S-4 and Form F-4 are often used where securities are being issued and registered in connection with certain business combination transactions.

Until recently, all registration statements became immediately available online when filed, other than those submitted by a small set of foreign private issuers. Under the Jumpstart Our Business Startups Act (the JOBS Act), a company with less than $1 billion of revenues and that meets other requirements qualifying it as an "emerging growth company" may now submit its first registration statement confidentially, subject to the requirement that it be filed publicly at least 21 days before the Company begins its road show.

Notwithstanding the general rule that registration is required to offer and sell securities, no registration is required if an exemption applies. The 1933 Act affords issuers two general categories of exemptions: exempt transactions and exempt securities. Companies often seek to offer and sell securities in a nonregistered, exempt offering for a variety of legal, economic and practical reasons.

Section 4(a)(2) of the 1933 Act provides one of the more common transactional exemptions which allow an issuer to offer and sell securities in a private offering. Under the Section 4(a)(2) private offering exemption, an issuer can offer and sell securities, without registration, to a limited number of investors (usually sophisticated or "accredited" investors) in an offering that is not made to the public at large through general solicitation or advertisements. Rule 506 under Regulation D is often followed because it is flexible due to having no offering size limitation, provides certainty of exemption as long as the specific exemption requirements are satisfied, and it causes the offering to be exempt from both registration under the 1933 Act and from registration requirements under the state blue sky registration laws (discussed later in this chapter). Another commonly used exemption, Rule 144A, allows issuers that sell debt securities to qualified institutional buyers (QIBs) to be resold to other QIBs, also without the use of general solicitation or advertisements. Other transactional exemptions include offerings of a limited size or amount, offerings made to persons in a single state and offerings made only to non-U.S. residents. Currently, exempt offerings generally result in securities that are "restricted" and that may not be resold absent a resale registration, or a resale exemption (such as resales to QIBs under Rule 144A, resales to non-U.S. persons under Regulation S, or, perhaps most commonly for smaller issuers, resales that satisfy holding period and other requirements under Rule 144). For a description of offering exemptions specifically regarding employee equity incentives, see Chapter 5.

Section 3(a) of the 1933 Act exempts specified securities from the registration requirements. Such exempt securities include government-issued securities, securities issued by banks or insurance companies that are subject to separate regulatory regimes, and securities issued by a company in a bankruptcy proceeding.

Section 11 and Section 12 of the 1933 Act are the principal provisions that impose civil liability upon persons who fail to comply with the mandates of the federal securities law when offering and selling securities. Section 11 establishes the categories of potentially liable persons and circumstances under which such persons bear liability for false or misleading registration statements and creates for a buyer of securities a private remedy for those infractions. Under Section 11, an injured purchaser of securities can sue signatories to a registration statement, directors, persons who prepared or certified a registration statement or underwriters if there is a material misstatement or omission in a registration statement.

Section 12 allows a purchaser of securities to sue anyone who impermissibly sells securities without proper registration or who sells securities using a prospectus or other materials that contain any untrue statement of a material fact or omits to state a material fact necessary in order to make the statements not misleading.

Securities Exchange Act of 1934

The Securities Exchange Act of 1934 (1934 Act) sets the legal standard for secondary market participants who are involved in the trading, purchase and sale of securities. It also imposes continuing disclosure obligations on companies whose shares are traded in the secondary market or otherwise subject to the 1934 Act. A company becomes subject to the 1934 Act (and therefore becomes a public company), by filing a 1934 Act registration statement with the SEC. Companies also become subject to some of the 1934 Act's requirements by filing a 1933 Act registration statement that the SEC declares to be effective. Full 1934 Act registration through a 1934 Act registration statement is generally required if the issuer has a class of securities held of record by 2,000 or more persons, or by 500 or more persons who are not accredited investors, and total assets exceeding $10 million. Bank holding companies with a fiscal year ending after April 5, 2012, must register if they have 2,000 or more record holders, whether or not the record holders are accredited investors. Registration under the 1934 Act is also required to become listed on a national stock exchange or quoted on the OTCBB.

There are exemptions to 1934 Act registration available to some foreign private issuers. Exchange Act Rule 12g3-2(a) provides that a foreign private issuer is exempt from the general 1934 Act registration requirement if its securities are held by fewer than 300 U.S. residents. The exemption lasts until the next fiscal year end at which the company's securities are held by 300 or more U.S. residents. The exemption may not be effective if the company is publicly traded on a foreign stock exchange since U.S. investors can often purchase shares on foreign exchanges. In situations where a foreign private issuer is already listed on a non-U.S. stock exchange, it may be eligible to use the exemption from 1934 Act registration under Rule 12g3-2(b).[1] These exemptions are not applicable if the company is listed on a U.S. stock exchange or quoted on the OTC Bulletin Board (OTCBB).

Under the 1934 Act, all public companies, many financial industry participants, and some specified individuals (directors, officers and significant shareholders) are under a continuing obligation to disclose information about themselves, such as their operations, finances and management in the case of public companies, and share ownership and investment motivations in the case of non-issuers. Antifraud provisions, reporting obligations and standards and other requirements applicable to issuers, provisions covering oversight of broker-dealers, requirements for proxy solicitations and rules regarding tender offers have their foundations in the 1934 Act, as discussed below in greater detail.

An issuer may deregister its stock from the 1934 Act to end its public company status if the issuer has less than 300 record holders (1,200 record holders in case of a bank holding company issuer) and the issuer has filed all reports required to be filed. Deregistration is a simple process. While deregistration is effective 90 days after filing of the Form 15 with the SEC, the issuer's obligation to file reports (except for proxy statements) will generally be suspended immediately. However, if the issuer has a registration statement declared effective in the current fiscal year or an effective shelf registration statement or a Form S-8 registering an employee benefit plan, it would need to withdraw or deregister these registration statements, and would also need to continue to file reports through the Form 10-K or 20-F for that fiscal year, unless it also conducts a going-private transaction and represents that it would have no public shareholders as a result of the transaction. A going-private transaction is typically designed to restructure the issuer so as to eliminate all public shareholders; due to the expense and complexity involved, it is normally only conducted if the issuer would otherwise be unable to deregister from the 1934 Act due to having a number of record holders in excess of the limit described above.

1 For a detailed discussion of the Rule 12g3-2(b) exemption, please see "Listing Made Simple: Using Rule 12g3-2(b) to List International Companies on OTCQX," by Louis A. Bevilacqua, Joseph R. Tiano, Jr., Woon-Wah Siu, and Joseph J. Kaufman, available at www.pillsburylaw.com/siteFiles/Publications/E2F2873C661D295E7C6E6AFAD8DC2C88.pdf.

Annual and Periodic Reporting Obligations

The overarching goal of federal securities laws, particularly the 1934 Act, focuses on investor protection by mandating full disclosure of information mainly about public companies, but also other securities industry participants. The duty to disclose all material information is a continuing obligation that a public company must conscientiously fulfill. When, and the extent to which, disclosure information is appropriate is a recurring question, and the answer centers around the somewhat opaque and subjective concept of "materiality."

The U.S. Supreme Court defined "material information" as information that, in the judgment of a "reasonable investor," would alter the "total mix of information" that an investor would consider when making an investment decision. The SEC also addressed the "materiality" concept in Staff Accounting Bulletin No. 99, when it stated that a "materiality" analysis requires both a qualitative as well as quantitative evaluation without any "bright line" materiality test. Although a public company determines for itself what information is "material" and usually maintains control of the public dissemination of material information, events outside a public company's control, such as market reports or rumors, can precipitate an unexpected obligation. Public companies should adopt policies that ensure that material information is promptly disclosed, both regularly and expectedly, by a periodic or current report and a press release, unless there is a bona fide corporate justification for not doing so. Prudence and legal compliance favors full and fair disclosure of material events on a timely basis.

Annual Report

All domestic public companies must file an annual report on Form 10-K. Most public companies must file a 10-K within 90 calendar days after the end of the fiscal year covered; however, some public companies that qualify as "accelerated filers" must file on an accelerated basis. Large accelerated filers and accelerated filers must file within 60 days or 75 days, respectively, after the end of the fiscal year covered. Public companies that are foreign private issuers must file an annual report on Form 20-F within four months after the end of the fiscal year covered.

Form 10-K and Form 20-F contain much of the same information required in a Form S-1 (or Form F-1, as applicable) Registration Statement (business, risk factors, executive and director compensation information, audited financial statements, management's discussion and analysis of results of operations and financial condition (MD&A) and description of the securities and the legal rights of holders of those securities). The annual report form must be signed by a public company's principal executive officer, its principal financial officer, its controller or principal accounting officer, and at least a majority of its directors, all of whom have a certain level of personal liability for any material inaccuracies in the report. Every effort should be made to have the Form 10-K or Form 20-F reviewed in final or substantially final form at the earliest practicable date by the officers whose signatures are required, as well as by all members of the board. Legal counsel and auditors are intimately involved with the preparation of the annual report form. Preparation should commence at least 60 days before the report is due. The SEC typically reviews a public company's Form 10-K or Form 20-F at least once every three years.

The principal executive officer and the principal financial and accounting officer must make certifications as required by the SOX. Essentially, each officer must certify that they have reviewed the annual report and that, based on the individual's knowledge, the report does not contain a material misstatement or omission, and they have undertaken certain internal control-related actions.

Quarterly Reports on Form 10-Q

A quarterly report on Form 10-Q must be filed by an issuer within 45 days (40 days in the case of large accelerated filers and accelerated filers) after the end of each of a public company's first three fiscal quarters. Part I of Form 10-Q requires (i) summarized comparative financial statements (unaudited, but reviewed), (ii) MD&A, (iii) a quantitative and qualitative discussion about market risk, and (iv) a discussion of the principal executive and financial officers' conclusions regarding a public company's disclosure controls and procedures and its internal control over financial reporting. Part II is designed to address quarterly changes in legal proceeding, risk factors, unregistered sales of equity securities and use of proceeds, defaults upon senior securities, mine safety disclosures, and other information.

The principal executive officer and the principal financial and accounting officers must also make Sarbanes-Oxley Act certifications.

Foreign private issuers need not file quarterly reports.

Current Reports on Form 8-K

A report on Form 8-K must be filed within four business days of certain enumerated events. Item 9.01 includes financial statements, pro forma financial information and exhibits, if any, of businesses acquired in a material acquisition reported under Item 2.01. These may be filed with the initial report on Form 8-K or by amendment not later than 71 days after the date that the initial report on Form 8-K must be filed. The general nature of the items requiring the filing of a Form 8-K can be deduced from the captions of each of the items:

Item 1.01	Entry into a Material Definitive Agreement
Item 1.02	Termination of a Material Definitive Agreement
Item 1.03	Bankruptcy or Receivership
Item 1.04	Mine Safety—Reporting of Shutdowns and Patterns of Violations
Item 2.01	Completion of Acquisition or Disposition of Assets

Item 2.02	Results of Operations and Financial Condition
Item 2.03	Creation of a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement of a Registrant
Item 2.04	Triggering Events That Accelerate or Increase a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement
Item 2.05	Costs Associated with Exit or Disposal Activities
Item 2.06	Material Impairments
Item 3.01	Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard; Transfer of Listing
Item 3.02	Unregistered Sales of Equity Securities
Item 3.03	Material Modifications to Rights of Security Holders
Item 4.01	Changes in Registrant's Certifying Accountant
Item 4.02	Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review
Item 5.01	Changes in Control of Registrant
Item 5.02	Departure of Directors or Certain Officers; Election of Directors; Appointment of Certain Officers; Compensatory Arrangements of Certain Officers
Item 5.03	Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year
Item 5.04	Temporary Suspension of Trading Under Registrant's Employee Benefit Plans
Item 5.05	Amendments to the Registrant's Code of Ethics, or Waiver of a Provision of the Code of Ethics
Item 5.06	Change in Shell Company Status
Item 5.07	Submission of Matters to a Vote of Security Holders
Item 5.08	Shareholder Director Nominations
Item 6.01	ABS Informational and Computational Material
Item 6.02	Change of Servicer or Trustee
Item 6.03	Change in Credit Enhancement or Other External Support
Item 6.04	Failure to Make a Required Distribution
Item 6.05	Securities Act Updating Disclosure
Item 7.01	Regulation FD Disclosure
Item 8.01	Other Events
Item 9.01	Financial Statements and Exhibits

Usually, public companies designate its CFO or General Counsel as the person primarily responsible for meeting the Form 8-K disclosure requirements.

The 8-K requirements do not apply to foreign private issuers. Instead, such issuers must "furnish" (as opposed to "file") a Form 6-K to promptly report material information that it:

- Makes or is required to make public under the laws of its jurisdiction of organization;
- Files or is required to file with a stock exchange on which its securities are traded and which was made public by that exchange; or
- Distributes or is required to distribute to its shareholders.

The distinction between "furnish" and "file" is important because material "furnished," and not "filed," with the SEC is not (i) subject to liability under Section 18 of the 1934 Act (which imposes liability for false or misleading statements in any application, report or document "filed" under the 1934 Act) or (ii) incorporated by reference into registration statements under the 1933 Act for purposes of Section 11 liability except to the extent the issuer specifically incorporates it by reference.

Proxy Rules and Shareholder Meetings

The proxy rules of the 1934 Act govern the contents and disclosure of materials used to solicit shareholders' votes in annual or special meetings held to elect directors and approve other corporate actions. Foreign private issuers are not subject to the proxy rules.

Generally speaking, a company whose securities are registered under Section 12[2] of the 1934 Act is required to disseminate to shareholders a proxy statement, which must have been filed with the SEC. Proxy solicitation materials, both from management and shareholders, have to inform shareholders about all important facts about the issues on which shareholders are asked to vote. Under the proxy rules, an annual report also must be distributed with or before the solicitation of proxies for the annual election of directors. The annual report is not required to be filed with or reviewed by the SEC, but must be submitted to the SEC concurrently with distribution to stockholders. The proxy rules require that an annual report must include (i) audited financial statements; (ii) changes in and disagreements with accountants; (iii) MD&A; (iv) business description; (v) information regarding directors and executive officers, their principal occupation or employment and the name and principal business of the organizations that employ them; (vi) the principal securities market and the high and low sales prices for each quarterly period during the two most recent fiscal years; and (vii) an undertaking to provide, without charge and upon request, a copy of the annual report.

2 Although typically an issuer becomes a public company by virtue of registration of its securities under Section 12 of the 1934 Act, some issuers become subject to some of the reporting requirements of the 1934 Act by virtue of registration under the 1933 Act by way of Section 15 of the 1934 Act.

Since January 1, 2009, every public company subject to the proxy rules has become obligated to comply with the e-proxy rules, which require proxy materials (e.g., a proxy statement, a proxy card, a "glossy" annual report and any other soliciting materials) to be made available over the Internet. A public company may choose among the three delivery options for proxy materials: "notice and access," "full set delivery," or a hybrid option.

Under the "notice and access" option, a public company can satisfy its proxy delivery obligations by sending shareholders a "Notice of Internet Availability" of proxy materials at least 40 calendar days before the meeting date and making its proxy materials available on the Internet. The "Notice of Internet Availability" must meet specified criteria and may not be accompanied by a proxy card or other information. Notwithstanding the fact that proxy materials are delivered electronically, upon a shareholder request, proxy materials must be physically delivered.

Under the "full set delivery" option, copies of all proxy materials must be delivered specifically to a shareholder in paper or electronic form; however, they must also be posted for general availability on the Internet. The delivered proxy materials must (i) be accompanied with a "Notice of Internet Availability" or (ii) incorporate the information required in a "Notice of Internet Availability" in the proxy statement and the form of proxy. When using this option, issuers need not comply with the 40-day notice period required under the notice and access option.

A company may utilize a bifurcated hybrid approach using the "notice and access" option for certain shareholders, and the "full set delivery" option for other shareholders.

Regulation FD—Fair Disclosure

The "Fair Disclosure" regulation (Reg FD) basically requires public companies to disclose material information to all investors at the same time. Reg FD was intended to create equal access to information by all investors thereby reducing the problem of selective disclosure. Reg FD focuses on material, nonpublic information disclosed by an authorized officer or spokesperson of a public company to a market professional or any shareholder outside the company likely to trade on the information. If the material information was intentionally disclosed to a select group, the public company must simultaneously disclose it in a fashion designed to reach the investor community at large. If the initial disclosure was unintentional, it must be disclosed "promptly" to the investing public in the same fashion. Exceptions to the disclosure requirements apply where disclosure is made to a person who owes a duty of trust or confidence to the issuer (such as an attorney, investment banker, or accountant) or to a person who expressly agrees to maintain the disclosed information in confidence.

Although foreign private issuers are not subject to Reg FD, such issuers should take care to make public disclosure of material information promptly. In the Reg FD adopting release, the SEC reminded foreign private issuers of their obligations to make timely disclosure of material information pursuant to applicable exchange rules and policies and also emphasized its expectation "that the markets will enforce these obligations."

Section 16—Short Swing Profit Recapture

Section 16 of the 1934 Act establishes special "short-swing" profit restrictions that apply to a public company's directors, officers and owners of more than 10% of its outstanding registered equity securities, often referred to as "statutory insiders." Section 16(b) requires disgorgement by statutory insiders of any profit realized on a purchase or sale of securities within a six-month period regardless of whether the sale or the purchase occurs first. The same shares need not be involved in the matched transactions; in fact, transactions are paired to match the lowest purchase price with the highest sale price within any six-month period, thus finding the maximum spread. Any shareholder of a public company may seek to recover Section 16(b) monetary damages for the benefit of the company if the company does not do so. A variety of transactions in addition to normal open market transactions are a "purchase" or a "sale" for Section 16(b) purposes. These include transactions by immediate family members or entities controlled by the statutory insiders, and other situations where the statutory insider may derive a pecuniary gain from a combination of transactions. There are limited exemptions from the short-swing profit recapture provisions of Section 16(b), but Section 16's beneficial ownership reporting requirements still apply to most exempted transactions. Section 16 also prohibits directors, officers and 10% holders from making any "short sale" or "sale against the box" of any equity security of a public company.

Directors, officers and owners of more than 10% of the outstanding equity securities of foreign private issuers are not subject to short-swing profit recapture provisions of Section 16(b) or the beneficial ownership reporting requirements under Section 16(a) discussed below. Note, however, that they continue to be subject to Section 10b-5 and Rule 10b-5, which are discussed below, of the 1934 Act and other antifraud provisions in federal securities laws.

Reports of Beneficial Ownership Under Section 16

To supplement the short swing provisions, Section 16(a) of the 1934 Act creates beneficial ownership reporting provisions for every statutory insider. These persons must file Form 3 (Initial Statement of Beneficial Ownership), Form 4 (Change in Beneficial Ownership) and, where permitted or required to do so, Form 5 (Annual Statement of Beneficial Ownership).

The initial report on Form 3 is filed by existing statutory insiders upon consummation of a going public transaction. Any new officer, director or 10% shareholder must file a Form 3 within 10 business days of the event that triggers his or her obligation to begin reporting. A statutory insider must file a Form 4 within two business days of (i) any change in such person's beneficial ownership of any class of equity securities or derivative securities in all nonexempt transactions and certain exempt transactions, and (ii) all exercises and conversions of options, warrants and other derivative securities, whether exempt or not. All changes in beneficial ownership (unless exempt) are reportable, and this includes changes resulting from transactions that are neither purchases nor sales. Form 5 is an annual statement of beneficial ownership, which is due no more than 45 days after fiscal year-end by every person who was a statutory insider at any time during the fiscal year (even if they are no longer insiders). No Form 5 is required if all reportable transactions have already been reported.

Both direct and indirect forms of beneficial ownership of a public company's securities must be disclosed in Section 16 reports. Indirect beneficial ownership includes holdings through a controlled entity or a spouse or certain other immediate family members. The underlying principle is that securities are considered beneficially owned and reportable by a statutory insider under Section 16 if the statutory insider has a direct or indirect pecuniary interest in them. Many arrangements may unexpectedly create Section 16 beneficial ownership reporting requirements.

Disclosures of any known late filings or failure to file a report that is required by Section 16(a) must be made in annual proxy statements and in Form 10-K reports. A public company, other than foreign private issuers, must also provide the number of late reports, the number of transactions not reported on a timely basis, and any known failure to file a required form. The obligation to file Forms 3, 4 and 5 is a personal responsibility.

Reports Under the Williams Act (1934 Act Sections 13(d) and 13(g))

Sections 13(d) and 13(g) of the 1934 Act deal generally with the reporting obligations of persons owning beneficially more than 5% of the outstanding securities of a public company. The objective of Sections 13(d) and 13(g) is to require disclosure of ownership information by shareholders with the ability to change or influence control of a public company and establishes the threshold ownership percentages at 5%. Persons owning beneficially more than 5% of the outstanding securities are required to file certain either a Schedule 13D or Schedule 13G, depending on the circumstances, as described below.

New 5% shareholders are required to file initial reports on Schedule 13D within 10 days of acquisition of in excess of 5% of a public company's securities. Thereafter, these persons must file an amendment to their Schedule 13D if any material change (which includes a change 1% or more of the class of securities outstanding) in their Schedule 13D information occurs. Certain institutional investors including broker-dealers, banks, insurance companies, investment companies, pension funds, investment advisors, are eligible to file a short-form Schedule 13G instead of Schedule 13D, and persons who are 5% shareholders when a public company's 1934 Act registration became effective must file a Schedule 13G, within 45 days after the first calendar year in which they become subject to this requirement. Certain "passive" investors are also eligible to file on Schedule 13G but must file it within 10 days of becoming a 5% shareholder. Additional filings on Schedule 13G are generally due each calendar year in which only minor changes in beneficial ownership occur, though certain institutional investor Schedule 13G filers must make monthly amendments. Material changes in shareholdings in the interim will trigger Schedule 13G or 13D filing requirements, depending on the circumstances of the acquisitions.

Determining whether Section 13(d) and 13(g) filing requirements exist can be a complex process, especially since the SEC's definition of beneficial ownership of 5% encompasses any securities under which the reporting person has direct or indirect investment or voting power. The formation of "groups" based on voting or other agreements relating to the public company's securities can also lead to shareholders that do not directly hold 5% of the public company's shares being attributed with beneficial ownership over the other group members' shares. Many arrangements may unexpectedly create Section 13(d)/(g) beneficial ownership reporting requirements.

Section 10b-5 and Rule 10b-5

Federal securities laws broadly prohibit fraudulent activities of any kind in connection with the offer, purchase, or sale of securities, including fraudulent statements and insider trading. Probably the most well-known securities regulation is from Rule 10b-5, promulgated pursuant to Section 10(b) of the 1934 Act, which provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange… (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 10(b) and Rule 10b-5 are the antifraud provisions of the federal securities laws and are used to establish civil and criminal liability for insider trading, market manipulation, fraud in connection with securities offerings and takeovers, and fraud in connection with dealings with investors. Illegal insider trading occurs when a person trades a security while in possession of material nonpublic information in violation of a fiduciary duty or other relationship of trust and confidence, tipping others to trade on the information or who receive a tip, or who misappropriate such information.

Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act was enacted in response to the corporate scandals involving Enron Corporation, WorldCom and others. SOX established a Public Company Accounting Oversight Board, which is supervised by the SEC and which regulates the registration of accounting firms that audit financial statements of public companies. SOX also restricts accounting firms from performing non-audit related services for the companies they audit, and adopts other rules governing auditors' conduct. In addition to the CEO and CFO certification requirements relating to periodic reports, SOX also requires additional disclosures for public companies and their officers and directors, requires public companies to maintain disclosure controls and internal control over financial reporting, prohibits public companies from making personal loans to their directors and officers, and directs the stock exchanges to adopt director independence and other corporate governance requirements. It also established more severe criminal penalties for public companies and their officers and directors for noncompliance with the U.S. securities laws, including fines of up to $5 million and imprisonment of up to 20 years. Among other issues affected by the Sarbanes-Oxley Act are securities fraud; internal assessment of management controls of the covered corporation, criminal and civil; destruction of records; and penalties for violating the securities laws and other laws, blackouts for insider trades of pension fund shares, and protections for corporate whistleblowers.

Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)

Dodd-Frank was enacted in July 2010 in reaction to the financial crisis that occurred after the collapse of Lehman Brothers in the summer of 2008. While Dodd-Frank primarily impacts banks and non-bank financial institutions, many of the provisions have an impact on public companies. The Act gave the SEC additional powers and rulemaking authority that affect the reporting and disclosure practices of public companies. The SEC has adopted rules implementing the Say-on-Pay, Say-on-Frequency and Say-on-Golden Parachute requirements, conflict minerals and mine safety disclosure requirements and rules prohibiting broker discretionary voting on executive compensation matters; the SEC has also proposed rules regarding compensation committee independence and use of compensation consultants and other advisors. The agency has not yet proposed rules to implement other corporate governance and disclosure-related provisions of Dodd-Frank, including rules regarding disclosure of pay-for-performance, pay ratios, and hedging by directors and employees or rules directing the stock exchanges to adopt compensation recovery listing standards.

Jumpstart Our Business Startups Act (JOBS ACT)[3]

The JOBS Act was enacted in April 2012. As noted above, the JOBS Act permits emerging growth companies (EGCs) to submit confidential drafts of their initial public offering registration statements and avoid publicity until 21 days before their road shows.[4] EGCs are also eligible for scaled public disclosure and somewhat freer investor and analyst exposure under the JOBS Act's "IPO On-Ramp" provisions. The JOBS Act requires the SEC to amend Rule 506 of Regulation D to allow private placements to use general solicitation and advertisements, if they are made to accredited investors only and the issuer takes reasonable steps to verify that the buyers are accredited investors; and to amend Rule 144A offerings to allow general solicitation and advertisements in offerings to non-QIBs if they are sold only to persons who are reasonably believed to be QIBs. The amendments are required to be made by July 4, 2012. So far the SEC has proposed rule amendments. The JOBS Act also raised the 1934 Act registration threshold for companies from 500 record holders to 2,000, as long as no more than 499 are not accredited investors or the company is a bank holding company, and raised the deregistration threshold from 300 to 1,200 record holders for bank holding companies, as discussed above. The JOBS Act also provides for a new exemption from registration of an offering, tentatively referred to as "Regulation A+," which would permit offerings of up to $50 million of unrestricted securities within a 12-month period to both accredited and non-accredited investors, subject to annual filing of audited financial statements and other conditions to be prescribed by the SEC. Regulation A+ has not been adopted and there is no deadline for the SEC to do so. In addition, the JOBS Act mandated a "crowdfunding" exemption from registration of an offering with numerous requirements, including the use of a broker-dealer or "funding portal," a maximum amount that may be raised of $1 million, audited financial statements for amounts raised of over $500,000, certified or reviewed financials for offerings of up to $100,000, and between $100,000 and $500,000, respectively, individual investment limits, and certain continuing SEC disclosure requirements after the exemption is used. The SEC is required to adopt the crowdfunding exemption's rules by December 31, 2012; however, the SEC has not yet adopted crowdfunding rules and has announced that the exemption may not be used before adoption of the related rules.

3 A full discussion of the JOBS Act is beyond the scope of this chapter. However, for a more detailed overview of the JOBS Act, please see "JOBS Act Targets Smaller Business Capital Raising," by Louis A. Bevilacqua, Joseph R. Tiano, Jr., David S. Baxter, Ali Panjwani and K. Brian Joe, available at www.pillsburylaw.com/siteFiles/Publications/CSAlertJumpstartOurBusinessesAct040512_final.pdf.

4 For a detailed discussion of the JOBS Act's confidential submission option, please see "JOBS Act Gives Confidential Review Option for U.S. Emerging Growth Company IPOs," by Joseph J. Kaufman, available at www.pillsburylaw.com/siteFiles/Publications/CorporateSecuritiesAlertConfidentialReviewOption042612_final.pdf.

State Securities Law

Each of the 50 states of the United States has its own securities laws and rules administered by its own securities regulatory agency. These laws are commonly referred as the "blue sky" laws. The laws vary in degree; some, like California's, may require significant additional disclosures or filings both with respect to securities offerings and on an ongoing periodic basis. Public companies may need to comply with several states' blue sky laws depending on a number of factors, including their state of incorporation and the residency of investors, particularly when making private offerings. Public companies that are listed on a national stock exchange have fewer obligations under blue sky laws because the blue sky registration of listed shares is generally preempted by federal law. Private placement offerings under Rule 506 of Regulation D are likewise generally exempt from blue sky registration requirements. Such preemption does not apply to unlisted securities, even of listed companies, such as offerings of unlisted preferred shares or debt securities. Under rules to be adopted under the JOBS Act, offerings under the Regulation A+ or crowdfunding registration exemptions, discussed above, would be exempt from blue sky registration in some circumstances. Other exempt offerings, including private placements under Section 4(2) not made under Rule 506, generally remain subject to blue sky registration requirements.

CHAPTER 3

FROM LET'S GO SHOPPING TO CLOSING: M&A PROCESS IN THE UNITED STATES

By Tom Shoesmith, Woon-Wah Siu and Lu Wang

Introduction

More and more non-U.S. companies are now looking for business opportunities in the U.S. Why? Lower valuation of U.S. targets, strength of home country currency against the U.S. Dollar in certain instances, and less competition from U.S. buyers due to the credit crunch combine to make acquisitions in the United States attractive to non-U.S. entrepreneurs.

However, cross-border M&A transactions involve complex legal, tax, business and regulatory issues. To help non-U.S. buyers navigate the U.S. M&A process, we provide below an overview of the different stages of the acquisition process and highlight some of the issues faced by foreign buyers.

Some Key Terms

We often use the term M&A as a single word, but it is actually composed of two different words that mean different things.

An "acquisition" is a broad term and covers a simple concept—I buy your business (or assets), and you sell them to me. The term "acquisition" covers all types of purchases, including purchases that are set up as "mergers."

A "merger" is a legal term to describe a very specific type of transaction. In a merger, one company actually merges into another company, and at the end of the transaction, one company has disappeared (the "disappearing company") and the other one survives. The stock of the disappearing company also disappears and is converted into something new—it is no longer a share of equity, it is a legal right to receive part of the "merger consideration," which can be stock of the buyer, cash or something else.

We also use the term "target" to describe the company whose stock or assets will be acquired and the word "buyer" (or "purchaser" or "acquiror") to describe the company that is doing the acquisition.

Some Key Differences Between Non-U.S. Companies and U.S. Companies

There are some important differences between Non-U.S. companies (especially those in emerging markets and non-common law jurisdiction, such as China) and American companies. These differences may affect the way M&A transactions are structured. Due to space limitations, we will not highlight all key differences between U.S. companies and other non-U.S. companies. Suffice it to say that other foreign buyers should recognize that there may be significant differences.

Shares of Stock vs. Percentage of Equity

The first major difference is that the equity of most U.S. companies is divided into units called "shares." Shares are also called "stock." The concept of "shares" permits you to talk about share exchanges at different ratios—one share of the seller will be exchanged for 2.5 shares of the buyer, for example.

The Role of the Board of Directors

Another major difference is the role of the companies' boards of directors. Major decisions of a number of companies in non-U.S. jurisdiction are made by the chairmen, and the legal duties of the directors may not be clearly defined.

In the United States, boards of directors often include outside or "independent" members. This is almost always true in the case of public companies that are listed on U.S. exchanges. The independent board members usually take their responsibilities seriously, and this means challenging the chairman of the board and the internal (or "executive") directors sometimes.

An important consequence of this is that even when you are negotiating with the CEO or the chairman of the board of another company, "board approval" is not 100% guaranteed, and no deal can be done without board approval except if the deal only involves an insignificant part of the U.S. business.

Shareholders' Rights

A third difference is that shareholders have many rights in the United States, some more than others depending on the state of incorporation of the companies. Approval by shareholders is required for some transactions. In some M&A deals, shareholders who did not vote in favor of the transactions have the right to demand an appraisal and to receive cash, instead of stock of the buyer, based on the appraised value of their shares. These rights are called "dissenters' rights."

Shareholders also have the legal right to have their interests cared for by the board of directors. Thus in the United States the legal obligation of every director, including any "executive" director, is to protect the interests of the shareholders.[5] A board of directors will make corporate decisions—including whether or not to approve a merger with another company or to sell shares or assets of the company to another company—with this obligation as a backdrop.

This right of shareholders in the United States has "teeth," as we say in English, because of our legal system. If shareholders believe a board of directors has failed to protect their interests, they have a right to get together and bring a lawsuit against the directors. These "derivative" suits occur frequently with large, publicly traded companies. Although most of these lawsuits fail, they are costly to defend and, worse yet, when they succeed they can have very serious consequences.

5 Under some circumstances, boards are required to consider the interests of other constituents of the company. In North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, et al., 2007 WL 1453705 (May 18, 2007), while denying the creditor's direct claim of breach of fiduciary duty against the directors, the Delaware Supreme Court affirmed a creditor's right to assert a derivative claim against the directors when a company is insolvent.

The Role of the Government

A fourth difference is the role played by the government in M&A transactions. As a general matter, the U.S. government stays out of the economics of deals between private parties. There is no requirement of mandatory valuation of companies or their assets, and no requirements for audits before a deal can be closed.[6] However, as discussed below, certain M&A transactions involving foreign buyers require filing with, and some transactions even require the approval of, the applicable government departments.

The United States has "privatized" much of the enforcement of commercial law. The U.S. Securities and Exchange Commission (SEC), for example, relies on the system of private shareholder lawsuits against companies and a strong plaintiff bar (i.e., lawyers who represent, often on a contingency fee basis, the parties that sue) to scare public companies into complying with securities laws.

Why Buy?

The Reasons

Some of the reasons for considering acquisitions are:

- "Build or buy"—It may be cheaper, or faster, to buy a new line of business, or expanded capacity, than to build it yourself
- Time to market—In today's world, you may need to get into a new market right away, and buying an existing player is the only way to do that
- Increase market share—Especially in the case of emerging technologies, sometimes market share is everything; only one or two companies will survive, and those will be the companies that captured the largest shares of the market
- Acquisition of intellectual property (IP)—Many companies use M&A to acquire new technologies; M&A can also be used to eliminate a third party who might have a "blocking technology"—some IP rights that you will inevitably infringe upon if you expand
- Increase manufacturing capacity
- Acquire key or trained personnel
- Acquire distribution channels
- Buy a customer base
- Vertical or horizontal integration
- Economies of scale

6 Public companies that are required to file reports with the U.S. Securities and Exchange Commission may have to file, after closing, audited financial statements relating to certain M&A transactions.

- Synergies between products, markets or personnel—The sum of the whole is greater than the sum of the parts, e.g., "1+1 = 3"
- Defensive buying—Occasionally a buyer will acquire a target primarily to keep someone else from buying it or to resolve or avoid a lawsuit initiated by the target

Some Challenges

A report of what a PRC Vice Premier said to the the president of a major Chinese company when the latter was advocating for government support for the company to make overseas deals highlights the challenges a Chinese company may face when it expands overseas.[7] The vice premier reportedly said:[8]

- Do you have a handle on your own management capabilities?
- Have you analyzed the cultural differences of the two sides?
- Do you understand the relationship between unionized labor and management in that place?
- If the other side's engineers resign, are you really going to send people from Changsha overseas, and make the whole company speak Hunanese?
- If you don't know yourself or your opponent, then this kind of confidence scares me.

These are questions that a buyer should consider before embarking on an overseas shopping spree.

The Cast: Role of Lawyers and Other Advisors

The Cast

Aside from the buyers and the sellers (which have their own constituencies: the owners, management and the employees), there are many other players that may be involved in a specific transaction. They may include:

- Third parties, such as such customers, suppliers and creditors
- Advisors, including lawyers, investment bankers, valuation experts, accountants and possibly escrow agents
- Regulators, including the U.S. Internal Revenue Service and State tax regulators, industry-specific regulators, SEC and State securities regulators (if one of the parties is a publicly held company or if stock is part of the purchase price), and the U. S. Federal Trade Commission (FTC) and U.S. Department of Justice (DOJ) if the transaction crosses the filing threshold of the Hart-Scott-Rodino Act, one of the principal anti-monopoly acts in the United States

7 TheDeal.com, March 17, 2009 (www.thedeal.com/corporatedealmaker/2009/03/sany_heavy_industry_and_chinas.php).
8 Reported at www.fx678.com/C/20090311/200903110506321020.html.

The Role of Lawyers and Other Advisors

Lawyers and other advisors play a very important role in M&A deals in the United States. This is partly because the structure of the deals can be very difficult, and financial and legal advisors are necessary to design the deals as well as execute them. They can also help the buyer and the seller come to terms regarding the value of the deal. Different deal structures will have different tax and accounting consequences. The tax and accounting consequences, in turn, will impact the value of the deal to the buyer and to the seller; knowing the tax consequences of different structures to the seller certainly gives the buyer an edge in negotiating the deal with the seller. Onerous regulatory approval requirements also may drastically change the buyer's views of how much the target is worth.

The advisors also provide an early warning system so that costly delay can be avoided. For example, there are some regulatory actions, including those relating to employment benefits matters, which are fairly routine but which may result in costly delay if not dealt with in a timely fashion.

U.S. lawyers, at least the good ones, do not just write down the deal, but they act as members of the company's M&A team. If a foreign party conducts an M&A transaction in the United States, its U.S. counterpart will have its lawyers involved right from the start and stay involved during the entire process. Some foreign parties find this wasteful and do not match their U.S. counterpart with their own lawyers. This can be quite dangerous.

Steps of the Acquisition Process[9]

Finding a Target

If an acquisition makes sense for your company, the first step is to see whether there is a target available in the market that will advance your strategic objectives. Companies often turn to investment bankers or financial advisors to survey the market and identify potential targets. Alternatively, you may already know who the targets are through your knowledge about the strengths and weaknesses of your competitors in your industry, or your other resources have identified the potential targets as having something your company desires.

9 Our discussion below does not include the auction process whereby the target's investment bankers invite potential buyers to submit a bid for the target. Generally, the solicitation for bid will be accompanied by a form of purchase agreement, and bidders are asked to submit the bid together with their proposed revisions to the purchase agreement. Thus potential buyers compete on the basis of price and non-price terms in those deals. Some of the steps and many of the concerns described here apply to those deals as well.

Valuation

Obviously, one of the first questions is what price you will have to pay—in other words, what is the value of the target. M&A in the United States is still different from M&A in many countries today, mainly because there is so much more reliable information available about companies and transactions that have been done before.

If the target is publicly traded, the market has already put a price on the company, which will inevitably be the starting point for discussions. Of course a buyer will not want to pay more than the target is worth, while the target will argue that a merger only makes sense if the merged companies are somehow more valuable than either one standing alone, and therefore you should pay a premium to market.

As different valuation methods produce different results, the target and its advisors will have analyzed the target and will be pushing for the method that gives the highest valuation. Therefore, it is important to understand the different methodologies. The most common valuation methods used in M&A negotiations are:

- Comparable transactions—Looking at M&A of similar companies and how they were valued
- Comparable companies—Looking at similar companies on which the market has placed a value (for example, publicly traded companies)
- Price-earnings (P/E) ratio—Often the price of a deal is calculated as a multiple of after-tax profit, or net earnings
- Revenue multiplier—In other industries, a multiple of gross revenue is used as a benchmark to price deals
- Replacement cost—The cost of actually replacing or duplicating the target's operations; this can make sense in some cases, where you are simply acquiring fungible capacity, i.e., if you don't buy the target, you can just as easily but not as quickly build your own.
- Discounted cash flow—This uses the target's estimated future free cash flow. "Free cash flow" is operating profit plus depreciation plus amortization of goodwill, minus capital expenditures, taxes and change in working capital. The result is then discounted to present value using an estimated cost of capital. This method looks very precise, and thus can seem persuasive, but it is not necessarily any better than the other methods.
- Book value—This generally gives a very low price and, therefore, is almost never used

Your own value, as the buyer, can be just as important to the M&A transaction as the target's value. If you are paying cash, the target only cares about your having the cash when the deal closes. When there is a delayed payment of the purchase price, naturally the target will be concerned about your future financial health.

If the "consideration" is completely or partially stock[10] of the buyer, then the value of that stock determines how much the buyer can pay for the target. If the buyer is privately held, then it will have to make an evaluation of its own worth using one of the methods discussed above. If the buyer is publicly traded, the market will give it a value. This sounds easy enough, but it has its own complications. The value of the stock will fluctuate. The buyer will want to protect itself against overpaying if its stock price goes up, and the target will want to protect against the stock price going down.

Letter of Intent

Once you have identified your target, you need to assess the information underlying its strengths and weaknesses. This information almost always includes confidential and proprietary information, which is accessible only if the other party consents. The seller is unlikely to exchange information unless it has agreed on some conceptual framework with you.

The letter of intent (or term sheet or memorandum of understanding) is the part of the process by which the buyer and the seller work out a ballpark price and general structure of the deal, and usually includes confidentiality obligations on the part of both parties. In addition, buyers usually are not willing to commit the time and other resources in conducting due diligence unless the target agrees to deal with the buyer exclusively for a certain period, the so-called "no-shop" provision (a provision that prohibits one or both parties from negotiating with third parties for a similar transaction). The letter of intent commits the parties to negotiate within this general framework.

Letters of intent generally are nonbinding except for provisions relating to confidentiality, no shop, payment of expenses and other terms specified by the parties.

Due Diligence

Through this process, the parties exchange information that will ultimately enable them to reach definitive agreements on the final price, the allocation of risks and other terms of the transaction. This process puts the buyer in a position to understand the target's business and the underlying financial information. The due diligence process usually runs contemporaneously with negotiation of the definitive acquisition agreement.

Particularly in the case of a target whose shares are publicly traded, confidentiality during the due diligence process is paramount. Thus the buyer's due diligence team should be discreet during the process and should carry out the investigation in as time efficient manner as possible to minimize the opportunity for leaks or trading on inside information.

10 Generally, a non-U.S. company can only engage in a stock-for-stock transaction if it can use an offshore subsidiary as the buyer.

Definitive Agreement

The result of due diligence will affect the terms of the definitive agreements, especially in these areas:

- Structure—Generally, the parties will have specified whether the transaction is a stock or asset deal or a combination of stock and assets in the letter of intent. Even for a stock deal, different structures can be devised, such as a forward triangular merger, reverse triangular merger, or merger of equals. The form of consideration and other payment terms can be as varied as the parties are willing to be creative. Sometimes, the outcome of the due diligence investigation can cause the parties to change the structure from what has been agreed on in the letter of intent.
- Representations and warranties; schedule of exceptions—Both parties would want to make sure that they are getting what they have bargained for. Representations and warranties of one party in the definitive agreement is one way of assuring the other party. Strict compliance with some representations and warranties is required, while immaterial variances from others may be allowed. Disclosure of any variance is made in a Schedule of Exceptions (sometimes called Disclosure Letter or Disclosure Schedule). Buyers usually do not care about minor variances, but material variances invariably will result in heavy negotiation.
- Conditions to closing—Very often, closing will occur some time after signing. The risk exists that events may occur between signing and closing that may impair the target's value. One way the parties allocate risks that may arise during this period is to agree on the conditions to closing, which determine when the buyer can walk away from the deal.
- Post-closing covenants—These are obligations of the parties to complete tasks that cannot be completed before closing or that may not be undertaken until after closing.
- Indemnities—Another means to make sure that the parties get what they bargain for is through indemnity. For example, if the seller breached the representation about the collectability of its receivables, as a result of which the buyer suffers damage, the buyer may have recourse under the indemnities provisions, in addition to other possible remedies under the contract. The parties may include minimums (or "floors") and maximums (or "caps") and other precise categories and formulas for indemnifiable amounts.

Between Signing and Closing

- Integration planning; no gun-jumping. After the agreement is signed, the parties will begin integration planning to ensure a smooth transition. Integration planning involves exchange of information and coordination in some aspects of operations. If the transaction is reportable under the Hart-Scott-Rodino Act, the parties must be careful not to take any action during this period that may be viewed as improper pre-closing integration. Companies that ran afoul of the anti-gun-jumping rules had to pay large amounts of fines.[11] While the regulators recognize the need for integration planning, the parties will be well served to consult with antitrust counsel before sharing information, especially pricing strategies, with each other.
- Regulatory approvals and third party consents. The parties will seek to obtain all necessary regulatory approvals and consents of lenders, lessors, major suppliers and major customers, and other third parties.
- SEC report. If one party is required to file reports with the SEC, a Form 8-K must be filed by that party within four business days after signing, unless the transaction does not meet the reporting thresholds specified under SEC rules. If the transaction must be reported on Form 8-K, the party has to file another Form 8-K within four days after closing to report the closing and, in some cases, file financial statements of the target with that Form 8-K or by an amendment to the Form 8-K within the specified period.

Buying Distressed Businesses

Companies that have run into liquidity problems and are unable to restructure their debt have limited options, and must decide whether to continue their business operations or to close their doors. These companies can be excellent acquisition targets.

There are five principal ways in which a distressed company's business or assets may be purchased:

- Acquisition Prior to a Chapter 11 Bankruptcy
- Acquisition Pursuant to a Bankruptcy Section 363 Sale of Assets
- Acquisition Pursuant to a Chapter 11 Plan of Reorganization
- Acquisition Pursuant to a Prepackaged Chapter 11 Plan
- Acquisition by Trading Claims

11 The DOJ imposed a fine of $1.8 million on QUALCOMM Incorporated and Flarion Technologies, Inc., finding that QUALCOMM had assumed operation control of Flarion's business in advance of obtaining Hart-Scott-Rodino clearance. Gemstar International Group Limited and TV Guide, Inc. were fined US$5.7 million by the DOJ which found that the two companies had, among other things, allocated customers and exchanged information on prices, marketing strategies and capacity. Computer Associates agreed to pay a $638,000 penalty to resolve DOJ gun-jumping charges.

The process described above applies more or less to an acquisition prior to a Chapter 11 bankruptcy of the target, with a few twists. Depending on the financial condition of the target, the timeframe may be compressed significantly. In approving the deal, the target's board may have to consider the interests of creditors as well. Finally, the buyer should review the transaction carefully to (i) avoid successor liability— under some circumstances, the buyer may be liable for the target's liabilities even absent an express agreement by the buyer to assume such liabilities— and (ii) protect itself from potential liabilities if the transaction is characterized as a fraudulent conveyance or voidable preference.

The other four techniques are applicable when the target is the subject of a bankruptcy proceeding. The bankruptcy court is involved invariably and the U.S. Bankruptcy Code or the bankruptcy court, as the case may be, prescribes specific rules for each technique.

Each technique has its own pros and cons, but all of them involve complex insolvency and bankruptcy issues. A buyer is well advised to consult with experts in the area so that it fully understands the implication of buying financially distressed assets before proceeding with the transaction.

Regulatory Requirements

BEA Filing

The United States has had a reporting requirement for foreign direct investment in the country since 1976, pursuant to the International Investment and Trade in Services Survey Act, an act aimed to collect information on international investment in the United States. Any investment in a U.S. business in which a foreign person owns at least a 10% voting interest is subject to the requirement. The requirement also applies to foreign ownership of real estate, except residential real estate held exclusively for personal use and not for profit-making purposes. Failure to file the requisite reports with the Bureau of Economic Analysis (BEA) of the United States Department of Commerce may result in a fine of up to $25,000 (subject to inflationary adjustments) and a prison term of up to one year.

Quarterly Filing

A U.S. business enterprise subject to the reporting requirements (U.S. Affiliate) must file a Quarterly Survey of Foreign Direct Investment in the United States on Form BE-605, which includes Claim for Exemption (generally, if the value of each of the U.S. Affiliate's total assets; sales (or gross operating revenue) and net income (or loss) is less than $60 million.

Annual Filing

Each U.S. Affiliate must file Annual Survey of Foreign Direct Investment in the United States on an appropriate form from the Form 15 Series (the appropriate form depends on the size of the U.S. Affiliate). A U.S. Affiliate is exempt from the annual filing requirements if the value of each of its total assets; sales (or gross operating revenue) and net income (or loss) is less than $40 million, in which case it should file a Claim for Exemption on Form BE 15.

Quinquennial Filing

The BE-12 Benchmark Survey is a comprehensive survey of foreign direct investment in the United States. The appropriate form from Form BE-12 series to be used (and thus the amount and type of data required to be reported) will vary according to the size of the U.S. Affiliate, whether it is a bank, and whether it is majority-owned by foreign investors. The survey is conducted once every 5 years. The current benchmark survey covers 2012. Majority-owned U.S. Affiliates not subject to this filing requirement should file a BE-12 Claim for Not Filing.

Reports filed with the BEA are confidential and may be used only for analytical or statistical purposes. The information cannot be used for purposes of taxation, investigation or regulation. Details of the current reporting requirements can be found at **www.bea.gov/surveys/pdf/2010current_Reporting_Requirements.pdf**.

Hart-Scott-Rodino Act

The purpose of the antitrust law is to promote competition. When the buyer and the target in a transaction are in the same industry, their combination may reduce competition significantly. That is why the parties in certain M&A transactions must notify the FTC and the DOJ, two federal agencies responsible for enforcing U.S. anti-monopoly laws, pursuant to the Hart-Scott-Rodino Act and wait 30 days (15 days in the case of a cash tender offer) after both parties have made the pre-merger notification. If the regulators take no action within that period, the transaction can proceed. If the regulators request more information, the parties may not close the transaction until the regulators are satisfied with the parties' responses, including on occasion, agreeing to divest certain assets before or after closing.

The civil penalty for failure to make a required filing or observe the waiting period can reach $11,000 for each day the violation continues.

Exon-Florio Amendment

This is an amendment to the Defense Product Act of 1950. The Amendment authorizes the Committee on Foreign Investment in the United States (CFIUS) to investigate and assess the effect of certain acquisitions by foreign investors on national security. In addition, the Amendment gives the president of the United States broad authority to investigate and prohibit (and even unwind) any merger, acquisition or takeover by or with foreign persons that could result in foreign control of business in interstate commerce if the president determines that the transaction constitutes a threat to national security. CFIUS is discussed in more detail in Chapter 7.

Other Federal and State Restrictions

Certain industries, especially in regulated industries including air transportation, banking, public utilities, maritime operations, mining, telecommunications and insurance, are subject to additional federal and state restrictions on foreign ownership or filing requirements. For example, the acquisition of agricultural land in the United States by foreign investors may be subject to filing requirements with the United States Department of Agriculture Farm Service Agency; the Federal Aviation Act prohibits non-U.S. airlines from owning more than 25% of the voting stock in a U.S. company serving the domestic airline market. Also, a non-U.S. entity that holds direct investments in U.S. property interests having an aggregate value in excess of certain thresholds would be subject to reporting requirements under the Foreign Investment in Real Property Act. Some other examples of federal laws, and rules that their enforcement agencies have enacted, that may need to be considered are the Federal Communications Act of 1934, Communications Satellite Act of 1962, Tax Equity and Fiscal Responsibility Act of 1982, Foreign Bank Supervision Enhancement Act of 1991, International Investment and Trade in Services Survey Act and Merchant Marine Act of 1920. The buyer should consult with counsel to address such issues early on.

CHAPTER 4

EMPLOYMENT CONSIDERATIONS

By Christine N. Kearns, Keith D. Hudolin and Daron T. Carreiro

Introduction

A non-U.S. company that hires employees in the United States must be aware of the many federal, state and local statutes that govern the employer-employee relationship. These statutes cover a wide range of topics, including prohibiting discrimination against employees and prospective employees based on a number of different characteristics, regulating the amount and manner of payment of wages, requiring employers to grant leave to employees in certain circumstances, and requiring employers to accommodate employees' disabilities and religious beliefs. The United States Department of Labor, the United States Equal Employment Opportunity Commission and similar organizations that exist in nearly every state government enforce many of these laws. Also, employees and prospective employees often have the ability to bring their own lawsuits against employers to enforce their rights.

An Overview of the Key Employment Statutes

The following is a brief description of the major statutes that govern employer-employee relationships in the United States.

The Federal Statutes

The following federal statutes cover most employers in the United States. Some apply only to employers with at least a minimum number of employees, while others apply regardless of the size of the employer.

Title VII of the Civil Rights Act of 1964 (Title VII)

Title VII prohibits employers with 15 or more employees from discriminating against employees based on race, color, religion, sex or national origin. Employers violate Title VII by taking any adverse employment action that is based on one of these protected characteristics, such as refusing to hire an applicant, terminating an employee, or providing inferior compensation or benefits. Employers also violate Title VII by harassing an individual because of a protected characteristic or retaliating against an individual for complaining about prohibited discrimination or harassment.

Employers can be found liable for discrimination in violation of Title VII under a number of different theories. Under a “disparate treatment” theory, an employer is liable if an applicant or current or former employee can show that the employer took an adverse action against that employee because of the employee’s protected characteristic. For example, failing to promote an individual because of that individual’s race would be impermissible disparate treatment. Under the “disparate impact” theory, an employer will be found liable if an applicant or current or former employee can show that a policy of the employer that does not facially discriminate against any protected class has an adverse impact on that protected class. For instance, an inflexible policy that all male employees be clean-shaven could have a disparate impact on African-American employees, and thus violate Title VII, because a skin condition that occurs primarily in African-American men prevents many African-American men from shaving.

Title VII includes an exception to its general prohibition against discrimination, however, when an individual’s religion, sex or national origin is a “bona fide occupational qualification” of the job that is “reasonably necessary” to the normal operation of an employer’s business. For example, a movie studio can lawfully exclude male actors from consideration for the role of a female character. Employers should proceed cautiously when relying on this exception, however, as courts have interpreted it very narrowly.

Employers are also prohibited from harassing employees because of the employees’ protected characteristics. Impermissible harassment occurs when an employer creates a “hostile work environment” or when an employer engages in “quid pro quo” harassment. A “hostile work environment” exists when unwelcome workplace conduct based on one of the protected characteristics is sufficiently severe or pervasive as to alter a term or condition of employment. Examples of such conduct include slurs, insults, offensive jokes and intimidation. Employers can protect themselves from hostile work environment claims, however, by implementing appropriate harassment training and a mechanism by which employees can raise harassment complaints and promptly investigating and responding to all harassment complaints. "Quid pro quo" harassment occurs when a supervisor promises an employee benefits, such as a promotion or a raise, in exchange for the employee submitting to sexual advances, or when a supervisor threatens to take an adverse action, such as terminating or demoting an employee, unless the employee submits to sexual advances.

Title VII also prohibits employers from taking retaliatory action against any applicant or employee who complains about discrimination or harassment. This prohibition extends broadly, and protects individuals who complain about discrimination they themselves feel they have suffered, individuals who oppose discrimination they perceive to be happening to others, and even family members of individuals who complain about discrimination. For example, if a husband and wife work for the same employer and the husband complains of discrimination, an employer would impermissibly retaliate if it took an adverse action against the wife because of the husband's complaint.

Finally, Title VII imposes an additional requirement on employers regarding employees' religious beliefs. Employers must provide a "reasonable accommodation" to employees when needed to allow for the employees' religious observances and practices, unless doing so would impose an undue hardship on the employer's business. For example, an employer would provide the required reasonable accommodation by allowing an employee to use accrued leave to avoid working on the employee's Sabbath or holy days.

The Age Discrimination in Employment Act (ADEA)

The ADEA, which applies to employers with at least 20 employees, protects employees and applicants who are at least 40 years old from discrimination based on age. Thus, employers are prohibited from refusing to hire an applicant, terminating an employee, providing inferior compensation or benefits or harassing an employee based on the employee's age. Employers are also prohibited from retaliating against employees or applicants for complaining about ADEA violations.

The Equal Pay Act

The Equal Pay Act generally requires that employers pay men and women equal pay for equal work. Unequal pay between male and female employees is permissible only when it is based on seniority, merit, productivity or some other factor other than an employee's sex.

The Americans with Disabilities Act (ADA)

The ADA, which applies to employers with at least 15 employees, generally protects employees from discrimination based on an employee's disability and requires employers to provide "reasonable accommodations" to allow disabled employees to perform the essential functions of their jobs. This statute is covered in greater detail later in this chapter.

The Family and Medical Leave Act (FMLA)

Under the FMLA, an employee who has worked for the same employer for more than 12 months is generally entitled to take up to 12 weeks of unpaid leave each year to care for the employee's serious health condition; to care for a spouse, son, daughter or parent of the employee who has a serious health condition; or for the birth or care of a newborn child or a child placed with the employee through adoption or foster care. The FMLA applies to employers with at least 50 employees. This statute is also covered in greater detail later in this chapter.

The Uniformed Services Employment and Reemployment Rights Act (USERRA)

USERRA protects members of the military from discrimination based on their military service, provides members of the military with unpaid leave for their military obligations and provides reemployment rights upon return from such leave. If an employee becomes disabled during his or her military service, USERRA also requires that an employer offer the employee reemployment in the position that is most comparable to the position the employee previously occupied in pay, status and seniority for which the employee remains qualified.

The Fair Labor Standards Act (FLSA)

The FLSA is the primary federal statute regulating wage rates and hours of work. It generally provides that employers must pay employees a minimum hourly wage for all hours worked plus additional overtime payments for hours worked over 40 in a week. The FLSA also regulates the conditions under which employers may employ workers under the age of 18. This statute is covered in greater detail later this chapter.

The National Labor Relations Act (NLRA)

The NLRA is the primary statute governing the interaction between employers and labor unions.

The statute governs both the unionization process (including the campaign and the election by which employees determine whether they want to unionize) and the interactions between the union and the employer once a facility's employees have unionized. Because of the complexity of this statute, any employer facing an employee unionization campaign should engage an experienced labor lawyer. Unlike most of the NLRA, however, Section 7 of the Act applies to all employers, regardless of whether the employer's workforce has unionized or is considering doing so. Section 7 gives employees the right to engage in concerted activities for the purpose of mutual aid or protection, which protects employee conduct such as discussing complaints about wages or working conditions with other employees. Employees may not directly sue employers for violations of Section 7, but may complain to the National Labor Relations Board, which enforces Section 7.

The Employee Retirement Income Security Act (ERISA)

If an employer establishes a pension or employee benefit plan, such as an employee health care plan, ERISA establishes minimum standards for the plan. ERISA generally requires plans to provide employees with information about the plans; requires plans to set minimum standards for participation, vesting, benefit accrual and funding; guarantees payment of some benefits if a plan is terminated; and gives employees the right to sue plan administrators to enforce their rights under ERISA.

State Statutes

Most state governments have enacted statutes that mirror the protections given to employees under the federal laws. For example, nearly every state has enacted laws prohibiting at least some forms of discrimination and governing the manner and amount of wage payments. Additionally, many states choose to expand on the protections given to employees under the federal laws, such as by adding additional characteristics on which employers are prohibited from discriminating or making the employment discrimination laws applicable to more employers. Many states have also enacted a higher minimum wage than is provided for by the Fair Labor Standards Act. These laws are in addition to the federal laws, so employers must be aware of both the federal laws and the laws of any state in which the employer has employees.

Local Statutes

Many cities have also enacted their own laws governing the employment relationship. These laws, which are particularly prevalent in larger cities, impose requirements on employers that are in addition to the protections employees have under the applicable federal and state laws and apply to all employees working within that city. While local statutes can cover a wide range of topics, they most commonly add additional protections against discrimination. For example, many cities around the country have enacted laws prohibiting discrimination based on an employee's sexual orientation.

Recruiting

Nearly every local, state and federal antidiscrimination law extends its protections to the recruitment of employees. Therefore, employers must take care to ensure that their recruiting processes are not discriminatory. First, any advertisements, job descriptions, or other information about the job that is communicated to potential applicants should convey that the employer is an equal employment opportunity employer, and must not convey a preference for or against any protected class. For example, a job advertisement that states that the employer seeks "recent college graduates" may violate the ADEA because the advertisement could discourage older workers from applying. Second, if the employer uses a recruiting agency or a temporary staffing agency to fill job openings, the employer should monitor the agency's recruiting efforts. If the agency is discriminating against a protected class of applicants, it is possible that the employer could be found liable for the agency's discrimination (the agency would generally be liable for such discrimination as well).

Rather than recruit by posting job openings or using employment agencies, some employers recruit by word-of-mouth. This method can be effective, but employers using it must carefully monitor their recruiting to ensure that it does not have a disparate impact on a protected class. For example, if an employer's current employees are almost exclusively of one race, word-of-mouth recruiting could lead to the employer receiving applications only from other individuals of that same race, thus excluding other races in violation of Title VII.

Hiring

Like the recruiting process, employers must conduct the hiring process with the applicable anti-discrimination laws in mind. Therefore, employers should tailor their job applications to obtain useful information while avoiding information that could lead to claims of discrimination, such as requests designed to determine whether an applicant belongs to a protected class. However, in some cases, employers are obligated to compile and retain information about the demographics of their applicants. For those employers, this information should be collected on a tear-off section of the application and not given to the individuals making the hiring decisions.

Employers also need to be careful about questions that, while not directly related to a protected class, could have the effect of discouraging members of a protected class from applying. For example, while employers may ask about criminal convictions, they may not ask about arrests, because some minority groups are more likely to be arrested than members of the general population (some states also have laws explicitly prohibiting questions about arrests). Similarly, questions about availability for weekend and holiday work could lead to religious discrimination claims, because such questions could imply that the employer will not be willing to accommodate an employee's religious obligations and practices.

Of course, when an employer conducts an in-person interview with the applicant, it will be readily apparent whether the employee belongs to certain protected classes. Nevertheless, the same restrictions on inquiries to job applicants described above apply to interviews as well as application forms. Employers likely will eventually need to collect information such as age, marital status or number of dependents (all of which are impermissible inquiries on job applications and in interviews) for compensation and benefits purposes, but this information should be collected after the employee has been hired.

In addition to the application and the interview, many employers want to conduct additional screening on applicants or new hires, such as drug tests, background checks and reference checks. However, employers must be cautious when doing so. First, if an employer uses a third party to collect information about applicants or new hires, the Fair Credit Reporting Act requires that employers provide notice and make certain disclosures to the applicant or employee. Second, many states impose strict restrictions on when employers may use drug tests and the manner of the testing, while other states go further and generally forbid the use of drug tests. Finally, employers who make reference checks should obtain a broad release from the applicant and ensure that inquiries to the employees' references are job related.

Documentation of the Employment Relationship

Documentation of the employment relationship may consist of the papers initiating the employment relationship (for example, letter agreements or employment contracts); company policies and procedures; employee handbooks; employee evaluations and performance reviews; employee achievements; records of disciplinary actions; descriptions of employee-related incidents, timesheets; benefits; and documents required to be made and retained by federal and state laws. This documentation provides an employer a written record upon which to base employment decisions such as salary changes, promotions, disciplinary actions and terminations. Proper documentation can also be invaluable for an employer's defense against employee lawsuits or government investigations.

The nature of the employment relationship and its legal consequences may differ depending on how an employer documents the relationship, for example whether hiring is done by verbal arrangement, letter agreement or employment contract. Thus, employers must be cautious in documenting the employment relationship to ensure that the documentation aligns with the employer's intentions. Similarly, company-generated documents such as employee handbooks must be worded carefully to avoid creating unintended rights and obligations, and employee handbooks should always clearly state that the handbook does not create a contract between the employer and the employee.

Issues Regarding the Family and Medical Leave Act and the Americans with Disabilities Act

The FMLA and ADA are the two major federal statutes giving employees rights when they are injured, sick, become disabled or have an injury or illness in their immediate family. The ADA protects employees who are disabled or are perceived as being disabled. For purposes of the ADA, a disability is any physical or mental condition that substantially limits a major life activity. The ADA prohibits employers from discriminating against individuals with disabilities, and requires that employers provide reasonable accommodations that will allow disabled employees to continue to perform the essential functions of their jobs. For example, if an employee has a disability that prevents the employee from remaining seated for long continuous periods, the employer might satisfy its obligation to provide a reasonable accommodation by allowing the employee to stand while performing his or her duties or by allowing the employee to take occasional short breaks. If, due to a disability, an employee cannot perform the essential functions of his or her job, but would be able to do so after a short time away from work, the employer may even be obligated to provide unpaid leave as a reasonable accommodation.

An employer's obligations under the ADA begin as soon as the employer learns that an employee has a disability. At this time, the employer and the employee must engage in an "interactive process" by which the employer and employee communicate to agree upon a reasonable accommodation. However, an employer is not required to provide an accommodation if it would impose an undue hardship on the employer, in light of the employer's size, financial resources and the needs of the business. Additionally, an employer is only required to provide a reasonable accommodation—employees are not entitled to their preferred accommodations.

Under the FMLA, an employee who has worked for the same employer for more than 12 months may take up to 12 weeks of unpaid leave each year to care for the employee's serious health condition. Employees also may use leave under the FMLA to care for a spouse, son, daughter or parent of the employee who has a serious health condition, or for the birth or care of a newborn child or a child placed with the employee through adoption or foster care. Employers may request that the employee provide a medical certification that establishes the necessity of the leave. During the employee's leave, the employer must maintain the employee's benefits (such as health care) and, after the employee's leave expires, the employee is generally entitled to return to his or her former position. In addition, employers are prohibited from retaliating against employees who exercise their rights under the FMLA.

It is important to note that while leave under the FMLA is limited to 12 weeks, employees may be able to take more leave in some circumstances. For example, some states have their own similar statutes that provide for longer leave. Additionally, if an employee remains disabled upon the expiration of his or her FMLA leave, the employee may be entitled to additional leave beyond the initial 12 weeks as a reasonable accommodation under the ADA.

The Fair Labor Standards Act

The FLSA requires employers to pay certain employees at least the federal minimum wage (currently $7.25), as well as overtime compensation for all hours worked over 40 in one work week. Overtime compensation must be paid to FLSA-covered employees at a rate of not less than one and one-half the employee's "regular rate" of pay. For example, an FLSA-covered employee that works 50 hours in one work week must be paid his or her regular hourly rate for the first 40 hours, and then at least one and one-half times his or her regular rate for the additional 10 hours worked.

The FLSA and related federal regulations define who is an "employer" and an "employee" for FLSA purposes. Workers who are not considered "employees" are not covered by the FLSA, and the FLSA's minimum wage and overtime compensation requirements do not apply to them. A worker's title is not determinative of whether he or she is an "employee" under the FLSA. Instead, courts apply a multifactored "economic realities" test that considers the nature of the work performed to determine whether the worker is an "employee" and whether the FLSA applies. Thus, merely labeling a worker as an "independent contractor" as opposed to an "employee" does not necessarily relieve an employer of its FLSA obligations.

The FLSA also contains several statutory exemptions for certain types of businesses and specific kinds of work. For example, employees classified as "executive, administrative or professional employees," as defined by federal regulations, are exempt from FLSA's minimum wage and overtime pay requirements.

The Wage and Hour Division of the U.S. Department of Labor administers and enforces the FLSA with respect to private employers. The Wage and Hour Division conducts investigations and gathers data on wages, hours and employment conditions in order to determine compliance with the law. Employees may also sue employers directly to recover unpaid wages. The FLSA prohibits employers from firing or otherwise discriminating against an employee who files a complaint or participates in a legal proceeding under the FLSA.

In addition to minimum wage and overtime pay requirements, the FLSA also requires employers to maintain records according to Department of Labor regulations. The records must be retained for the time periods stated in the regulations and must contain, for example, each employee's personal information, workweek hours and days, regular rate of pay, wage basis, hours worked, straight-time earnings, weekly overtime pay, wage deductions and additions, total wages paid per pay period, date of payment and pay period covered.

It should be noted that many states have similar minimum wage and overtime compensation laws that apply in addition to FLSA.

Termination Considerations

While federal, state and local laws provide a great deal of protection to employees, the employment laws recognize that employers must, at times, discharge employees for any number of reasons. This section provides an overview of the considerations that must factor into the termination process.

Individual Terminations

Every state except Montana recognizes the "employment-at-will" doctrine. Under this doctrine, absent an employment agreement specifying otherwise, an employer may terminate an employee for any reason or no reason at all (and an employee may quit at any time). However, this doctrine has substantial limits. For example, an employer cannot terminate an employee based on any characteristic protected by an applicable federal, state or local antidiscrimination law. Additionally, many states recognize a public policy exception to the employment-at-will doctrine. This exception prohibits employers from terminating employees when doing so would contravene public policy, such as if an employer were to terminate an employee for exercising the right to vote, serving on a jury or reporting a violation of the law.

Employees who believe they have been wrongfully terminated can generally sue their former employer and, if successful, obtain damages that include back wages, lost future earnings and occasionally punitive damages. Many employers, therefore, choose to mitigate the risk of discrimination and wrongful termination claims by obtaining separation agreements and releases from terminated employees in exchange for severance pay.

Once an employer has decided to terminate an employee, in general, the employer must pay that employee all wages that are due for work up to the date of termination. Most states have laws specifying how and when employers must provide these final paychecks. For example, some states require final paychecks to be provided immediately, while others allow employers to provide final paychecks on the next ordinary payday. Many states impose different requirements for final paychecks depending on whether the employee was terminated or quit.

Additionally, when an employer terminates an employee for a reason other than gross misconduct, the employee is usually entitled to unemployment benefits under unemployment compensation systems established in every state. Employers are required to make contributions to these systems, with the amount of the contribution generally determined in part by the rate of unemployment among the employer's workforce. Employees who quit or are terminated also have the option of continuing their group health benefits for a limited period of time under the Consolidated Omnibus Budget Reconciliation Act (COBRA), but the employee may be required to pay the entire premium for this continued coverage.

Layoffs or Reductions-in-Force

When an employer is forced to conduct a mass layoff or reduction-in-force, additional considerations apply. Under the Worker Adjustment and Retraining and Notification (WARN) Act, employers must generally give 60 days' advance notice of plant closings or mass layoffs to affected employees, unions (if the affected employees are represented by a union), the state's unemployment compensation insurance agency and the mayor of the local government. Some states have similar laws requiring notice of plant closings and mass layoffs that can impose additional obligations on employers. Like individually terminated employees, employees who are terminated in a layoff or reduction-in-force are entitled to all wages earned up to the date of their termination, unemployment benefits and continuing health care under COBRA.

When deciding which employees to include in a mass layoff or reduction-in-force, employers must be careful to reduce the risk of discrimination charges. To do so, employers should: (i) decide which employees to terminate based solely on objective criteria; (ii) ensure that no protected class is impacted more severely than others (which includes paying special attention to ensure that older workers are not singled out for termination); and (iii) obtain signed *separation agreements and releases* from every terminated employee. Additionally, employers may want to consider providing outplacement services to affected employees to reduce affected employees' motivation to bring wrongful discharge claims.

Separation Agreements and Releases

When terminating employees, employers can use separation agreements and releases to protect themselves from discrimination and wrongful discharge claims. These agreements will generally provide the terminated employee with a lump-sum severance payment in exchange for a release of claims against the employer. Such releases can be a valuable tool to prevent lawsuits by former employees, but a release will be valid only when the employee enters it knowingly and voluntarily. Therefore, the release should be written as clearly and explicitly as possible.

However, there are limits on the claims an employee may release. For example, many states do not allow employees to agree to release claims for unpaid wages. Additionally, when a release waives age discrimination claims, the ADEA requires that employers give the employee at least 21 days to consider the agreement, or 45 days to consider the agreement where the separation agreement is offered as part of a mass layoff or reduction-in-force. Agreements releasing ADEA claims must also be revocable by the employee for at least seven days after execution. Finally, individual states may have additional limitations on claims that may be released or the terms of separation agreements.

Rehire Policies

When an employer begins hiring for positions it had previously eliminated, it faces a heightened risk of discrimination claims. For example, if a former employee over the age of 40 reapplies for a position that he or she had previously held, but is rejected in favor of a younger candidate who has not previously worked for the employer, the former employee might have a strong age discrimination claim. To protect against this risk, employers should have a clear policy in place covering the circumstances under which it will rehire former employees.

This policy should first specify whether former employees are eligible for rehiring. Some employers choose to implement "no-rehire" policies, but such a policy could itself subject an employer to age discrimination claims if it leads to the rejection of older former employees in favor of younger applicants. Assuming the policy allows for rehire, it should state whether and under what terms former employees will receive preferential treatment over other applicants in filling any job vacancies. The policy should also explain the manner by which the employer will determine which former employees will be rehired. For example, an employer may decide to fill vacancies based on seniority or by giving the highest priority to the last employee laid off.

Conclusion

This chapter attempts to provide general guidance to foreign companies that hire employees in the United States on the issues and statutes that frequently arise when businesses make employment decisions. However, to avoid making costly mistakes, foreign companies must be aware of the intricacies of the numerous federal, state and local laws affecting the employment relationship. Therefore, engaging legal counsel experienced in employment law before any disputes arise can help to ensure full compliance with the applicable laws and reduce the risk of future liability.

CHAPTER 5

EQUITY INCENTIVES FOR U.S. EMPLOYEES

By Susan P. Serota[12]

Compensation for U.S. employees, including foreign nationals, often includes equity awards in addition to salary and annual bonuses. Most companies limit equity awards to key executives and other management employees. The types of long-term equity compensation awards commonly offered by U.S. corporations are stock option plans, employee stock purchase plans (ESPPs), stock appreciation rights (SARs), restricted stock, and performance shares or restricted stock units (RSUs). The tax, securities law, and other reporting requirements related to equity compensation may vary depending on the nature of the plan and the type of awards offered. See Appendix A for a comparison of the U.S. taxation and accounting treatment of various types of long-term equity compensation.

12 This Chapter is based on the chapter 'United States' included in Employee Share Plans: International Legal and Tax Issues, Second Edition, Globe Law and Business, 2011, contributed by Susan P. Serota, a partner in the New York office of Pillsbury Winthrop Shaw Pittman LLP.

Types of Equity Incentives

There are two basic types of option plans which are distinguished by their respective tax consequences—incentive stock options (ISOs) and non-qualified stock options (NQSOs). While the executive receives a right to acquire company shares for both, only ISOs qualify under the U.S. Internal Revenue Code (Tax Code) for favorable tax treatment from the executive's perspective provided certain statutory requirements are met, whereas NQSOs do not. SARs allow the recipient to receive the difference between the value of the stock on the date the SAR is granted and the date the SAR is exercised. Performance shares function like SARs, but derive their value from a measurement external to the price of company stock (i.e., cost reduction, cash flow, earnings per share or book value multiples). By comparison, RSUs are provisional allocations for which neither stock nor options are actually issued at the date of grant, but which represent the company's promise to distribute shares, or the cash equivalent of such shares, when the recipient satisfies certain service and/or performance vesting requirements.

With respect to pure stock programs, an ESPP allows a broad-based group of employees to purchase employer stock at a discount, typically through payroll deductions. As with ISOs, ESPP recipients enjoy favorable tax treatment under the plan provided Tax Code requirements are met. Restricted stock is stock that is issued and granted to the employee either without consideration or for a nominal purchase price and is subject to transferability, vesting, forfeiture, and/or repurchase restrictions for a certain service period. During the restricted period, the employee has the same dividend and voting rights as other stockholders. A special election under the Tax Code permits the employee to accelerate the taxation of the award, even though still forfeitable, and then receive capital gains treatment on the later sale for the entire appreciation.

U.S. Securities Law Requirements

Equity awards to employees generally implicate a variety of U.S. federal and state securities laws. In the absence of an exemption, these awards are subject to the registration requirements of the Securities Act of 1933 (Securities Act). If the underlying security is not traded on a U.S. exchange the award is usually subject to most state securities laws. Furthermore, reporting companies under the Securities Exchange Act of 1934 (Exchange Act) must make ongoing equity compensation disclosures; companies whose securities trade on a U.S. exchange must also comply with the exchange's rules. Securities laws often impose restrictions on the employee recipient's ability to resell stock, including strict reporting obligations and trading limitations imposed on certain key employees. For a general discussion on U.S. securities law, please see Chapter [2].

Securities Act of 1933—Registration

In the absence of an exemption, equity awards are generally subject to the registration and prospectus delivery requirements of the securities laws at the time of sale or offer to sell such securities to employees; however, under the 'no-sale' theory, registration is not required if the employee provides nothing of value in exchange for the award. Because stock options require the payment of value (i.e., the exercise price) to receive the shares, the securities underlying the options generally are subject to registration when the options first become exercisable. However, awards broadly available to employees (where employees do not individually bargain for the award) are not subject to registration because there is no offer or sale under the Securities Act. Similarly, if ESPP stock is acquired directly from the employer, registration is required unless an exemption is available; but if ESPP stock is acquired on the open market, registration is necessary only if the employer has solicited employees to participate in the plan.

Where a company is required to file reports under the Exchange Act, a Form S-8 is typically used to register equity compensation awards. The Form S-8 prospectus materials must contain, among other things, material information regarding the plan and its operation that will enable recipients to make informed investment decisions. The prospectus should describe the tax effects of plan participation and any restrictions on resale of the underlying securities. It must also be regularly updated to reflect any material changes during any period in which offers or sales of securities are made. Furthermore, registering with Form S-8 generally requires the employer to deliver or properly incorporate by reference many of the same documents routinely delivered to stockholders, including a Form 10-K (or Form 20-F in the case of foreign issuers) containing the employer's audited financial statements.

The Securities Act provides an exemption, Rule 701, from registration for certain written compensation plans under which shares offered or "sold" to employees, directors, general partners, trustees, officers, or certain consultants of companies that are not subject to the reporting requirements of the Exchange Act (otherwise known as private companies) and are not investment companies. Rule 701 is subject to disclosure and volume limitations and does not exempt resales by plan recipients. Other exemptions that may be relied upon by the issuer of plan benefits include Regulation S, which applies to certain offshore transactions, Section 4(2), which applies in the context of a private offering, and Regulation D, which provides specific safe harbors for limited offerings. While some of these exemptions may require the issuer to follow certain formalities, a full-blown registration process is avoided.

Securities issued by the employer under an equity plan in reliance on an exemption are "restricted" securities which may not be freely sold by the employee to third parties. The securities must be registered upon resale or resold in reliance on an exemption. Conversely, plan securities that have been registered under the Securities Act are generally freely tradable by recipients without any resale restrictions at all. However, affiliates of the issuer (generally directors, key executive officers and controlling stockholders), as well as recipients who are non-affiliates holding restricted securities (i.e., unregistered securities issued in reliance on an exemption), cannot offer or sell their securities unless either the securities are separately registered for resale purposes or an exemption from such registration is available.

The primary exemption normally relied upon in this context is Rule 144, which provides a specific safe harbor for resales that comply with certain holding period and manner of sale requirements. The other resale exemptions available to plan recipients are the judicially crafted Section "4(1½)", which applies to certain private resales. Another exemption available is Regulation S which is very useful to non-U.S. public companies. Thus, U.S. employees of a non-U.S. public company may generally sell shares they received under the equity plan through a non-U.S. broker on the local stock exchange.

Regardless of whether an exemption from registration is available, securities transactions are subject to anti-fraud and other liability under the U.S. securities laws. Indeed, the general anti-fraud provisions of SEC Rule 10b-5—which cover all securities transactions—require the disclosure of honest and complete information regarding the plan securities. Liability for material misrepresentations in a registration statement is also provided for under other provisions of the Securities Act, which are considerably more generous to plaintiffs than Rule 10b-5.

Securities Exchange Act of 1934 - Registration

The Exchange Act provides that an issuer must register with the SEC any security, including plan securities, if it is listed on a national securities exchange or if the issuer has a class of 500 or more persons holding such security in the United States and total assets exceeding $10 million. Upon such registration, the issuer becomes a reporting company and is subject to ongoing reporting obligations (i.e., filing of Forms 10-Q, 10-K, 20-F and other reports with the SEC). While SEC Rule 12g3-2(a) traditionally provided the primary exemption from such registration for certain foreign issuers, the SEC has approved specific exemptions for issuers of employee stock options that conform to certain eligibility requirements.

The Exchange Act also requires each U.S. securities exchange to adopt rules that regulate issuers whose securities are listed on its exchange; such rules must be considered whenever an equity plan is introduced. For example, the rules of the major exchanges typically require stockholder approval and prompt notification to the exchanges of new plans and any revisions to plans.

State Blue Sky Laws

In the United States, the states have their own securities laws that are often referred to as "blue sky" laws. Generally speaking, when an exemption is valid under U.S. federal law, the company need not meet additional requirements under blue sky laws. In fact, most states offer an automatic exemption from registration for employee-benefit plans, without any filings or applications. Certain states offer such an exemption provided that procedures for notification and disclosure are followed. In some states, such as New York, a formal application for exemption must be filed. Compliance with some other states' securities laws may be more onerous. Under California law, for example, employers offering equity awards in reliance on Rule 701 must file a notice within 30 days after the initial issuance of any security under the plan, pay a filing fee, and seek stockholder approval if more than 35 plan recipients are California residents. The other California exemptions often require analysis of grantees on a continuing basis, or, alternatively, the filing of an application, including copies of organizational documents and audited financial statements.

Employee Tax and Social Security

Section 83 of the Tax Code governs the taxation of property (including plan securities) transferred to an employee in connection with the performance of services. This section provides that such property is taxable to the employee as ordinary income in the year in which the property is transferable or is no longer subject to a substantial risk of forfeiture. Because plan securities are issued as remuneration for services, the amount of any ordinary income recognized by the employee is characterised as wages and is subject to withholding of income tax and Federal Insurance Contributions Act (FICA) tax, which consists of Social Security and Medicare. Currently, the ordinary income tax rates in the United States range from a minimum of 10% up to a maximum of 39.6% depending on the taxpayer's income and tax-filing classification. The FICA tax is 12.4% for Social Security up to a maximum wage amount set each year by the IRS and 2.9% for Medicare on all compensation income, but only one-half of those respective percentages are paid by the employee. The other half is paid by the employer. In 2013, employees must pay an additional 0.9% Medicare tax when income exceeds a certain threshold. On sale of stock, the employee must pay a 20% capital gains tax if he has held the stock for more than 12 months plus a 3.8% Net Investment Income tax.

On the other hand, ISOs and ESPPs are eligible for more favorable taxation from the employee's perspective, since income is generally characterized as a capital gain and is taxed at the capital gain rate. This taxation is deferred until the time the securities are sold. While short-term capital gains are taxed at the ordinary income tax rates, the long-term capital gain tax for plan investments held over one year is currently capped at 20%. This favorable tax treatment is conditioned on numerous restrictions affecting both the plan's design and transferability of shares. High income earners may also have a 3.8% net investment income tax applied to both their capital gains and investment income.

If such restrictions are met, no taxable income is recognized and there will be no income tax or FICA withholding at the time of exercise. The sale of stock received under an award will generally not trigger the withholding of income tax to the extent that the income recognized is characterized as capital gain. In the case of ISOs, provided the shares received upon exercise are held for the minimum holding period, the employee will defer the recognition of income until the ultimate sale. Upon the sale, the employee is taxed at the capital gain rates. However, the spread between the exercise price and the fair market value of the stock upon exercise of the option, though not taxable as compensation, must be included by the employee as an adjustment in computing the alternative minimum taxable income in the year of exercise.

In the case of NQSOs, there are generally no tax consequences when option awards are granted because no property is yet considered to be transferred within the meaning of the Tax Code. But the employee will generally recognize wage income subject to income tax and FICA withholding at the time of exercise (unless the shares obtained are restricted) equal to the difference between the fair market value of the stock received and the exercise price. When the shares acquired upon exercise of an NQSO are sold, the difference between the fair market value of the stock on the date of exercise and the sale price should be treated as short or long-term capital gain, depending on whether the shares were held for more than one year following the date of exercise.

Unless the NQSO plan satisfies Tax Code Section 409A, which relates to deferred compensation, adverse tax consequences may result from the issuance of NQSOs where the exercise price is less than the fair market value of the stock on the date of grant or if the exercise of otherwise exercisable options is deferred by the recipient. Deferred compensation not meeting the requirements of Section 409A results in the imposition of an additional 20% penalty tax plus a premium interest tax at the time the option first becomes exercisable. For restricted stock, unless a Section 83(b) election is made within 30 days after the grant, the value of the stock at the time of grant is generally not taxed to the employee. However, when the transferability and forfeiture restrictions lapse and the shares become vested, the employee will recognize ordinary income equal to the value of the stock at vesting less the consideration, if any, contributed by the employee for the award.

The employee may make a voluntary Section 83(b) election. Upon making a timely election, the excess of the fair market value of the shares at the grant date over any amount paid for the shares is taxed to the employee as ordinary income and is subject to income and FICA tax withholding at the time of grant. When the employee sells the shares, any excess of the sales price over the fair market value of the shares at the date of grant is treated as short- or long-term capital gain depending on the holding period of the shares. The forfeiture of restricted stock after a Section 83(b) election has been made will result in a capital loss and not an ordinary loss for U.S. federal tax purposes; generally, capital losses may be used as a deduction only to the extent the employee has capital gains. The employee typically benefits from a Section 83(b) election where the net benefit of being taxed on stock value increases during the vesting period at the lower capital gain rates instead of the ordinary income rates exceeds the detriment of paying income and FICA taxes on the excess of fair market value over the purchase price, if any, paid at the time of grant. Whether or not the Section 83(b) election is made, restricted stock is generally not subject to the deferred compensation penalties and interest provisions of Section 409A.

With respect to SARs, an employee will recognize ordinary income, subject to withholding, but only when the SAR is exercised in an amount equal to the cash and/or the fair market value of property received, unless the property received (cash, securities or other property) is otherwise restricted. SAR awards also generally pose deferral issues under Section 409A.

Tax Deduction by the Employer

Under the Code, the employer is generally entitled to an income tax deduction equal to the amount of compensation income characterized as wages by and taxed to the employee. It may take this deduction at the same time that the employee must recognize such compensation income. Accordingly, in the case of NQSOs, the employer is generally entitled to a deduction at the time of exercise for the spread between the exercise price and the fair market value of the stock upon exercise of the option. By contrast, in the case of ISOs, the employer receives no deduction either at the time of exercise or sale where the required holding period has been met because no corresponding wage income is taxable to the employee. As with ISOs, no employer deductions are permitted for ESPPs where the tax qualifications for employee-favorable tax treatment are met.

With respect to restricted stock, the employer is entitled to a deduction equal to the ordinary income recognized by the employee either upon the lapse of the restrictions or at the time a Section 83(b) election is made. Likewise, with respect to SARs, the employer is entitled to a deduction only at the time the SAR is exercised, for an amount equal to the corresponding ordinary income recognized by the employee. With respect to all plan securities, under U.S. tax law, it is not necessary to have a so-called “recharge arrangement” between a parent and its subsidiary, whereby the parent charges the subsidiary for the equity or cash it provides to the employees of the subsidiary, for the subsidiary to obtain a deduction for the compensation element of incentive awards granted to its employees, even if the awards are actually funded by the parent.

The Tax Code limits a U.S. public corporation's income tax deduction to $1 million for compensation paid to a covered employee who is either the chief executive officer of the corporation or among the four highest paid officers whose total compensation must be reported under the Exchange Act. Performance-based awards that meet certain conditions (i.e., stockholder disclosure and approval) are exempt from these limitations. Accordingly, stock options and SARs generally satisfy the performance-based exemption as long as the exercise price is at least equal to the fair market value of the stock on the date of grant, and certain other procedural requirements are met. Restricted stock, however, would rarely qualify for an exception unless the vesting conditions are performance-based.

Internationally Mobile Executives

Income Taxes

The United States taxes its citizens and non-citizens residing in the United States on all of their worldwide income, regardless of the geographic origin of that income. Accordingly, an employee who is a U.S. citizen, resident or green card holder will ultimately pay income tax related to incentive awards no matter the origin of that income or where the employee resides. A non-citizen employee who rendered services in the United States for only a portion of the period during which the award vested is generally taxed only on his or her U.S. source income, which will be based on services in the United States during the vesting period. If a foreign person who is a non-resident alien has U.S.-based award income that is not effectively connected with a U.S. business (either because the person has no such business or because the income is not related to the business), or for some reason is not subject to wage withholding (e.g., an independent contractor), the income may be taxed at a flat rate of 30%. In addition to U.S. taxes, the recipient of plan securities is subject to taxation in the relevant foreign jurisdiction. However, bilateral income tax treaties with some countries may change the sourcing of income. In addition, foreign income tax credits against U.S. tax often mitigate, or even eliminate, the effects of international double taxation.

FICA Taxes

In general, FICA taxes apply to payments of wages for services performed in the United States. Services performed outside the United States are not subject to FICA, unless the person performing the services is a U.S. citizen or green card holder, and the employer is an "American employer." Accordingly, the recipient must pay FICA taxes on the award only if they are covered by the U.S. Social Security system at the time of FICA taxation (vesting or exercise). In certain instances, Social Security totalization treaty provisions may provide eligible taxpayers with some relief from international double taxation.

Reporting Requirements

The employer must generally report to the Internal Revenue Service compensation income required to be recorded by, and taxed to, the employee. These reporting requirements ensure that the correct amount of taxable compensation income is taxed to and included by the employee. Starting in 2011, the employer must also furnish an information return for each employee who exercises an ISO. The employer also has reporting obligations under the requirements of Section 409A, including an obligation to report the total amount of deferrals for the relevant tax year.

Lastly, the employer, if a U.S. public company, may also have securities law reporting obligations relating to plan securities, including proxy disclosures, disclosure of material events, disclosures on periodic filings to comply with Exchange Act, and registration requirements under the Securities Act. If the employer is not a public company and is not relying on the exemption from registration under the Securities Act provided by Rule 701, Regulation D, Regulation S, or Section 4(2), the employer may still have disclosure requirements to participants.

Exchange Control Issues

There are no exchange control issues for U.S. employees unless cash (as opposed to a paychecks) exceeding $10,000 is used to remit monies abroad for the purchase of shares or to repatriate monies from the sale of shares. Cash includes the currency of any country. Because cash transactions are very unlikely in the context of a stock option exercise payment or even a sale of shares, generally speaking there are no exchange control issues to consider.

Employment Law

Employment law issues may arise from incentive awards in the context of collective bargaining agreements. For example, labor-union agreements often include provisions that limit the company's ability to issue incentive awards as a form of compensation. In addition, issues may arise in the context of wrongful termination claims. If the termination cuts off the option vesting, for example, employment-based claims for damages may arise. Also, stock options can and have become an issue in employment discrimination cases under U.S. federal law as well as in cases involving attempted enforcement of non-compete provisions.

Data Protection

U.S. federal data protection law tends to focus on the regulation of financial institutions and other organizations maintaining consumer information, and does not generally govern employee information maintained by employers in connection with equity plans. U.S. state laws, however, often regulate keepers of personal data more broadly. Many states have adopted data breach notification procedures that require those who keep personal data to notify individuals whose information is believed to have been misappropriated in an unauthorized fashion. In New York, for example, companies that own or license computerized data that include "private information" must notify residents, the state attorney general, the consumer protection board, and the state office of cyber security in the event of a breach of stored private data. Many states have also adopted provisions relating to data destruction and procedures for maintaining reasonable security measures.

ANALYSIS OF TYPES OF EQUITY-BASED COMPENSATION IN THE UNITED STATES[13]

TYPE	DESCRIPTION	TAXATION	ACCOUNTING
INCENTIVE STOCK OPTIONS (ISOs)	Options granted under a plan meeting certain statutory requirements. Exercise price cannot be less than fair market value of stock on date of grant.	Employee: No regular income tax at grant or exercise. Taxed at capital gain rates when underlying shares are sold (ordinary income tax rates if employee fails to meet holding period requirement). No FICA tax. Alternative minimum tax may apply at exercise. Employer: No deduction, unless employee fails to meet holding period requirement. No FICA tax.	Fair value of options at date of grant expensed over service period (typically, vesting period). Fair value in most cases must be determined using valuation formula (e.g., Black-Scholes or lattice model).
NONQUALIFIED STOCK OPTIONS (NQSOs)	Options that are not ISOs.	Employee: No tax at grant. Taxed on spread at exercise at ordinary income tax rates, plus FICA tax. Discounted options (exercise price less than fair market value at date of grant) will be treated as deferred compensation, resulting in taxation in first year option is exercisable plus 20% additional tax (plus interest penalty) on employee, unless timing of exercise restricted to be exempt from Code section 409A or Code section 409A requirements are satisfied.[14] Employer: Deduction equal to spread at time of exercise in same year employee recognizes income. FICA tax at exercise.	Fair value of options at date of grant expensed over service period (typically, vesting period). Fair value in most cases must be determined using valuation formula (e.g., Black-Scholes or lattice model). Tax benefit of the corporate deduction is a credit to earnings or equity.
OUTRIGHT STOCK GRANTS	Awards of stock without any restrictions as to vesting or resale. Stock can be granted for little or no purchase price.	Employee: Taxed on fair market value of stock at time of award (less any amount paid by employee for stock). Ordinary income tax rates apply, plus FICA tax. Employer: Deduction equal to fair market value at time of award (less any amount paid by employee for stock) in same year employee recognizes income. FICA tax at time of award.	Expense recognized at time of award equal to fair market value of stock. May be possible to charge expense over period of years when services are to be performed. Tax benefit of the corporate deduction is a credit to earnings.

13 For purposes of this chart, "Code" means the U.S. Internal Revenue Code of 1986, as amended, and an award "vests" in the grantee as of the time the award is no longer subject to a substantial risk of forfeiture.

14 NQSO awards will be exempt from Code section 409A under the "short-term deferral rule" where the optionee must exercise the option no later than March 15 of the year following the year the option vests. Alternatively, restrictions on the exercise period can be established to comply with the requirements of Code section 409A.

TYPE	DESCRIPTION	TAXATION	ACCOUNTING
RESTRICTED STOCK GRANTS	Grant of stock with vesting (years of service) requirements and/or other restrictions on immediate resale. Stock can be granted for little or no purchase price.	Employee: Taxed at time of vesting on fair market value of stock at that time (less any amount paid by employee). Employee can make "83(b)" election to be taxed earlier at time of grant. In either case, ordinary income tax rates apply, plus FICA tax. Employer: Deduction equal to fair market value of stock (less any amount paid by employee) in same year employee recognizes income. FICA tax at tax point for employee.	Expense measured based on fair market value at time of grant (less any amount to be paid by employee). Expense charged to earnings over service period. Restrictions on transferability that survive service period are factored into fair market value determination. Tax benefit of the corporate deduction is a credit to earnings or equity.
"NIL COST" OPTIONS	Grant of options having a $0 (or nominal, e.g., 1 penny) exercise price, entitling recipient to acquire a certain number of shares of company stock at specified exercise date or during designated exercise period.	Employee: Ordinary income tax on fair market value of underlying shares (less exercise price, if any) when option is first exercisable (regardless of whether actually exercised), plus FICA tax, subject to compliance with Code section 409A. May be treated as deferred compensation, resulting in taxation in first year exercisable, plus 20% additional tax (plus interest penalty) on employee, unless timing of exercise restricted to be exempt from Code section 409A or Code section 409A requirements are satisfied.[15] Holding period for purposes of capital gain characterization upon subsequent sale of stock does not begin until shares are actually transferred to employee. Employer: Deduction equal to fair market value of stock (less any amount paid by employee) in same year employee recognizes income. FICA tax at exercise.	Fair value of options at date of grant expensed over service period (typically, vesting period). Fair value in most cases must be determined using valuation formula (e.g., Black-Scholes or lattice model). Tax benefit of the corporate deduction is a credit to earnings or equity.

15 Nil cost option awards will be exempt from the requirements of Code section 409A under the "short-term deferral rule" where the award must be settled no later than March 15 of the year following the year the award vests. Alternatively, a fixed exercise date or schedule can be established to comply with the requirements of Code section 409A.

TYPE	DESCRIPTION	TAXATION	ACCOUNTING
RESTRICTED STOCK UNITS (RSUs)	Grant of units each representing the equivalent of one share of stock. Units can be settled in actual shares of stock or in cash after vesting requirements (years of service or performance vesting) are met. Can provide for deferral of time of settlement beyond vesting date, subject to compliance with Code section 409A.	Employee: Ordinary income tax at time of settlement (regardless of vesting date), subject to compliance with Code section 409A, on fair market value of actual shares or amount of cash received at settlement. FICA taxes payable at vesting. May be treated as deferred compensation, resulting in taxation at time of vesting plus 20% additional tax (plus interest penalty) on employee, unless timing of exercise restricted to be exempt from Code section 409A or Code section 409A requirements are satisfied.[16] Employer: Deduction equal to fair market value of stock or cash paid in same year employee recognizes income. FICA tax at vesting.	Generally same as for restricted stock where settlement will be in actual stock – expense based on fair market value of underlying shares at time of grant, charged to earnings over service period. If unit can be settled in cash at election of employee (or can only be settled in cash), fluctuations in value of stock during service period will result in fluctuations in expense. Tax benefit of the corporate deduction is a credit to earnings or equity.
STOCK APPRECIATION RIGHTS (SARs)	Contractual right to receive appreciation in value of company stock over period of time. Can be granted alone or in tandem with stock options. Appreciation can be paid in cash or in shares.	Employee: No tax at grant. Taxed at ordinary income tax rates on cash and shares (if any) received upon exercise, plus FICA tax. If maximum "cap" put on appreciation, may be taxed prior to exercise if cap is reached. If starting point in measuring appreciation is less than fair market value of stock at time of grant, will be treated as deferred compensation, resulting in taxation in first year SAR is exercisable plus 20% additional tax (and interest penalty) on employee, unless timing of exercise restricted to be exempt from Code section 409A or Code section 409A requirements are satisfied.[17] Employer: Deduction equal to ordinary income recognized by employee in same year employee recognizes income. FICA tax at exercise.	Expense measured based on fair value of SAR at time of grant. Charged to earnings over period services are to be performed. If SAR can be settled in cash at election of employee (or can only be settled in cash), fluctuations in stock value during service period will result in fluctuations in expense. Tax benefit of the corporate deduction is a credit to earnings or equity.

16 RSU awards will be exempt from the requirements of Code section 409A under the "short-term deferral rule" where the award must be settled no later than March 15 of the year following the year the award vests. Alternatively, a fixed settlement date or schedule can be established to comply with the requirements of Code section 409A.

17 SAR awards will be exempt from Code section 409A under the "short-term deferral rule" where the optionee must exercise the option no later than March 15 of the year following the year the option vests. Alternatively, restrictions on the exercise period can be established to comply with the requirements of Code section 409A.

TYPE	DESCRIPTION	TAXATION	ACCOUNTING
PHANTOM STOCK	Use of hypothetical shares to provide payments similar to stock option, stock grant or SAR plan. Payout can be in cash or shares. Payout can be based on full value of phantom share, or just on appreciation. Can provide for deferral of time of settlement beyond vesting date, subject to compliance with Code section 409A.	Employee: No tax at grant. FICA tax payable at vesting. Taxed at ordinary income tax rates at the time employee has right to receive payment. Most likely treated as deferred compensation, resulting in taxation at time of vesting plus 20% additional tax (plus interest penalty) on employee, unless timing of settlement restricted to be exempt from Code section 409A or Code section 409A requirements are satisfied.[18] Employer: Deduction equal to ordinary income recognized by employee in same year employee recognizes income. FICA tax at vesting.	Expense recognized equal to value of anticipated payout. Charged to earnings over period services are to be performed. Fluctuations in anticipated value during this period will result in fluctuations in expense. Tax benefit of the corporate deduction is a credit to earnings.
PERFORMANCE UNITS	Represent right to receive payments in future based on company achieving specified long-term performance goals (3-5 years). Goals can be based on any number of measures (e.g., EPS, ROE, ROA, comparisons with industry benchmarks). Payments can be in cash or in shares. Can provide for deferral of time of settlement beyond vesting date, subject to compliance with Code section 409A.	Employee: No tax at grant. FICA tax payable at vesting. Taxed at ordinary income tax rates at the time employee has right to receive payment. Most likely treated as deferred compensation, resulting in taxation at time of vesting plus 20% additional tax (plus interest penalty) on employee, unless timing of settlement restricted to be exempt from Code section 409A or Code section 409A requirements are satisfied.[19] Employer: Deduction equal to ordinary income recognized by employee in same year employee recognizes income. FICA tax at vesting.	Expense recognized equal to value of anticipated payout. Charged to earnings over period services are to be performed. Fluctuations in anticipated value will result in fluctuations in expense. Tax benefit of the corporate deduction is a credit to earnings.

18 Phantom stock awards will be exempt from the requirements of Code section 409A under the "short-term deferral rule" where the award must be settled no later than March 15 of the year following the year the award vests. Alternatively, a fixed settlement date or schedule can be established to comply with the requirements of Code section 409A.

19 Performance unit awards will be exempt from the requirements of Code section 409A under the "short-term deferral rule" where the award must be settled no later than March 15 of the year following the year the award vests. Alternatively, a fixed settlement date or schedule can be established to comply with the requirements of Code section 409A.

TYPE	DESCRIPTION	TAXATION	ACCOUNTING
EMPLOYEE STOCK PURCHASE PLAN (ESPP)	Broad-based plan allowing employees to purchase employer stock (usually at a discount up to 15%). Discounted purchases may receive favorable tax treatment if plan complies with certain requirements (Code section 423). ESPP is essentially a broad-based option plan. Stockholder approval is required.	Employee: Taxed when shares acquired at a discount (ordinary income equal to discount). However, if plan complies with Code section 423, employees will not be taxed at acquisition, and instead will be taxed when shares are subsequently sold. In a qualifying disposition, a portion of the gain up to an amount equal to the discount from fair market value at time of grant is taxed at ordinary income tax rates; the remainder of the gain is taxed at capital gain tax rates. Employer: Deduction equal to discount from fair market value at time of grant. However, under a Code section 423 plan, employer will get no deduction unless and until employee sells shares prior to expiration of holding period.	Fair value of options at date of grant expensed over service period (typically, vesting period). Fair value in most cases must be determined using valuation formula (e.g., Black-Scholes or lattice model). Under safe harbor, no expense recognized provided that (i) plan is broad-based, (ii) discount does not exceed 5% (based on fair market value at time of purchase) and (iii) purchase price is not based on either value of stock at time of grant or lesser of value at time of grant or time of purchase (look-back). Any tax benefit is a credit to equity.

CHAPTER 6

UNITED STATES IMMIGRATION LAW

By Woon-Wah Siu

Introduction

The immigration laws in the United States are administered by the Bureau of Citizenship and Immigration Services (USCIS), formerly known as the Immigration and Naturalization Service, of the Department of Homeland Security, the Department of State, and the Department of Labor. These federal agencies sometimes coordinate with state government departments such as the state departments of labor.

Generally, a citizen of a non-U.S. country who wishes to enter the United States must first obtain a visa, either a non-immigrant visitor visa for short-term stay, or an immigrant visa for permanent residence. non-U.S. employers who wish to send their employees to the United States either for business meetings or to work for extended periods must obtain visas for these employees.

Visa applications should be submitted to the U.S. embassy or consulate with jurisdiction over an applicant's place of permanent residence. Although it may be possible to apply for a visitor visa in a jurisdiction other than one's place of permanent residence, it is much more difficult to obtain a visa that way. Other categories of visas, such as employment-related visas, require the prior approval of USCIS and possibly one or more other federal agencies before issuance by the local U.S. embassy or consulate.

Visitor Visas

B-1 Visa – Business Visitor Visa

An individual who intends to enter the United States as a temporary visitor for business may apply for a B-1 visa. The B-1 visa permits the holder to enter the United States to attend business meetings and seminars, negotiate contracts, litigate, consult with clients or business associates, solicit orders for goods manufactured outside the United States and explore investment opportunities. The B-1 visa holder may not work or receive any remuneration (other than certain incidental expenses) in the United States.

A B-1 visa may be issued for a period ranging from one month to several years, but the period of initial admission into the United States may not be longer than one year. Typically, B-1 visa holders are authorized to enter into the United States for six months or less at a time. Once in the United States, the person may be able to obtain extensions of stay for additional six-month periods.

B-2 Visa – Visitor for Pleasure Visa

An individual who intends to enter the United States for pleasure or medical treatment may apply for a B-2 visa. Similar to the B-1 visa, a B-2 visa may be issued for a period ranging from one month to several years, and the maximum period of initial admission cannot be more than one year. Usually the initial period of stay granted is for no more than six months. B-2 visas may be issued to spouses and children who accompany B-1 business visitors, or to dependents of other non-immigrants, if they do not qualify for another visa. Canadian and Bermuda nationals generally do not need a visa to enter the United States if they are traveling for visitor visa purposes.

Visa Waiver Program (VWP)

VWP allows individuals from specified countries who would otherwise qualify for business (B-1) or pleasure (B-2) visitor visas to enter the United States for a period of up to 90 days without obtaining visas. To qualify for VWP, an individual must enter the United States with a return trip ticket, have an unabandoned non-U.S. residence, not be entering the United States for the purpose of employment and not receive any remuneration in the United States. VWP participants may not extend their period of stay or change their status in the United States.

Persons from the following countries are currently eligible to enter the United States under the VWP: Andorra, Australia, Austria, Belgium, Brunei, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Monaco, The Netherlands, New Zealand, Norway, Portugal, San Marino, Singapore, Slovakia, Slovenia, South Korea, Spain, Sweden, Switzerland and the United Kingdom.

Prior to traveling to the United States under VWP, eligible nationals from all VWP countries must obtain approval through the Electronic System for Travel Authorization (ESTA) (**esta.cbp.dhs.gov/esta/**), a fully automated, Internet-based electronic system for screening passengers before they begin travel to the United States under VWP.

H-1B Visa – Visa for Temporary Worker in a Specialty Occupation

A "specialty occupation" is an occupation that requires a university degree. A person coming to the United States to take up employment in a specialty occupation may qualify for an H-1B visa. If the specialty occupation requires licensure, the person must have full state licensure to obtain the visa. If an applicant does not have an appropriate degree, equivalent work experience must be demonstrated and evaluation from an expert must be obtained. There is an annual quota, although some applicants may be exempt from the quota and, further, there is an additional quota for individuals holding masters or higher degrees granted by a U.S. university.

To obtain an H-1B visa for an employee, an employer must file a Labor Condition Application (LCA) and post a copy at its principal place of business or the employee's place of employment. The employer is required to certify in the LCA that: (1) it will pay the H-1B applicant the higher of the prevailing wage in the region or the actual wage in the workplace for the position; (2) employment of the H-1B applicant will not adversely affect the working conditions of workers similarly employed by the employer; (3) at the time of filing, no strike or lockout is occurring in the applicant's occupation at the workplace; and (4) the employer has provided notice of the filing of the LCA to the relevant collective bargaining representative, if one, or has conspicuously posted the LCA in the workplace. The employer must also keep certain records and make them available for public inspection. If an employer has a large number of H-1B workers in proportion to U.S. workers, the employer may be deemed "H-1B dependent" and may be subject to additional restrictions on its ability to employ H-1B workers.

The LCA must be approved by the U.S. Department of Labor before the USCIS approves the H-1B petition. After the USCIS has approved the employer's H-1B petition, the individual may apply for the visa at a U.S. embassy or consulate abroad. H-1B visas are available for an initial period of up to three years, and they may be renewed for a period of up to three additional years. The spouse and minor children of a H-1B visa holder may obtain H-4 visas.

L-1 – Intracompany Transferee Visa

The L-1 visa enables a U.S. employer, including the U.S. affiliate of a non-U.S. company, to transfer an executive or manager from one of its non-U.S. offices to one of its offices in the United States. The executive or manager must have worked for the employer outside the United States for at least one year in the last three years immediately preceding his or her admission to the United States and be entering the United States to be employed in an executive or managerial capacity by a branch or an affiliate of the same employer.

The employer must file a petition on behalf of the individual with the USCIS in the United States. After the USCIS has approved the petition, the individual may apply for a visa at a U.S. embassy or consulate abroad.

The L-1 visa also enables a non-U.S. company that does not yet have a U.S. office to send an executive or manager to the United States for the purpose of establishing an office. The business must be viable, but it need not be engaged in international trade. The employer must show that (i) it has secured sufficient physical premises to house the new office, (ii) the employee has been employed as an executive or manager for one year in the three years preceding the filing of the petition, and (iii) the intended U.S. office will support an executive or managerial position within one year of approval of the petition.

L-1 visas are valid for an initial period of up to three years (one year for employees entering the United States to establish a new office). L-1 visas may be extended for up to four additional years for executives and for up to two additional years for individuals with specialized knowledge. The spouse and minor children of an L-1 visa holder may obtain L-2 visas.

Certain employers may establish the required intracompany relationship in advance of filing individual L-1 petitions by filing a blanket petition. Approval of a blanket L petition does not guarantee that an employee will be granted an L-1 visa. Because the employer does not have to file individual petitions with the USCIS, an approved blanket L petition provides a means for the employer to transfer eligible employees to the United States quickly and with short notice.

E Visa – Treaty Trader and Investor Visa

E-1 visas for treaty traders or E-2 visas for treaty investors are available to certain executives, managers and individuals with essential skills, who are nationals of a non-U.S. country that has entered into a treaty of commerce and navigation with the United States and who seek to enter the United States pursuant to the provisions of the treaty.

To obtain an E-1 visa, an individual must be entering the United States as an executive, manager or employee with specialized knowledge of a company that carries on substantial trade between the United States and the non-U.S. country.

To obtain an E-2 visa, an individual must be entering the United States as an executive, manager or employee with specialized knowledge of an enterprise in which the individual or the individual's employer has invested or is actively in the process of investing a substantial amount of capital.

A company wishing to send an employee to the United States under an E visa must first file an application with a U.S. embassy or consulate in the company's home country to register the company as an organization eligible for the issuance of E visas. The validity of E visas depends on reciprocity provisions with the non-U.S. country. For many countries, E visas are valid for up to five years. Typically, individuals who hold E visas are admitted into the United States for an initial period of two years. Extensions of stay are available in two-year increments as long as the individual continues to meet the requirements for E-1 or E-2 status. E-1 and E-2 visas are available to the spouse and minor children of E-1 and E-2 visa holders.

O Visa – Visa for Individual of Extraordinary Ability or Achievement

An O-1 visa may be granted to an individual with extraordinary ability in the sciences, arts, crafts, education, business or athletics (O-1A), or who has a demonstrated record of extraordinary achievement in the motion picture or television industry and has been recognized nationally or internationally for those achievements (O-1B).

O-1 visas are issued for an initial period of up to three years, and may be extended in one-year increments thereafter.

O-2 visas are granted to individuals who accompany an O-1 artist or athlete to assist in a specific event or performance. For an O-1A visa holder, the O-2 visa holder's assistance must be an "integral part" of the O-1A holder's activity. For an O-1B visa holder, the O-2 visa holder's assistance must be "essential" to the completion of the O-1B holder's production. The O-2 worker has critical skills and experience with the O-1 holder that cannot be readily performed by a U.S. worker and that are essential to the successful performance by the O-1 holder.

The accompanying spouse and minor children of O-1 visa holders may obtain O-3 visas.

Work Authorization for Practical Training

Certain persons who have been in the United States as students or exchange visitors are eligible for temporary employment either during or upon completion of their studies or exchange programs.

F-1 Practical Training. The F-1 visa is granted to students enrolled full-time at a U.S. college, university or other qualifying educational institution. Students with F-1 visas who are in a bachelor's, master's or doctoral degree program may obtain employment authorization for temporary employment for up to one year during vacation periods or after completion of the studies. The person's employment must be related to his or her major area of study. This means that an employer may hire a non-U.S. student directly out of college for a period of up to one year under the practical training component of the F-1 visa. The spouse and minor children of F-1 visa holders may obtain F-2 visas.

J-1 Practical Training. J-1 visas may be granted to trainees who enter the United States to receive training in their area of specialty from an employer in the United States for up to 18 months. Employers in the United States may employ J-1 trainees under a sponsoring J-1 program recognized by the U.S. Department of State for up to 18 months. The spouse and minor children of J-1 visa holders may obtain J-2 visa status.

EB-5 Immigrant Investor Program

The EB-5 program was created by the U.S. Congress in 1990 to stimulate the U.S. economy through job creation and capital investment by non-U.S. investors. Under the pilot program first enacted in 1992 and most recently extended in 2009, certain EB-5 visas are set aside for investors in Regional Centers that are designed by USCIS based on applicants' proposal for promoting economic growth. Section 203(b)(5) of the U.S. Immigration and Nationality Act allocates 10,000 EB-5 immigration visas each year, of which (i) 3,000 visas are reserved for non-U.S. investors who invest in targeted employment areas (TEAs) and (ii) 3,000 visas are reserved for non-U.S. investors who invest in commercial enterprises affiliated with Regional Centers.

Investment in a New Commercial Enterprise

EB-5 investors must invest in a new commercial enterprise, which is a for-profit activity formed for the ongoing conduct of lawful business and:

- Established after November 29, 1990, or
- Established on or before November 29, 1990, which is:
  - Purchased and the existing business is restructured or reorganized in such a way that a new commercial enterprise results, or
  - Expanded through the investment so that a 40% increase in the net worth or number employees occurs.

Capital Investment

Capital can be cash or cash equivalents, equipment, inventory, other tangible property and debt secured by assets owned by the non-U.S. entrepreneur, provided that the non-U.S. entrepreneur is personally and primarily liable and that the assets of the new commercial enterprise based on which the petition is made are not used to secure any of the debt. The required minimum qualifying investment by the non-U.S. entrepreneur in the United States is US$1 million, except in the case of a TEA where the minimum requirement is US$500,000. A TEA is either a high unemployment area (calculated as an area with an unemployment rate that is at least 150% of the national average in the United States) or a Rural Area.

Job Creation

The investment must create or, in the case of a troubled business, preserve at least 10 full-time jobs for qualifying U.S. workers within two years (or under certain circumstances, within a reasonable time after the two-year period) of the investor's admission to the United States as a Conditional Permanent Resident. Direct and indirect creation or preservation of jobs are permitted:

- Direct jobs are actual identifiable jobs for qualified employees located in the commercial enterprise in which the EB-5 investor has directly invested capital.
- Indirect jobs are jobs shown to have been created collaterally or as a result of capital invested in a commercial enterprise affiliated with a regional center by an EB-5 investor. A non-U.S. investor may only use the indirect job calculation if affiliated with a regional center.

Regional Center

A Regional Center is any public or private economic entity, which is involved with the promotion of economic growth, improved regional productivity, job creation and increased domestic capital investment. The organizers of a regional center seeking the "Regional Center" designation from USCIS must submit a proposal, supported by economically or statistically valid forecasting tools, showing (i) how the regional center plans to focus on a geographical region within the United States, (ii) in verifiable detail, how jobs will be created directly or indirectly through capital investments made in accordance with the regional center's business plan; (iii) the amount and source of capital committed to the regional center and the promotional efforts made and planned for the business project; and (iv) how the regional center will have a positive impact on the regional or national economy. A complete list of approved Regional Centers is available online at **www.uscis.gov/eb-5centers**.

Regional Center designation does not mean that the regional center's capital investment projects are backed or guaranteed by the United States or state government.

Removal of "Conditional" Status

After 21 but before 24 months after the grant of Conditional Permanent Resident status, the investor immigrant must petition to remove the conditions by confirming that the investor has made and maintained the investment and the required jobs have been created or preserved. If the petition is approved, a permanent Green Card will be issued to the investor immigrant. A Green Card will enable its holder to apply for U.S. citizenship after the holder has resided in the United States for five years.

Immigration Law Compliance

The Immigration Reform and Control Act of 1986 (IRCA) prohibits employers from employing, recruiting or referring for a fee any person who is not authorized to work in the United States. IRCA also requires employers to verify the identity and employment eligibility of all regular, temporary, casual and student employees in the United States. Employers and employees must complete an Employment Eligibility Verification Form I 9. Furthermore, employers are required to inspect employees' employment authorization and identity documents and maintain records of such documents. Employers of four or more employees may not discriminate in hiring or discharge on the basis of citizenship status and national origin.

Failure to comply with IRCA can subject an employer to a range of fines and possible criminal penalties. Penalties for noncompliance with record-keeping requirements can range from $100 to $1,000 per violation, even if the employee is legally employed. Penalties for employing an illegal alien can range from $250 to $2,000 for the first violation; from $2,000 to $5,000 for the second violation; and from $3,000 to $5,000 for the third and subsequent violations. In addition, in case of a pattern and practice of violations of IRCA's hiring and referral provisions, employers can be fined $3,000 per illegal alien and be imprisoned up to six months. Violation of the antidiscrimination provisions of IRCA can lead to awards of reinstatement, backpay and attorney fees, in addition to civil fines.

It is also unlawful knowingly to forge any document, or possess or use any forged document, for the purpose of satisfying IRCA's work authorization verification requirements. An employer who knowingly accepts fraudulent documents for I-9 purposes can be subject to both civil and criminal penalties. Civil penalties for document fraud can range from $250 to $5,000 (depending on the number of violations) for each instance of use, acceptance or creation of a fraudulent document.

The immigration laws also prohibit anyone from encouraging a person to enter or bringing a person to enter the United States unlawfully or harboring or transporting an illegal alien into the United States. Anyone who violates these laws is subject to criminal penalties and to government seizure of any vessel, vehicle or aircraft used to bring in, harbor or transport an illegal alien to or in the United States.

To ensure ongoing compliance with U.S. immigration laws, employers should perform internal audits of their immigration and IRCA procedures with the assistance of counsel.

CHAPTER 7

UNITED STATES INTERNATIONAL TRADE AND INVESTMENT

By Nancy A. Fischer and Aaron R. Hutman (with contributions from Stephan E. Becker, Noman A. Goheer, and Benjamin J. Cote)

Introduction

Companies successful in doing business in the United States are those who anticipate, understand and comply with laws and regulations impacting international trade and investment. Such rules have several sources including the U.S. Constitution, treaties and implemented international agreements, statutes, regulations, administrative guidance, judicial decisions and in some cases state and local law. These rules can apply to conduct and business transactions both inside and outside the United States.

U.S. international trade, business and investment laws have been developed to address a number of legal and policy goals. Many of the U.S. trade laws were implemented to comply with international obligations such as the WTO or to address national security concerns through foreign investment restrictions or export controls on sensitive technology. Domestic political interests also can impact the interpretations of existing laws to satisfy special interests. Consequently, successful companies will engage experts to assist with navigating these requirements and anticipating potential road blocks to avoid adverse impacts on a company's investment or its business transactions with the United States.

This chapter will explore several of the key legal regimes that impact business, trade and investment in the United States. In doing so, it also will explore how advance planning in import, export, business transactions and investment is critical under U.S. law. This includes:

- Knowing how to minimize potential import duties, anticipating and successfully navigating trade remedy investigations, and identifying other investment tariff barriers such as those that may apply to particular technologies or industries.
- Compliance planning and training to deal with diverse and at times overlapping regulatory regimes and criminal statutes affecting international trade and business—export controls, sanctions policies, anti-money laundering rules, and anti-corruption laws.
- Communicating mistakes (often inadvertent) to government regulators—transparency and voluntary disclosure is often rewarded in the U.S. system.
- Planning sensitive investments in advance with counsel to navigate regulatory and political channels.

Awareness and understanding of rules, advance planning, demonstrating an intent to comply with applicable laws and transparency generally are more important than developing relationships or favor with government or elected officials.

One final note is that it is increasingly easy for individuals and businesses to access information on U.S. rules via the internet. All U.S. government agencies have web sites and most include helpful summaries, guidance, past decisions, published regulations and relevant statutes. This chapter will provide website information in several sections below. Many of these rules and legal regimes are complex, and seeking the advice of experts is advisable, but online tools make the first step to learning and asking questions more accessible.

Importing and Exporting

The movement of goods into and out of the United States is controlled by the U.S. federal government, which operates a Customs infrastructure, sets and collects import duties and applies several regulatory regimes to ensure fair trade and to protect public safety, health and national security. Many elements of the U.S. trade system will be familiar. The United States is a member of the WTO, participates in the World Customs Organization (WCO) and employs the Harmonized Commodity Description and Coding System (Harmonized System).

Other elements may not be as familiar or are applied in a particular way in the United States. For imports, there are several trade laws and treaties that may affect import duties—the tax applied on the entry of goods into a country. The United States also operates a system for trade remedies via the International Trade Commission (ITC) and the Commerce Department designed to monitor fair trade, ensure compliance with WTO rules and in some cases protect U.S. industry. There are also several different agencies that regulate health and safety of imported goods, plants, animals and substances. Finally, individual states can have additional laws that may affect trade.

While there are no duties on the exports of goods or technologies from the United States, there are several relevant legal regimes. The export of items or technologies that can have both commercial and defense uses are regulated by the Commerce Department's Bureau of Industry and Security (BIS), while the export of defense articles and technical data are regulated by the State Department's Directorate of Defense Trade Control (DDTC). Sanctions regimes that may impact trade or transactions with certain countries, companies and individuals are operated by the Department of Treasury's Office of Foreign Assets Control (OFAC). In addition, the United States has anti-boycott laws that prevent U.S. companies from participating in or supporting certain countries' boycotts.

Importing into the United States

Customs

Each import into the United States undergoes entry through the U.S. Customs system. The Bureau of Customs and Border Protection (CBP) within the Department of Homeland Security oversees the Harmonized Tariff Schedule of the United States (HTSUS), import valuation, markings, rules of origin, duty drawback and foreign trade zones, as well as administrative and penalty procedures. Understanding these rules can allow a foreign company or U.S. importer to develop an import strategy that reduces tariff/duty expenses, navigates regulations and improves logistical efficiency. The CBP website has further information—**www.cbp.gov**.

CBP oversees the importation of goods through designated ports of entry. Many goods are subject to customs duties, and the rate depends on the proper classification of the items under the HTSUS and country of origin. All products imported into the United States must be marked with their country of origin in a manner that will be visible to the ultimate purchaser in the United States. In addition, the value of imported products declared to the customs authorities (to which the customs duty and user fee rates are applied) is subject to special rules on valuation. These rules can be particularly complex when the U.S. importer is related to the foreign exporter. Finally, there are sector-specific rules for imports of various categories of products, such as food products, communications devices, medical-related items, etc.

Goods are not immediately subject to duties when delivered to a Foreign Trade Zone (FTZ) or bonded warehouse. FTZs are physically within the United States and consist of (a) General-Purpose Zones—specified facilities used by multiple firms (such as ports or industrial parks) and (b) Subzones—usually a single firm's site where manufacturing, processing, warehousing or distribution takes place. FTZs can be a beneficial tool for foreign companies as they are legally outside customs territory for tariff and customs entry processes. Goods brought into a FTZ may be further processed or assembled, allowing for strategic tariff categorization based on the final product when it leaves the FTZ. Bonded warehouses provide similar tariff deferment benefits, but without the ability to further process the product.

Import Duties

The import duties that apply to goods vary based on the category of imported item and country of origin—in particular, whether the country has WTO "Most Favored Nation" status (now called "Permanent Normal Trade Relations" or "NTR"), is subject to a free trade agreement or is subject to one of the U.S. trade preference programs. These three considerations are all discussed in the sections directly below.

Other than the duty which applies, U.S. law generally treats like goods imported from different countries the same for regulatory purposes[20] and, once in the United States, applies the same rules to foreign products as to domestic products. Thus, it is important to understand how to find tariff rates and what general and specific policies affect those rates when crafting business strategies. We will also discuss trade remedies below, which can add extra duties on top of the tariff rates.

The HTSUS records goods and tariffs along with country information and is maintained by the ITC. The HTSUS is based on the Harmonized System organized by the WCO. For each classification, the HTSUS indicates a general tariff rate, a special tariff rate and another, higher, tariff rate for countries not having NTR. The HTSUS can be accessed online at **hts.usitc.gov**.

20 The primary exception would be for items from a country subject to a sanctions regime, as discussed below.

Note that in limited cases goods may be subject to “tariff rate quotas” or “trade preference levels.” This means that a certain amount of the goods may be imported at a low rate, but after the quota is met further imports are subject to a higher rate (often the non-NTR rate). Goods subject to tariff rate quotas have included sugar, cheeses, cotton and certain textiles.

Policy Affecting Import Duties—WTO, Free Trade Agreements and Preferences

World Trade Organization

The WTO is the most significant multilateral trade mechanism in which the United States participates, negotiates with other countries and resolves trade disputes. Each WTO member agrees to accord other members NTR status. This means that the lowest negotiated tariff rate agreed to with one WTO member generally must be offered to all other members. WTO agreements seek to remove non-tariff barriers to trade, provide a framework to lower tariffs around the world and require members to provide “national treatment” to imported items, meaning that imported items will be treated for legal purposes the same as domestic goods after import into a country (import duties may apply prior to entry).

Several agreements make up the organization of the WTO. The agreements address trade in goods (General Agreement on Tariffs and Trade, or GATT), rules for trade in services (General Agreement on Trade in Services, or GATS), protection of intellectual property (Agreement on Trade Related Aspects of Intellectual Property Rights, or TRIPS), investment measures (Agreement on Trade Related Investment Measures, or TRIMS) and other areas affecting international commerce. The WTO agreements also provide for trade remedies in the case of “unfair trade”—anti-dumping and countervailing duty action—and safeguards for domestic industry. The United States has legal regimes consistent with these agreements, as addressed below.

The WTO’s legal arm, the Dispute Settlement Body (DSB), is a global arbiter of international trade issues. Decisions by the DSB (and its Appellate Body) require countries to bring non-conforming measures into compliance and failure to do so may be subject to retaliation by winning parties in the form of tariffs imposed on the losing countries’ goods or services. Developing countries and emerging powers such as China and India have become more active in taking advantage of the DSB.

It is up to individual member countries to implement WTO obligations via national laws and regulations. With regard to NTR status, the United States designates these rates for WTO member countries and several other countries under the HTSUS. Presently only two countries, Cuba and North Korea, do not have NTR status in trade with the United States.

Free Trade Agreements (FTAs)

As WTO negotiations under the present Doha Round have stalled over the last decade, there has been an explosion of multilateral and bilateral FTA negotiations around the world. These agreements allow tariff-free or lower-duty access to most or all goods traded between countries. The rates are often lower than the NTR tariffs under the WTO and are not required by WTO rules to apply to all other WTO members. The benefits accrue to goods from or produced or processed in the countries that make the agreement and there are "rules of origin" that are specific to each FTA. In addition, FTAs usually address other commitments to open markets including trade in services (such as telecommunications or banking), intellectual property protections, and labor and environmental commitments.

The United States is a member of two multilateral FTAs: the North American Free Trade Agreement (NAFTA) for North America and the Dominican Republic and Central American Free Trade Agreement (DR-CAFTA) agreement. It also has several bilateral agreements in place. Between the multilateral and bilateral agreements, the United States currently has FTA arrangements with:

> Australia, Bahrain, Canada, Chile, Colombia, Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, Israel, Jordan, South Korea, Mexico, Morocco, Nicaragua, Oman, Panama, Peru and Singapore.

For further information on the individual agreements, go to **www.ustr.gov/trade-agreements/free-trade-agreements**.

The United States is currently exploring a larger multilateral FTA in the Trans-Pacific Partnership Agreement (TPP). The present participants in the negotiations are Australia, Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, Vietnam, and the United States, some of which already have FTAs with the United States which would be expanded by the TPP negotiations. In addition, the Philippines, South Korea, Taiwan, and Thailand have expressed interest in membership. China has been absent from the negotiations thus far. A large-scale FTA like TPP has the potential to significantly change the trade dynamics of the Pacific Rim.

Also under consideration is a transatlantic trade framework between the United States and European Union. This is currently named the Transatlantic Trade and Investment Partnership (TTIP) negotiations and is the subject of ongoing meetings as of the time of this publication.

Preferences

The United States has several regimes for "preferences" which lower import duties for a number of countries. These preference rates are lower than the "bounded" tariff rates agreed to for WTO members and made on a voluntary basis by the United States. The goals of preferences are usually to support development in poorer countries and U.S. foreign policy interests.

The broadest preference program, had been the U.S. Generalized System of Preferences (GSP), which provides duty-free treatment for several thousand products from designated developing countries—123 nations as of July 2013—when legal authorization expired. As of October 2014, the U.S. Congress is considering legislation that would extend its authorization. Other preference programs include:

- African Growth and Opportunity Act (AGOA) (2000)—This program provides duty free treatment for most goods from sub-Saharan African countries that the U.S. deems to have met criteria relating to market-based economies, rule of law, poverty reduction, worker rights, and anti-corruption. 39 sub-Saharan African countries were eligible for AGOA benefits as of September 2014.
- The Andean Trade Preferences Act provides duty free treatment or preferential tariffs for goods imported from Bolivia, Colombia, Ecuador, and Peru.
- The Caribbean Basin Initiative provides duty-free access for goods from seventeen countries in the Caribbean and Central America.

Information on U.S. preference programs can be found on the U.S. Trade Representative (USTR) website at **www.ustr.gov/trade-topics/trade-development/preference-programs**.

Trade Remedies

Overall duties for imported items can be impacted, in some cases significantly, by U.S. trade remedy actions. U.S. law provides for administrative procedures under which special duties can be applied on the import of goods to counteract unfair trade by or benefiting the foreign companies. In other words, these trade-remedy duties are added on top of the normal tariff rate. Claims of unfair trade—dumping or subsidies by foreign governments—are adjudicated by the Department of Commerce's International Trade Administration (ITA) and by the ITC. There also are provisions under Section 301 of the Trade Act of 1974 to respond to another country engaging in unfair trade practices, including where the WTO authorizes retaliation. Finally, Section 337 proceedings before the ITC allow the banning altogether of unfairly traded goods mainly in response to patent infringement. As addressed below, Section 201 (i.e., Safeguards actions) actions offer a means for the United States to provide protection for a given U.S. industry even in the absence of unfair trade by a foreign party or country mainly addressing surges in imports.

Antidumping and Countervailing Duty Remedies

Antidumping (AD) duties are imposed when a foreign company sells merchandise in the U.S. market for a lower price than it sells the product in its own country or in a comparable export market. In order to determine the dumping margin (the difference between the price of the product in its own country and the price in the U.S. market), the Department of Commerce's ITA conducts an investigation that determines the comparison price between the foreign market and the home market. See **www.trade.gov**. In a parallel proceeding, the ITC determines whether the U.S. industry is materially injured or retarded by the alleged dumping. See **www.usitc.gov**. Affirmative findings of both dumping and material injury to U.S. industry are required in order to impose anti-dumping duties.

Countervailing duties (CVD) are imposed when the ITA determines that a foreign government, person, or organization is providing a subsidy conferring an economic benefit to a "class or kind" of merchandise being exported to the United States. Just as with anti-dumping claims, the ITC must also find injury to the U.S. industry. Foreign companies should keep in mind that actionable subsidies include both benefits conferred directly on exports and benefits that indirectly subsidize exports.

Anti-dumping and CVD actions are brought by interested parties with standing—usually a U.S. manufacturer or industry group, but this can also include domestic trade unions. For CVD matters, the U.S. government also can initiate the action. In many industries that traditionally have seen significant AD and CVD case activity, such as steel production, U.S. companies have increasingly become part of foreign conglomerates, either due to industry consolidation or deliberate purchasing. Thus, in recent years, a larger share of new cases have been brought by U.S. trade unions or other non-company industry representatives.

Findings in anti-dumping, CVD and other proceedings described above normally are appealed through the U.S. court system to the Court of International Trade (a special federal district court with jurisdiction over actions relating to customs and international trade laws).[21] For actions involving Canada or Mexico, participants in U.S. anti-dumping and countervailing cases can appeal decisions to special appeals panels under Article 1904 of the NAFTA agreement. Finally, members of the WTO may appeal decisions made under U.S. law to the DSB to determine whether the decision violates the United States' WTO obligations.

Several key rules relating to AD and CVD cases have been in flux in recent years. In particular, (1) recent court cases and legislation have addressed the application of CVD rules to non-market economies (NMEs), (2) double-counting between AD and CVD duties and (3) the practice of "zeroing" in AD cases.

GPX Court Decision and Subsequent Legislation

In what would have been a major change in U.S. trade remedy law, the Federal Circuit (the highest court for trade appeals before the Supreme Court) ruled in GPX International Tire Corp. v. USA on December 19, 2011 that CVD law could not apply to NMEs such as China. The Court reasoned that because NMEs are inherently directed by the state, government payments cannot be characterized as subsidies. Under

21 Further appeals can be made to the U.S. Court of Appeals for the Federal Circuit. In rare cases, the Supreme Court will hear Federal Circuit cases.

political pressure from domestic constituencies, the U.S. Congress responded quickly, passing a bill that essentially nullified the Federal Circuit's decision and allowed the United States to continue its application of CVD rules to China and other NMEs. President Obama signed the bill into law on March 13, 2012.[22]

Double Counting

The same bill passed in response to the GPX decision also sought to bring U.S. anti-dumping law into compliance with a WTO ruling that called on the ITA to adjust its AD calculations for NMEs to ensure subsidies subject to CVD duties were not being "double counted" where concurrent AD and CVD duties were imposed on NME imports. It is possible the issue may be brought to the WTO for further resolution.

Zeroing

On February 14, 2012, the Department of Commerce (DOC) issued a final rule that eliminated a long-standing practice known as "zeroing" from administrative reviews. After an AD investigation determines that an AD duty should be imposed, the order undergoes yearly "administrative" reviews. During this review, Commerce recalculates the foreign market price and the U.S. price, the difference of which determines the AD duty going forward. When determining the dumping margin (and hence the AD duty), if the U.S. price is higher than the normal value, the margin is positive. If the U.S. price is lower than the normal value, the margin is negative. Zeroing refers to the practice of consolidating all of the positive dumping margins and setting them to zero. The negative dumping margins are then used to determine the AD duty. In effect, this precludes positive dumping margins offsetting negative dumping margins. The elimination of zeroing in AD cases likely will result in lower dumping margins in most investigations and administrative reviews, while possibly eliminating them completely in others. This will be to the advantage of the foreign parties involved in these cases. However, DOC has the discretion to use alternative methodologies, including zeroing, when it "determines another method is appropriate in a particular case." Thus, it would be prudent for parties ensnared in an AD case, or whose activities could make them a target for one, to stay updated on developments in this area.

Safeguards under Section 201

Section 201 proceedings act as a safeguard measure for U.S. industries. Under Section 201(b) of the U.S. Trade Act of 1974, reflecting the GATT "escape clause" and the WTO Agreement on Safeguards, the President of the United States may provide relief to a domestic industry when imported articles are a "substantial cause" of "serious injury" to the industry. Relief can take the form of higher tariffs, quantitative restraints on import, or a combination of both, and in some cases also adjustment assistance to workers in the industry. A section 201 proceeding takes place before the ITC, which

22 A rehearing was sought in the GPX case to apply the law retroactively in the earlier litigation. GPX is opposing the retroactive application as unconstitutional. This case should continue to draw attention as it proceeds.

considers injury issues and makes a recommendation to the President. The President ultimately decides whether to provide relief to the domestic industry and in what form. As a result, a foreign party would need to defend a case both from a legal and political standpoint. Unlike in AD or CVD cases, action under Section 201 does not require an unfair trade practice or decision by the Department of Commerce's ITA.

Section 301

U.S. law authorizes the President to take appropriate action, including retaliation, to remove any act, policy, or practice of a foreign government that violates an international trade agreement or is unjustified, unreasonable, or discriminatory, or that burdens or restricts U.S. commerce. The primary use for Section 301 presently is to implement retaliation authorized by WTO dispute resolution. Where a foreign country's rules are found to violate its WTO obligations to the detriment of another WTO member, retaliation can be authorized by the DSB. In such cases, the United States may choose how to retaliate (generally by adding duties to a sensitive export from the offending country). Given this discretion, it is important for those engaging in trade with the United States to remain apprised of any potential 301 retaliation which may raise effective tariff rates.

Section 337

Over the past few years there has been an explosion of Section 337 litigation at the ITC. Section 337 of the Tariff Act of 1930 deals primarily with intellectual property violations (patent, trademark, and copyright). However, rather than simply impose tariffs when a violation occurs, an affirmative determination can completely exclude the offending merchandise from entering the United States. The severity of the remedy has made it popular with technology companies seeking relief for patent infringement. Countries with a prevalence of technology-related manufacturing are particularly susceptible to the impact of Section 337 actions.

Other Regimes Affecting Imports

Under exceptions provided by WTO agreements relating to public safety and national security, certain goods are subject to additional regulation for health and public safety—barriers that go beyond import duties. These include those of the Department of Agriculture, the Food and Drug Administration and the Bureau of Alcohol, Tobacco, Firearms and Explosives. In addition, there are consumer protections under the auspices of the Consumer Product Safety Commission.

U.S. Department of Agriculture (USDA)

The USDA Animal and Plant Health Inspection Service (APHIS) regulates the import of animal and plant-derived products and materials. APHIS performs inspections and issues permits prior to clearance from Customs. This includes live animals, animal tissue, fluids or genes and microorganisms. It also includes meat products and dairy products other than butter and cheese. This system can be invoked to prevent the import of animals or materials from countries feared to have livestock diseases exotic to the United States, such as Foot and Mouth Disease or Mad Cow Disease.

Since 2008 there has been heightened attention given to the Lacey Act, which prohibits trade in "illegal" wildlife, fish and plants. APHIS administers the Lacey Act's plant provisions, which place a particular emphasis on wood. Non-U.S. wood suppliers, particularly dealing with regions or tree-species perceived to be high risk, need to be aware of stringent documentation and certification requirements they may face from U.S. importers striving to achieve "due care" compliance under the act.

U.S. Food and Drug Administration (FDA)

The FDA, an agency of the Department of Health and Human Services, regulates a wide range of products, including food products not regulated by the USDA, human tissue and fluids, drugs/pharmaceuticals, medical devices, cosmetics and radiation-emitting products. See **www.fda.gov/ForIndustry/ImportProgram**. If an imported article falls under FDA jurisdiction, it is subject to review under Section 801 of the Federal Food, Drug and Cosmetic Act. The CBP will notify the FDA of relevant imports and the FDA may require samples of a product so that it may grant approval prior to distribution in the United States. The FDA's regulation of food and beverages was expanded under the Public Health Security and Bioterrorism Preparedness and Response Act of 2002. Almost all businesses in the food manufacture, processing and packing chain must register with the FDA and importers must be prepared to provide such registration information for the food to enter the United States.

Bureau of Alcohol, Tobacco, Firearms and Explosives (ATF)

Imports of firearms, ammunition or implements of war generally require a permit for importation issued by the ATF. Such imports are regulated under the Gun Control Act of 1968 and the Arms Export Control Act. Generally, an importer or dealer is required to obtain a Federal Firearms License (FFL) from the ATF.

ATF regulations prevent the issuance of licenses for the import of firearms originating from certain countries. This includes China, Myanmar and North Korea as well as most weapons originating from Russia and certain former Soviet block countries.

Consumer Protection

The Consumer Product Safety Commission (CPSC) broadly regulates the safety of consumer products under the Consumer Product Safety Act and several more specific acts, including the Federal Hazardous Substances Act, the Flammable Fabrics Act, the Poison Prevention Packaging Act, and the Refrigerator Safety Act. The CPSC's regulations extend to imported products which are held to the same consumer safety standards as domestic equivalent products. CPSC has the authority to determine the import admissibility of consumer products and some hazardous substances. This includes the ability to detain products at Customs to determine admissibility and to deny entry of certain products. For information on rules for particular types of products regulated by the CPSC, see **www.cpsc.gov/businfo/reg1.html**.

Export from the United States

Exports from the United States are not subject to restrictions in most cases and there are no taxes or tariffs on exports.[23] However, to protect U.S. national security and advance foreign policy and humanitarian interests, the United States does regulate exports through three primary regimes: the Export Administration Regulations, the International Traffic in Arms Regulations, and the Office of Foreign Asset Controls Regulations. The U.S. government has been particularly active in enforcing export control regimes and their violations in recent years.

Export Administration Regulations (EAR)

The Export Administration Regulations are authorized under the Export Administration Act of 1979 and are implemented by the BIS. The EAR regulate the export and re-export of U.S.-origin commodities, software and technology (including the direct products thereof) wherever located. Generally, any items, software or technologies that are not under the export jurisdiction of regimes for defense articles and nuclear technology (discussed below) are subject to EAR regulation. The EAR also regulate activities of U.S. persons, wherever located.

The EAR prohibit exports of controlled items and technologies, or products with controlled U.S. content, to certain listed countries or their nationals without a license or license exception. Controlled items are described on the Commerce Control List (CCL) at Supplement 1 to 15 CFR Part 774 and identified by an Export Control Classification Number (ECCN)—e.g. 5A992 or EAR99.[24] The ECCN identifies the type of product, software or technology covered, describes the items controlled in detail, and outlines any licensing requirements and license exceptions that apply. Licensing requirements consist of two digit codes providing the reason for control—e.g. AT1, NS or UN. An exporter can then review the Commerce Country Chart at Supplement 1 to 15 CFR Part 738 to see if the code(s) apply. If so, a license normally must be obtained from BIS for an export or reexport to the destination country (such licenses are frequently granted under industry-friendly procedures). However, even if a product or technology is controlled for export to a given country, a "license exception" may still apply. The ECCN provides some information on license exceptions that may be applicable, such as for personal

23 The U.S. government generally does not provide export subsidies or support, which are prohibited in most cases by WTO obligations. Note, however, that there are some United States export subsidies related to agricultural and dairy products (for example), in most cases designed to counteract or respond to export programs by other countries. The primary programs are the Export Enhancement Program (EEP) and the Dairy Export Inventive Program (DEIP). In addition, exporters of products from the U.S. may be eligible to receive financing and other support from the Export-Import Bank of the United States. These programs are generally outside the scope of this chapter, but non-U.S. companies considering investment in these sectors should seek further information.

24 Where it is unclear which ECCN should apply to a product, software or technology or where an exporter wishes to have additional certainty, they may request a CCATS (Commodity Classification Automated Tracking System) number from the BIS.

travel or in many cases where an item is controlled only for encryption software. Further information on license exceptions can be found at 15 CFR Part 740. Items with an EAR99 classification and other ECCNs not controlled for export to a particular country or subject to an exception may be shipped without a license.

It is important to understand and be aware of the concept of a "deemed export." Where a technology or source code is released to a foreign national within the United States, it is treated for most purposes as an export to that foreign national's country. So, if export of the technology or source code to a country requires a license, so does sharing the same with a foreign national in the United States or in a third country. This situation arises frequently where a U.S. company has foreign employees. It also can arise where a foreign company purchases a U.S. company or conducts business in the United States.

There are both civil and criminal penalties for violation of the EAR. Criminal penalties for willful and knowing violations are severe, including imprisonment, substantial fines, denial of export privileges, exclusion from practice, or seizure of goods. It is important to speak with experienced counsel in advance when confronted with a possible export of dual use goods, technologies or software with encryption or with a "deemed export" situation. If a violation has already occurred, an attorney can help a company make a "voluntary disclosure" to the BIS. Voluntary disclosures, when offered before the government becomes aware of the issue and when presented with proper arguments, can substantially reduce fines and the prospect of more serious forms of punishment.

China and Russia Military End-Use or Military End User Restrictions

The EAR state that licenses are required for exports and re-exports to China or Russia of certain items where the exporter has knowledge, or was informed by BIS, that the items will be intended to have "military end use" in China or for a "military end use" or "military end user" in Russia. Because the EAR also controls re-exports, companies may face risks if they export items and then retransfer the items to other Chinese or Russian companies that they know aim to incorporate products into a military application. Further, the EAR generally prohibit exports of 9x515 and 600-series items to the China without a license. The Russia restrictions were added to the EAR in September 2014.

Validated End User Program (VEU).

Under the EAR's VEU program, which is currently available only for China and India, BIS can amend the EAR to add Chinese and Indian end users to which eligible items may be exported, re-exported, or transferred under a general authorization instead of an export license. Eligible items may include commodities, software and technology except those controlled for missile technology or crime control reasons. Companies that achieve VEU status can facilitate increased transfers of high-technology items for civilian end uses.

International Traffic in Arms Regulations (ITAR)

The ITAR implement the Arms Export Control Act (AECA) and regulate exports, re-exports and temporary imports of defense articles, controlled technical data and defense services. The Department of State's Directorate of Defense Trade Controls (DDTC) implements the ITAR and maintains the U.S. Munitions List (USML), which describes what are defense articles for purposes of U.S. law. DDTC also regulates activities such as the provision of defense services, brokering of defense articles and political contributions, fees and commissions. See **www.pmddtc.state.gov**.

The export of defense articles normally requires authorization in the form of a DSP-5 license (for permanent exports) or DSP-73 license (for temporary exports).[25] There are a limited number of exemptions in the ITAR which can provide authorization in lieu of a license, although such exemptions should be employed with great care. Exporters must first register with DDTC in order to apply for a license, apply for an agreement or claim exemptions under the ITAR.

Similar to the EAR deemed export rule, companies have to obtain proper authorization for release of technical data relating to defense articles to foreign nationals in the Unites States or abroad. The ITAR has also introduced the concept of "defense services." The ITAR require prior authorization for the "furnishing of assistance (including training) to foreign persons, whether in the United States or abroad in the design, development, engineering, manufacture, production, assembly, testing, repair, maintenance, modification, operation, demilitarization, destruction, processing or use of defense articles." Training based on information in the public domain can still give rise to a defense service under the present rule as of October 2014. However, the DDTC has issued a proposed rule that would change this definition and limit defense services to non-public domain information.

The DDTC authorizes the sharing of technical data via "agreements" or in some cases by DSP-5 licenses. "Agreements" refers to Technical Assistance Agreements and Manufacturing License Agreements made between two parties but filed for approval with DDTC. Such agreements are described in Part 124 of the ITAR and can facilitate the sharing of technical data and provision of defense services to foreign companies and their personnel over time. DSP-5 licenses are used to authorize access by a foreign employee to technical data or defense articles in the course of employment.

Penalties for ITAR violations tend to be even more severe than EAR, including imprisonment, fines, forfeiture, and denial of export privileges. As with the EAR, companies are advised to seek the advice of counsel in advance to avoid unintentional violations and chart a course for compliance. If a violation is discovered, the ITAR also provide for voluntary disclosure, which can mitigate penalties.

25 Larger shipments of major defense articles can require U.S. congressional certification under Section 123.15.

Arms Embargo Countries

U.S.-imposed arms embargo countries are listed as a prohibited country under the ITAR. This means it is the policy of the United States to deny authorization for exports and imports of defense articles or services destined to or originating from these countries (subject to any listed exceptions). Sales or transfers of defense articles or services to such countries are forbidden. Additionally, the embargo prohibits companies from those countries from exporting defense articles or technologies to the United States.

Export Control Reform

As part of an initiative the Obama Administration first announced in 2010, the Departments of Commerce and State have published regulations that would result in shifting jurisdiction over a variety of items from the ITAR to the EAR. Export Control Reform's overarching purpose is to allow the more flexible rules of the EAR to apply to less sensitive items, while enabling the State Department to focus its resources on more sensitive items and eliminating ambiguity regarding the scope of each set of regulations. The initial final rule implementing Export Control Reform was published in April 2013, with respect to aircraft. Several rules have issued since that time to revise USML categories and transfer control in various areas to the EAR. Items transferring to the EAR will generally be represented by "600-series" or "9x515" ECCNs. Many of these items still will be subject to significant controls, including a denial policy with respect to countries subject to a U.S. arms-embargo. License exceptions sometimes will be available for other countries–such as license exception Strategic Trade Authorization (STA), which applies to 36 allies of the United States. Further certain least-sensitive ".y" items will be controlled for anti-terrorism (AT) purposes only, and may be exported without licenses to non-embargoed destinations.

One important segment of Export Control Reform concerns satellites and spacecraft. Satellites and their components had long been regulated under the ITAR due to an act of Congress, even though much of the technology is no longer cutting edge. In 2012, Congress restored authority to the President to remove commercial satellites and components from the USML and transfer them to EAR control. The Departments of State and Commerce issued interim final rules, which will make transfer of certain space-related items effective in November 2014. By statute, however, these items may not be transferred to entities or nationals of China, North Korea or designated state sponsors of terrorism, and such entities or persons may not launch them into space.

Nuclear Export Controls

The United States has particularly strict controls over the transfers and retransfers of U.S.-origin nuclear equipment, components and technology. Two agencies regulate nuclear exports from the United States: the U.S. Nuclear Regulatory Commission (NRC), which controls the export of certain nuclear equipment, components and materials and the U.S. Department of Energy (DOE), which controls the export of certain nuclear commercial technologies and specific nuclear reactor technologies.

Companies looking to do business in the United States can become subject to these regulations if they create U.S. subsidiaries and engage in projects and sales that involve foreign or multinational companies or non-U.S. citizens. Importantly, foreign nuclear technology becomes subject to U.S. export controls if it is imported into the United States and therefore retransfers of this technology, even back to the parent company, could be subject to U.S. licensing requirements. Further, because most exports of nuclear technology require DOE approval, companies looking to do business with the U.S. nuclear industry may have to agree to non-disclosure and other export control agreements before they can participate in U.S. projects.

Sanctions Policy

The Treasury Department's Office of Foreign Assets Controls (OFAC) implements and enforces a variety of economic and trade sanctions regimes relating to foreign governments, organizations, entities and individuals. This includes rogue states such as Iran, North Korea and Cuba, entities or groups such as the Taliban and individuals such as drug kingpins or Al Qaeda leaders. These regimes serve a number of U.S. foreign policy interests, including national security, implementing sanctions directed by the United Nations Security Council, countering proliferation, countering terrorism and traffic in drugs, and supporting humanitarian goals. Current OFAC country sanctions programs are listed at **www.treasury.gov/resource-center/sanctions**.

There are several non-country-related sanctions regimes focused on narcotics traffickers, transnational criminal organizations, counter-terrorism, humanitarian, diamond trade controls and non-proliferation-related sanctions. Up-to-date information on OFAC sanctions programs are available at www.treasury.gov/resource-center/sanctions/Programs/Pages/Programs.aspx.

Generally, OFAC regulations prohibit U.S. persons (including foreign subsidiaries) from conducting transactions or other interaction with embargoed countries and their specially designated nationals unless authorized by the agency. Sanctions also prohibit "facilitation" of transactions by non-U.S. persons, which can cover a wide range of activities relating to a transaction with a sanctioned person or entity. Financial institutions must either reject or block (accept and freeze) transactions by or through them involving entities or persons subject to OFAC sanctions. Examples of these transactions include accounts, credit cards, money orders, safety deposit boxes, and currency exchanges.

OFAC may grant licenses that authorize some transactions or activities which otherwise would be prohibited under the sanctions regimes. This can include a general license issued by OFAC covering a range of activities (these can function almost like minor/temporary amendments to a sanctions regime). It can also include specific licenses authorizing an activity or transaction by a particular company or individual. Generally, there also are reporting requirements for U.S. persons involved in these types of transactions.

OFAC regimes are important elements of U.S. foreign policy and consequently penalties for OFAC violations can be as severe as ITAR violations, with criminal fines, individual imprisonment, civil fines, and seizure. There are other risks for foreign companies to consider:

Blocking

OFAC regulations could lead to the blocking of property of foreign companies. For example, if one or more blocked entities or individuals gains ownership of 50 percent or more of a company, that company and its assets are considered blocked property. This may be an important consideration for any company that seeks to do business in the United States and that is subject to 50 percent ownership by one or more sanctioned entities or persons.

Causing a Violation

Foreign entities that are not themselves U.S. persons may be subject to liability if they "cause violations" of sanction regulations. In 2009 Lloyds TSB, a non-U.S. company, agreed to pay more than $467 million in U.S. criminal and civil fines for "causing a violation" of sanction laws against Iran and Sudan. Lloyds had "stripped" customer names, bank names, and addresses from SWIFT payment messages to allow them to pass undetected through filters at U.S. correspondent banks (which would have been required to reject or block the transactions in compliance with U.S. sanctions regulations). Over the past few years, a number of large banks headquartered outside of the United States have settled enforcement actions with U.S. authorities for "causing" a U.S. person to violate OFAC sanctions regulations based on similar actions. Recently issued OFAC sanctions dealing with Russia and Ukraine also have adapted the concept of "causing" a violation of the prohibitions.

Antiboycott

Two antiboycott laws enacted in the 1970s, the Ribicoff Amendment to the 1976 Tax Reform Act (TRA) and the 1977 amendments to the Export Administration Act (EAA), aim to prevent U.S. persons from participating in other countries' economic boycotts or embargoes. In practice, this has usually involved preventing companies from supporting anti-Israel policies of certain Middle Eastern and other countries.

Administered by the Department of Treasury, the TRA denies tax benefits to U.S. firms that participate in or cooperate with a disapproved international boycott. The TRA requires that any U.S. firm with operations in, with, or related to any country participating in a boycott identified by Treasury[26] file an annual report relating to such operations.

The EAA-authorized Antiboycott Regulations are administered by BIS's Office of Antiboycott Compliance. Antiboycott Regulations prohibit U.S. persons from:

- Refusing or agreeing to refuse to do business with or in Israel or with boycotted companies.
- Discriminating or agreements to discriminate against other persons based on race, religion, sex, national origin or nationality.
- Furnishing or agreements to furnish information about the race, religion, sex, or national origin of another person.
- Furnishing information or agreements to furnish information about business relationships with or in a boycotted country, its business concerns, nationals or residents, or any other person known or believed to be restricted from having any business relationship with or in a boycotting country.
- Furnishing or agreements to furnish information about a person's membership in, contributions to, or association with charitable or fraternal organizations that support a boycotted country.
- Paying, honoring, confirming, or otherwise implementing letters of credit with boycott-related terms.

The EAA regulations also require firms to report the receipt of boycott requests to BIS on a quarterly basis. Failure to report is a violation of the regulations.

The Antiboycott Regulations apply to "U.S. persons" whose activities are in the "interstate or foreign commerce of the United States." A U.S. person is a U.S. resident or national, including controlled-in-fact subsidiaries, affiliates, or other permanent foreign establishments of domestic concerns. Virtually all transactions of the foreign subsidiary or branch of a U.S. company would be covered by the Antiboycott Regulations even if U.S. nationals are not involved in the transaction. Thus U.S. subsidiaries of foreign companies and foreign subsidiaries of U.S. companies would have to comply with Antiboycott regulations.

26 As of Spring 2012, Treasury's list of boycotting countries included: Kuwait, Lebanon, Libya, Qatar, Syria, United Arab Emirates and the Republic of Yemen.

Other Rules Affecting Trade, Business and Transactions in the United States or with U.S. Companies

Laws designed to prevent corruption and the unlawful transfer of funds to criminals not only impact doing business in the United States but also activities of foreign companies subject to U.S. jurisdiction. The Foreign Corrupt Practices Act (FCPA) is one tool used by the United States to discourage corrupt payments to foreign officials to obtain business. The FCPA applies to many foreign companies who have activities in the United States or benefit from access to U.S. stock exchanges. The anti-money laundering laws provide restrictions on transactions to prevent funds going to terrorists or other criminal enterprises. These rules require screening by legitimate businesses to ensure that they are not knowingly or unknowingly perpetrating unlawful financial transactions.

Foreign Corrupt Practices Act (FCPA)

The FCPA addresses foreign bribery and contains two primary types of violations: first, it prohibits bribery of foreign officials for business advantages; and second, its books and records provisions require maintenance of accurate accounting records and a system of internal accounting controls. Three types of entities are subject to the FCPA:

- Issuers—corporations that have issued securities that have been registered in the United States;
- Domestic concerns—any U.S. citizen, national or resident, or business organization with principal place of business in the United States; and
- Other persons—who conduct any act to further corrupt payments within the United States. Only issuers are subject to the books and records violations, while all entities and individuals are subject to these anti-bribery prohibitions.

The act is enforced by the Department of Justice (DOJ) and the Securities and Exchange Commission (SEC). The DOJ conducts criminal enforcement and civil enforcement against foreign nationals and companies while the SEC conducts civil enforcement of anti-bribery provisions with respect to issuers, particularly for books and records violations.

Penalties for FCPA violations can include fines up to $2 million per violation and disgorgement of profits. Individuals also may face fines or imprisonment or both for criminal violations. Accounting violations can also lead to substantial fines. Moreover, FCPA violations can also coincide with violations of anti-bribery laws of other countries. This leads to the possibility of being prosecuted in more than one country for the same acts. Finally, violations can also lead to possible civil litigation, as well as damages to a company's reputation.

Anti-Bribery Prohibition

The FCPA's anti-bribery prohibition has five elements. It prohibits (1) directly or indirectly giving anything of value (2) to a foreign official (3) with intent (4) to secure improper advantage in (5) obtaining or retaining business.

Some of these elements have been broadly interpreted. First, the FCPA prohibits "indirect" payments through intermediaries, while "knowing" that the payment will go directly or indirectly to a foreign official. Actual knowledge is not required; it can be established in cases of "willful blindness" or when a person is aware of a "high probability" of the existence of the circumstance. For example, in December 2011 the federal Court of Appeals for the Second Circuit upheld a conviction of Frederic Bourke, who "consciously avoided" knowing that particular payments would occur, yet knew of the pervasiveness of bribes in the country and his business partner's corrupt reputation, and established companies to shield himself from FCPA liability.

Second, "anything of value" includes more than currency; charitable contributions or vacations may also be sufficient. Third, "foreign official" means any officer or employee of foreign governments or their instrumentalities, officers and employees of public international organizations, party officials and political candidates. This can include low-level employees, and the employees can be from state-owned entities. In a recent decision, the 11th Circuit affirmed that "foreign official" is interpreted broadly and provided a test to determine if an entity is an "instrumentality" under the FCPA. The two prongs are 1) whether the government controls the entity; and 2) whether the entity performs functions that the foreign government "treats as its own" but the court specified that inquiries into each of these are fact intensive questions.

There are some limitations to the FCPA's reach. The FCPA has an exception for "facilitating payments"—that is, minor sums to expedite nondiscretionary acts. Moreover, affirmative defenses are available for payments that are expressly allowed in foreign law, or directly related to promotion, demonstration or explanation of products or services.

Risks to Foreign Entities and Individuals

The FCPA presents several potential risks to individuals and entities. First, companies that issue securities in the United States—including American Depositary Receipts—are subject to both the FCPA's books and records and anti-bribery provisions. For example, Siemens Aktiengesellschaft, a German company that trades on a U.S. stock exchange, was prosecuted in the United States for FCPA violations that resulted in over $1 billion in fines and disgorgement of profits.

Second, foreign entities and individuals could be liable for corrupt payments made to foreign officials within the United States or through the use of U.S. mail, phone or email service. For example, the Federal Bureau of Investigation (FBI) recently conducted a sting operation involving Pankesh Patel, a British defense articles merchant, who traveled to the United States to discuss an allegedly corrupt deal with a FBI agent purportedly reporting to the Defense Minister of an African country, and sent a copy of the purchase agreement via DHL to the United States.[27]

Third, entities that have or may join U.S. subsidiaries or U.S. parents may have FCPA obligations. Moreover, potential FCPA liability for other companies' past conduct may be assumed through mergers and acquisitions, and therefore substantial FCPA due diligence is necessary for these transactions. U.S. companies may walk away from transactions or require renegotiation in the event of FCPA issues.

These risks may be magnified by two factors for foreign companies: first, substantial state -ownership of some corporations may make them "instrumentalities" of the state, and thus officials of these companies may be treated like public officials for FCPA purposes. In other words, it would violate the FCPA for persons/entities subject to its jurisdiction to offer gifts, money or other things of value to officials of these certain companies to obtain or retain business. Second, other countries have also enacted anti-corruption laws and prosecuted companies under them. This may lead to even greater cumulative penalties because of the potential for prosecution in multiple jurisdictions.

The FCPA is a complicated statute that can have unexpected impacts on the conduct of business abroad and transactions with, or acquisitions of, companies. For foreign companies doing business in the United States or with U.S. companies, it is important to assess FCPA risks, plan compliance in advance and maintain careful book-keeping policies.

Anti-money Laundering (AML)

While historically more of a banking and criminal-enterprise issue, U.S. anti-money laundering laws have developed substantially over the past twenty years and should be understood by any foreign company or individual seeking to do business in the United States or with American companies. There is an expanding regulatory regime under the Bank Secrecy Act and USA PATRIOT Act which is operated by the Treasury Department's Financial Crimes Enforcement Network (FinCEN). There are also two criminal anti-money laundering laws that can impact business transactions which include illicitly-derived funds under prescribed circumstances.

FinCEN both implements AML policy in the United States and acts as the country's "financial intelligence unit" for communication and coordination with other countries and with the Financial Action Task Force (FATF). The Bank Secrecy Act had long required basic AML compliance for traditional financial institutions. Following the attacks of September 11, 2001, the USA PATRIOT Act expanded the definition of

27 These charges led to an unsuccessful prosecution in 2011, but resulted in significant legal fees and placed the individual in significant legal jeopardy for fines and jail time.

"financial institution," encouraged FinCEN to enact additional regulations and provided FinCEN with broad powers to implement "special measures" against jurisdictions, financial institutions or transactions under Section 311.

Currently, FinCEN regulations require AML compliance programs and the reporting of suspicious activities to Treasury for the following "financial institution" categories:

- Depository Institutions
- Casinos
- Money Services Businesses
- Insurance Companies
- Brokers or Dealers in Securities
- Futures Commission Merchants and Introducing Brokers in Commodities
- Mutual Funds
- Operators of Credit Card Systems
- Dealers in Precious Metals, Stones and Jewels
- Residential Mortgage Lenders and Originators

AML compliance programs include due diligence on accounts, know-your-customer practices and internal record keeping. FinCEN is in the process of expanding rules that require companies with AML compliance programs to determine "beneficial ownership" of accounts. Thus, foreign companies, governments and investors, who may be accustomed to greater anonymity in their business dealings, may soon face additional scrutiny when doing business in the United States.

Further, where a financial institution will handle cash in excess of $10,000 in a transaction, or a financial institution suspects fraud or unlawful activity, that institution (including everyone from banks to casinos to dealers in precious metals or jewels) may file Suspicious Activity Reports to the U.S. government calling attention to an account and its transactions. FinCEN may communicate such reports and information relating to the company (note the beneficial ownership discussion above) to the person/company's government abroad or to other foreign governments.

Under the USA PATRIOT Act, the Treasury Department and FinCEN are empowered to apply "special measures" to any foreign jurisdiction, institution, class of transaction or type of account that is a "primary money laundering concern." Where FinCEN makes such a determination, it may require domestic financial institutions to take special measures with regard to the designated target. This includes measures ranging from enhanced due diligence on accounts to prohibiting U.S. financial institutions from engaging in transactions and correspondent account activity with any bank in an identified country. Currently Myanmar, Iran and several banks in Asia and the Middle East are subject to special measures. See **www.fincen.gov/statutes_regs/patriot/section311.html** for up-to-date information on special measures under Section 311.

In addition to the regulatory regime, the United States has two strong criminal anti-money laundering statutes. Both have slightly different formulas, but together apply criminal liability to individuals or companies involved in a transaction while knowing that the funds originated from some unlawful activity and in fact derived from specified unlawful activities. Specified unlawful activities are a broad list of predicate criminal offences. "Knowledge" for the purposes of these statutes in interpreted broadly and can include indirect information or even willful blindness. Thus, foreign companies need to take great care in engaging in transactions where any parties' funds or goods may relate to unlawful activity (including things that may not be unlawful in the foreign country but are unlawful in the United States or other jurisdictions). Foreign companies also need to be aware that U.S. attorneys advising on a transaction may be sensitive to these issues and require due diligence or contractual protections.

Rules Affecting Trade and Investment in the United States

Foreign investment in the United States is generally welcome and subject to minimal regulation. Foreign individuals or companies can open bank accounts, create U.S. entities and own property similar to any U.S. citizen. For major investment in the United States, foreign actors (and particularly Chinese, Russian and Middle Eastern interests) should be aware of the Exon-Florio rules for review of transactions by the Committee on Foreign Investment (CFIUS) in the United States. There are also protective rules of which investors should be aware such as the U.S. constitutional protection of property against takings of private property and certain SEC rules.

The Committee on Foreign Investment in the United States (CFIUS)

Exon-Florio is a law that empowers the President to block transactions on national security grounds. Specifically, it provides authority to the President to suspend or prohibit any foreign acquisition, merger or takeover of a U.S. corporation that is determined to threaten the national security of the United States. CFIUS, an inter-agency committee chaired by the U.S. Department of Treasury, implements the Exon-Florio provision.

The Exon-Florio provision is intended to prevent foreign control (especially foreign-government control) of U.S. defense and intelligence capabilities, including plants, technology, personnel or materials comprising the U.S. defense industrial base. CFIUS generally reviews transactions in which a foreign entity acquires an ownership interest in a U.S. corporation or business unit involved with export controlled items or technology, has contracts or subcontracts with the U.S. government, has cleared facilities, or is otherwise involved in areas considered U.S. critical infrastructure including energy, telecommunications, ports, certain technologies and natural resources. Under the Foreign Investment and National Security Act of 2007, there is significant emphasis on reviewing transactions that involve U.S. critical infrastructure.

The primary focus of the Exon-Florio provision and CFIUS review is on whether foreign control of U.S. persons could impair national security. National security includes "those issues relating to 'homeland security,' including application to critical infrastructure." Critical infrastructure, in turn, is defined to mean "systems and assets, whether physical or virtual, so vital to the United States" that their incapacity or destruction would have a "debilitating impact on national security." Over the years CFIUS has reviewed and investigated transactions in sectors other than defense, including technology, telecommunications, energy and natural resources.

Notice to CFIUS is normally done jointly by both parties to the transaction. In total, the current process cannot exceed 90 days. Parties to a transaction are encouraged to submit a draft pre-filing notice. If the parties elect to submit the draft, it must be submitted at least a week in advance prior to submitting the formal notice. Once the formal notice is submitted, CFIUS will conduct an initial 30-day review. After the 30-day review if CFIUS determines that an investigation is warranted, the investigation period is 45 days, after which the President has 15 days to act. At present, filing a CFIUS notification is voluntary. It is not a violation to proceed without notifying CFIUS, even if a transaction is clearly subject to the law, although failure to file could expose the transaction to the risk of blocking and unwinding the transaction.

The contents of a voluntary notice of a foreign acquisition to CFIUS can facilitate and shape CFIUS's view of potential foreign control or national security concerns. A CFIUS notice will identify in detail the U.S. person's government contracts and activities with any federal agency, items controlled by the DDTC under ITAR and by the BIS under the EAR, negotiations with the Defense Security Service (an agency of the Department of Defense) to mitigate Foreign Ownership, Control or Influence (also known as "FOCI") concerns if the target has a facility security clearance, and anything else that might be of interest in connection with homeland security.

In recent years, CFIUS reviews have frustrated a number of transactions involving foreign parties. Most prominently, in 2012 President Obama issued an order prohibiting the purchase of wind farms in the vicinity of U.S. restricted air space. The purchaser (Ralls Corporation) was a U.S. company owned by Chinese nationals. Ralls filed suit against CFIUS and in 2014 the DC Circuit found that the President deprived Ralls of constitutionally protected property interests without due process of law. The case was remanded with an order allowing the defendants to have access to unclassified evidence used by the President and an opportunity to respond to it. This could indicate that there will be more of an information flow between the applicants and CFIUS in the future.

Protections for Investors in the United States

Both U.S. and foreign investors in the United States are protected by the "takings clause" of the Fifth Amendment to the Constitution. This provides that "private property [may not] be taken for public use without just compensation." Where the federal or state governments exercise eminent domain or other powers to take property or property rights in the United States, they are required to provide fair market compensation for the value at the time of the taking. Federal courts have a long record of upholding the takings clause against federal and state legislative or executive action. The takings clause protection can be invoked by both U.S. and foreign persons. This powerful right against the government is one of the reasons that the United States is considered among the safest countries in the world for investment.

Note, however, that the takings clause does not interfere with the exercise of foreign policy or national security policies, such as OFAC sanctions, even where they cause a loss of property or contract rights. For example, courts have ruled that a Cypriot national with ties to Libya who had U.S. stock options blocked by OFAC could not recover under the Fifth Amendment, although the stock options had expired while blocked and became worthless. See Paradissiotis v. U.S., 304 F.3d 1271 (Fed. Cir. 2002). Foreign investors, particularly those from countries such as China or Russia who engage in trade with parties sanctioned under U.S. law, should be aware of these legal risks.

Other investment protections are provided by the SEC. The elaborate U.S. regulatory structure designed to protect U.S. investors by the SEC and other agencies applies to foreign investors as well. One increasingly important SEC protection is the prohibition on "finders" in business deals. Only properly-registered brokers may facilitate investment, real estate and other deals and receive fees or commissions for arranging the business. It is increasingly common for unlicensed individuals to present business or investment opportunities to wealthy foreign individuals or companies. Investors should always confirm whether the introducing party is registered with the SEC. Where an investment is made pursuant to an unregistered "finder," the SEC may be empowered to intervene and, in some cases, freeze and unwind the investment.

Multilateral and bilateral agreements can add investment protections to nationals of countries reaching agreement with the United States that go beyond the takings and SEC protection examples noted above. The WTO TRIMS treaty and NAFTA, for example, provide investment protections, as do most bilateral investment treaties or "BITs." Common examples of BIT provisions are protections for investment, compensation for expropriation by governments, fair treatment of companies and nationals under domestic law and binding arbitration of claims by neutral panels such as the International Centre for Settlement of Investment Disputes.

Federalism and the Role of State Law

The United States Constitution allocates power between the federal government and states under the U.S. federal system. Most matters relevant to international trade are entrusted to the federal government including customs, tariffs, trade law, currency, interstate commerce and export rules. However, the states have significant powers which may impact business planning within the United States. The creation of businesses in the form of companies, partnerships and trusts are done at the individual state level pursuant to state regulations. They also regulate items such as alcohol and firearms within their jurisdiction.

Some states over time have sought to regulate international trade and investment. For example, in 1996 Massachusetts passed a law designed to prevent companies with investments in Myanmar from receiving state procurement contracts. The Supreme Court found this foray into sanctions policy unconstitutional in Crosby v. National Foreign Trade Council, 530 U.S. 363 (2000). In the 1980's, however, several states and local governments took positions on divestment from South Africa in opposition to that country's Apartheid policies at the time and the U.S. Congress passed the Comprehensive Anti-Apartheid Act of 1986 which indicated those efforts could remain in effect. Such state efforts have generally derived from issues relating to human rights and democracy. Foreign companies from countries perceived as having such issues should monitor state law initiatives which may affect business plans in the short term (even if overturned as an infringement on federal prerogatives, such laws can still exist long enough to create business challenges).

In addition, currently, U.S. federal law has permitted states to engage in sanctions against Iran. The Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (CISADA) provides that state and local governments may identify persons that engage in certain investment activities with Iran and divest the assets of the state or local government from, or prohibit investment of their assets in, such companies or individuals. See CISADA Section 202. This includes affiliates and successors to listed companies. "State or local government" can include any agency or instrumentality of a state or local government, and "any public institution of higher education." States generally enact one or both of the following Iran sanctions: (a) contracting ban laws, and/or (b) divestment laws. A large number of states have implemented such laws, including California, New York and Texas.

CHAPTER 8

COMMERCIAL REAL ESTATE TRANSACTIONS

By Glenn Snyder

Introduction

The following is a brief overview of the major legal issues associated with the ownership and development of commercial real estate in the United States. In particular, this chapter will provide a brief summary of the following areas: (i) ownership interests in real property and real estate due diligence, (ii) issues associated with development of real estate, (iii) basic real estate transactions and (iv) commercial leases.

Ownership Interests in Real Property and Real Estate Due Diligence

Real estate may be owned by an individual or an entity, such as a corporation, partnership or limited liability company.

Basic Ownership Types:

Fee Simple

Most commercial properties are owned in "fee simple." In this case, the owner of the land has the exclusive ownership of and right to use the property. Other forms of holding title (such as joint tenancy) are less common in the commercial context.

Ground Leases

A lease is a grant of the right to use and occupy real property for a specific time period in exchange for payment of rent. A "ground lease" is a long-term lease of land only. Ground leases are often used in connection with commercial property. Ground leases often involve the tenant constructing improvements (e.g., buildings) on the land. This is particularly important in situations where the landlord may not have the knowledge or capital required to develop the land. A ground lease arrangement with a sophisticated tenant can result in development of the land in such a way as to maximize the potential value of the land.

There are several advantages to ground leases for business tenants. For example, an owner may be unwilling to sell fee simple title to a particularly desirable tract of land. As a result, a ground lease allows the tenant to use the land for a period of time and the owner to retain its ownership interest. Also, a tenant may want to avoid tying up capital in a large land purchase. Leasing the land, as opposed to an outright purchase, may free up the tenant's funds to build improvements or pay for other obligations.

Tenants in Common

Tenancy in Common (TIC) is another way to hold title to real property. TIC involves the ownership of property by two or more individuals or entities. Each owner owns a particular percentage interest of the property and has a right of possession. In commercial transactions, the use of the TIC structure has become more prevalent as owners have restructured ownership of properties to facilitate like-kind exchange transactions for income tax deferral purposes.

Due Diligence Prior to the Acquisition of Real Property

Title Insurance

Prior to acquiring any property, a prospective buyer needs to review the status of title. "Title" essentially means a right to ownership or documents serving as evidence of the right to ownership of a property. If the prospective buyer buys the property without taking any protective steps relating to title, it risks being sued by competing claimants to the property and losing part or all of the property. The most efficient means of determining the status of title is obtaining and reviewing a preliminary title report. A preliminary title report is obtained from a title company and discloses all encumbrances and other matters affecting title based on a search of the applicable public records, which are typically maintained by the local government. For example, a title report to property in San Francisco would be maintained by the county of San Francisco—not by the state of California or the federal government.

In connection with the acquisition of real property, a prospective buyer should purchase title insurance that provides insurance against losses incurred by the prospective buyer if the status of title to the property is not as stated in the title insurance policy. The policy will cover loss or damage up to the insured amount stated in the policy. Title insurance policies may be obtained to insure fee simple ownership, rights in an easement, a leasehold interest, a mortgage or other lien, and other interests in real property.

Survey

A prospective buyer should obtain a survey of the property prior to a purchase. A survey is an engineered drawing that confirms the boundaries of the property and other characteristics of the property (e.g., the location of easements, improvements, waterways, flood zones, encroachments, access roads, etc.) In addition, a survey will be required in connection with most commercial loan transactions or if the owner wants to obtain extended title coverage.

Environmental Assessment

Many prospective buyers obtain an environmental site assessment prior to the acquisition of real property. Most commercial property acquisitions involve the preparation of a Phase I Environmental Assessment. A Phase I Environmental Assessment usually involves the evaluation of the site history, neighboring properties and governmental or other public records pertaining to the historic use and environmental condition of the property. If issues are uncovered during this process, additional environmental testing is usually recommended.

The primary purpose for conducting an environmental site assessment is to reduce the risk of liability for the prospective buyer. Environmental due diligence should include a thorough review of the following matters: (i) status of environmental permits, (ii) status of environmental compliance, (iii) likelihood of capital expenditures for future environmental compliance, (iv) environmental liabilities arising out of past or current activities, (v) new requirements that would require capital to satisfy, (vi) continued availability of resources necessary for continued production (vii) and all associated costs.

Property Level Due Diligence

The nature of the property being acquired may also require other forms of due diligence. For example, if the property includes existing buildings, then the structural and physical aspects of the buildings need to be reviewed. In addition, if the building is occupied by tenants, all leases affecting the property should be carefully reviewed in order to ensure that the terms of the leases are fully understood.

Prospective buyers also typically request an "estoppel certificate" from the tenants of the property that will disclose any issues with respect to the landlord's performance of its obligations under the lease and the existence of any potential claims by the tenant.

Real Estate Development

There are a wide range of legal issues associated with the development of real estate in the United States. Real estate "development" involves activities that range from the renovation and re-lease of existing buildings to the development of unimproved land for the eventual sale to others. The following is a brief summary of the legal issues affecting real estate developers in connection with the development of real property.

Land Use Restrictions

Local Zoning Regulations

The most common form of land use regulation is zoning. Zoning regulations and restrictions are used by municipalities to control and direct the development of property.

Municipal zoning laws often have "use restrictions" that regulate particular uses in certain areas. In addition, zoning laws regulate the size, type, and structure of particular buildings in designated areas. There are also historic and architectural requirements that need to be evaluated on a project by project basis.

The scope of zoning restrictions can vary greatly from jurisdiction to jurisdiction. Prior to the commencement of any real estate development, the applicable zoning regime should be carefully examined by experienced land use counsel. The approvals of new development often take significant time, money and energy. To successfully navigate the entitlement process, extensive negotiations with local government authorities and interest groups are often required.

New projects may also be subject to exactions, levies, or other fees under state and local law. The cost of permits and fees for a new project is often very expensive and should be evaluated in connection with determining the economic feasibility of any potential development.

Private Covenants

Private covenants are agreements between property owners that restrict the use of, or impose obligations on, real property. These restrictions often "run with the land" (i.e., are binding on subsequent buyers of the property) and are encumbrances against the individual property (as opposed to zoning restrictions, which apply against the entire designated area).

Restrictive covenants are often utilized in a commercial context. For example, developers of office parks or residential subdivisions often impose design standards and restrict the scope of permitted uses for property included in such development.

Environmental Regulations

Real estate development projects (especially the development of power plants and other major industrial projects) must obtain a variety of environmental permits and approvals from various governmental environmental agencies prior to any development. In addition, there are a variety of federal and state statutes that come into play in connection with the development of real property. For example, the Endangered Species Act may prohibit development if it interferes with the habitat of an endangered species.

In addition, developers may be required to provide an environmental impact report (EIR) that analyzes the proposed project's impact on the environment. An EIR sets forth mitigation measures and alternatives that may reduce or avoid the environmental impacts. In addition, the EIR process is often utilized by environmental groups to attempt to impose additional environmental requirements or mitigation measures on proposed developments.

Real Estate Transactions

This section provides a brief overview of the legal documents that are utilized in transactions involving real property.

Acquisitions and Dispositions

- Purchase Agreement—This is the contract between buyer and seller that sets forth the terms of the purchase and sale of real estate pursuant to which the buyer is obligated to deliver the purchase price and the seller is obligated to convey the real property. In addition, there are a host of other issues that are heavily negotiated in commercial real estate transactions, including the scope of the seller's representations and warranties, limitations on liability, allocation of costs and risks, indemnity provisions and closing conditions.

- Deed—This document conveys the seller's interest in the land to buyer. It is recorded in the official records of the jurisdiction in which the property is located. There are different forms of deed depending on the nature of the interest being conveyed and the jurisdiction in which the property is located.
- Assignment of Leases—For occupied buildings, an assignment of all of the leases will be necessary to transfer the leases to the new owner.
- Bill of Sale—This conveys the seller's interest in any personal property sold in connection with the real property.

Real Estate Finance

Prior to making commercial loans, commercial lenders conduct extensive due diligence on the property that is very similar to the type of due diligence performed by prospective buyers. Although a commercial lender is not purchasing the real estate, the real estate is serving as collateral for the loan to the borrower-buyer. In addition, the lender will conduct extensive due diligence on the credit and background of a prospective borrower.

The following is a short summary of the basic documents that one typically sees in a commercial loan transaction:

- Promissory Note—This is the basic document evidencing the borrower's obligation to repay the loan.
- Loan Agreement—This is the document that sets forth the rights and responsibilities of the lender and borrower. Typical provisions that are often negotiated are default and remedy clauses, operational covenants of the borrower, control of condemnation and casualty proceeds and insurance requirements.
- Deed of Trust or Mortgage—The deed of trust (or mortgage) is the document that grants the lender a security interest in the property. This document is recorded in the official records of jurisdiction in which the property is located.
- Assignment of Leases and Rents—For income-producing properties, the lender will also take a security interest in the leases. This is the document that grants the lender a right to take over those leases in the event the borrower defaults with respect to its loan obligations.

Commercial Leases

Commercial Leases—Basic Issues

The following is a brief summary of some of the major business issues that need to be addressed in connection with the negotiation of commercial leases:

- The length of the lease, when it begins and whether there are any renewal or extension options.

- Rent, including allowable increases (referred to as "escalations") and how they will be computed.
- Gross vs. net lease—a "net" lease requires the tenant to pay, in addition to rent, some or all of the property expenses that normally would be paid by the property owner. These often include expenses such as real estate taxes, insurance premiums, maintenance, repairs, utilities and other items. On the other hand, in a "gross" lease, the property owner receives only a negotiated rent from the tenant, and the property owner is responsible for property expenses.
- The security deposit and conditions for its return.
- Exactly what space is being rented (including common areas such as hallways, restrooms, and elevators) (referred to as the "premises") and how the landlord measures the premises.
- Whether the landlord, tenant, or both jointly, will add improvements, modifications or fixtures to the premises (referred to as "tenant improvements").
- Specifications for signs.
- Allocation of responsibility for maintaining and repairing the premises, including the heating and air conditioning systems.
- Whether the lease may be assigned or subleased to another tenant.
- Whether there are any expansion rights under the lease.
- If and how the lease may be terminated, including notice requirements, and whether there are penalties for early termination.

Brokers

Property owners and prospective tenants are often represented by leasing brokers in connection with a commercial lease transaction. Typically, leasing brokers are paid a "commission" by the property owner based on a listing agreement. Tenants are often represented by "tenant representatives."

Tenant Improvements

The cost of tenant improvements and whether the landlord or the tenant will control the construction of the tenant improvements are critical issues in connection with negotiating commercial leases. There are three basic ways that the tenant improvements will be addressed in commercial leases: "Tenant Build," "Turn-Key," and "Landlord Build with Allowance."

Tenant Build

In this structure, the tenant selects the general contractor and enters into a construction contract, typically requiring the landlord to deliver the base, shell and core of the premises in a condition suitable for the installation of the tenant improvements (e.g., with demolition of any previous tenant improvements and installation of basic improvements completed). The tenant manages the construction of improvements to the premises after the landlord delivers the premises in the agreed-upon delivery condition. The landlord typically provides a tenant improvement allowance toward the cost of the improvements, and the tenant bears all costs in excess of that allowance.

Turn Key

In this structure, the parties approve the plans for the tenant improvements prior to lease execution, and the landlord agrees to pay for the completion of the work in accordance with those plans (regardless of the cost). The landlord enters into a construction contract with the general contractor and the architect, and the lease term commences upon substantial completion of the work described in the approved plans.

Landlord Build with Allowance

In this structure, the lease is executed prior to the completion of the plans for the tenant improvements, and the landlord's cost for the work is limited to a set dollar amount per rentable square foot of the premises. The landlord enters into the construction contract with the general contractor, and the commencement date is determined in the same manner as with a turn-key work letter.

CHAPTER 9

INTELLECTUAL PROPERTY

By David A. Jakopin

Introduction

If there is one suggestion for a non-U.S. company to remember with respect to this entire chapter on Intellectual Property (IP), it would be to make sure the company engages competent U.S. IP counsel. This counsel will be able to guide you in establishing your IP strategy in the United States, with the rest of the world in mind, so that you can derive maximum value from your IP assets, and understand how to protect your IP in the United States, license you IP, as well as how to assert your IP in litigation and defend you if you are sued for infringement of the IP of others.

This chapter begins with an overview of the basic types of IP protection available in the United States, followed by a discussion that focuses on how to protect your IP in the United States. Then we discuss IP litigation briefly and conclude the chapter by offering some practical suggestions.

Types of IP

The basic forms of IP are:

- Patents—A patent is an exclusive right granted under federal law to a person (unless otherwise stated, we will use "person" to mean an entity or an individual throughout this chapter) to use an invention for a limited time in exchange for the public disclosure of an invention.
- Copyrights—A copyright is an exclusive right owned by a creator of an original work to reproduce, display or perform the work publicly and to create derivative works. In the United States, copyrights are obtained almost exclusively using federal law, though the existence of the copyright is automatic upon creation of the work.
- Trademarks—A trademark is an exclusive right to a distinctive indicator, which indicator should not be descriptive, and which will identify the source of the product or service, and thus distinguish it from products or services of other entities. In the United States, state "common law" trademark laws also coexist with federal trademark laws but do not provide as much protection as the rights provided in the federal trademark laws.
- Trade Secrets—A trade secret, also known as confidential information, will have a definition that varies from jurisdiction to jurisdiction, as there is no federal trade secret law, only state trade secret laws based upon common law. A typical definition of a trade secret is that it is information that is not generally known or reasonably ascertainable, and from which an entity or an individual can obtain an economic advantage over competitors or customers arising from ownership of the information.

Common law is law that has been developed through court decisions and gives precedential weight to earlier court decisions. A later court deciding a case with similar facts as an earlier decided case, due to precedent, will likely be bound to follow the precedent unless it can find other facts that distinguish the case at hand from the earlier precedent. Precedent from courts in a particular jurisdiction, however, only binds courts in the same jurisdiction (such as one local area or one state, except decisions of the U.S. Supreme Court, which are binding in the entire country). Because the United States is a federal republic consisting of 50 states and the District of Columbia and, further, states have lower tier political subdivisions, there are many different "common law" jurisdictions that exist at the same time within the United States.[28]

28 The State of Louisiana is not a common-law jurisdiction and follows the civil law system.

In the United States, only the federal government may grant patents and protection of one's rights in a patent is a matter of federal law. As mentioned above, state common law on copyrights and trademarks also affords owners of works and marks certain protections. However, a federally granted copyright or federally registered trademark provides the greatest amount of protection.

Common-law trademark rights exist within a specific jurisdiction (e.g., an owner of a common-law trademark in California only has rights over the trademark in California and not in other states). Common-law trademark rights that exist in a specific jurisdiction may or may not be consistent with trademark rights as granted by the federal government or with the trademark rights under the common law of another jurisdiction.

Protecting Your Own IP in the United States

Just as in many other countries, there is a formalized process to apply for patents, copyrights and trademarks in the United States. While common law rights may exist for copyrights and trademarks in a local jurisdiction, the common law rights that exist are not nearly as strong as the rights granted federally.

Most countries around the world and the United States have signed The Paris Convention for the Protection of Industrial Property. The treaty establishes priority rights for trademarks, inventions, and industrial property designs, and is administered by the World Intellectual Property Organization (WIPO). Similarly, such countries are also signatories to the Berne Convention for the Protection of Literary and Artistic Works, which requires its signatories to recognize the copyright of works of authors from other signatory countries in the same way as the signatory recognizes the copyright of its own nationals.

As a result of treaties relating to protection of IP rights, most foreign applicants for patents, trademarks and copyrights can obtain IP rights (other than rights over trade secrets) in the United States with priority dates based upon their application filings in their home country.

Patents

While passage in 2011 of the Leahy-Smith American Invents Act (AIA) adds another layer of complexity to the patent laws in the United States, for purposes of the general discussion here, the changes to U.S. patent law as a result of the AIA in fact will make it easier for non-U.S. applicants to understand the patent laws of the United States. Previously the "date of invention" was a complex combination of "conception" (when the invention was conceived, as shown by admissible evidence) plus "reduction to practice" (when the invention was first made, as shown by admissible evidence). Once the implementing regulations of the AIA come into effect on March 16, 2013, the United States patent system will move from the current "first-to-invent" system to a "first inventor-to-file" system, which will be much simpler than at present and much more like the rest of the world. Under the regime introduced by the AIA, the application with the earlier filing date wins if two different applicants have the same invention. This change is by far the most significant aspect of the AIA, with other changes being of much less significance.

To obtain a patent (or "to prosecute a patent," in IP practitioner parlance) in the United States, a non-U.S. applicant may use a Patent Cooperation Treaty (PCT) application as its U.S. utility application with the U.S. Patent and Trademark Office (USPTO). An examination process by an examiner will then take place "ex parte" (only between the patent applicant and the examiner at the Patent Office, and not any other entity). This examiner will then determine whether the claims of a patent are of appropriate scope (and allow the patent to issue) or have a scope that is too broad (and issue a rejection, which the applicant will then need to address). Whether a patent will be issued depends on the ability of the patent applicant to convince the USPTO that the claims should be granted. The term for a patent is 20 years from the date of the original application. During the term, the patent owner has the right to exclude others from making, using or selling the patented invention in the United States.

Although the owner of a patent has the right to prevent others from practicing the invention covered by the patent, the patent *does not* give the patent owner the absolute right to practice the patented invention, as practicing the invention may infringe a patent owned by another party, and sometimes it may be necessary to obtain approval from a government agency, such as the U.S. Food and Drug Administration, to sell a patented drug or medical device.

In the United States, generally speaking, in order for a claim to be deemed to contain allowable subject matter, the claim must:

- be of statutory subject matter;
- distinguish from the prior art; and
- be clear and definite.

One aspect of the U.S. patent prosecution process that is, at present, different from that in many other countries is the ability of an applicant to more easily amend the claims of the invention in order to obtain claims of differing scope. This allows for a variety of opportunities with respect to claim drafting strategies and obtaining multiple different patents for inventions that are related, possibly even being entitled to the same invention date as an earlier filed patent application. Whether to take advantage of this difference will depend upon the strategy that a foreign applicant has with respect to development of an IP portfolio in the United States. It should be recognized that patent litigation in the United States carries with it potentially significant damage awards – much higher than are typical in most other countries. This fact should be factored in when determining how to grow one's patent portfolio in the United States versus growing that same portfolio in other countries.

Also, in the United States, individual inventor(s) must be identified with each claim for which patent protection is sought. The originally filed specification must identify the inventor(s). Consequently, employers must take care to ensure that appropriate assignment of rights exists from the inventor to the employer; otherwise, the employee or consultant may have the ability to assert ownership rights in the invention. It is typical for an employer to require each employee (as well as consultants and independent contractors) who may invent to sign an invention assignment agreement at the initiation of employment or engagement, to ensure that ownership of inventions subsequently created will properly vest in the employer.

Trademarks

The more distinctive a word that is used as a trademark, the stronger the mark. Coined terms (such as XEROX for copiers) that have no previous known meaning are strong marks. In contrast, the more descriptive the mark is, the weaker it will be. Selecting a trademark, therefore, should include first determining a mark that suits one's purpose, the more arbitrary or coined the better, and then performing searches to determine that no one else is using the same mark for the same type of goods or services in all jurisdictions in which the mark will be used.

Common-law trademark protection exists by virtue of using a trademark in commerce, and generally no formal registration is required for common-law trademark rights to exist. Federal registration of a trademark requires filing of a formal application with the USPTO to ensure that the same trademark is not being used for the same type of products or services by another person who already has a federal trademark registered for the same or substantially similar mark. In addition, a trademark applicant must show that the trademark has been used in interstate commerce before the USPTO will accept registration on the principal trademark register. Once deemed allowable, the trademark is published for a 30-day opposition period, and if unopposed, will become registered on the principal registry. Once registered, the initial term is 10 years from the date of registration and is renewable for additional 10-year terms thereafter.

If a registrant cannot meet all of the criteria for registration on the principal register (such as a mark being too descriptive), an option is registration on the supplemental trademark register. This option allows the applicant additional time to prove to the USPTO that the particular trademark in question has acquired a secondary meaning due to the significant and widespread recognition that the trademark has achieved over time, although recognition for the trademark did not exist at the time the original trademark registration was filed.

Unlike patents, for which the application can only be made by the individual inventor, entities such as a corporation, limited liability company or partnership can also apply for trademark registration.

Copyrights

Upon creation of a work, its ownership vests for copyright purposes. While there is no requirement that the copyrighted work be registered with the U.S. Copyright Office in order to establish ownership, it is a requirement that the copyrighted work be registered in order for a copyright applicant to initiate copyright litigation.

If the copyrighted work is also the subject of trade secrets (such as many computer programs), then it is possible to redact portions of the copyrighted work to preserve its confidentiality.

Once a copyright work is registered, however, the term varies depending upon when the copyright was created and registered, as well as other criteria, but generally is 70 years after the death of the author. For a work of corporate authorship, the term is 95 years from publication or 120 years from creation, whichever expires first.

Whether registered or not, however, it is beneficial for each copy of a copyrighted work to include a notice of the copyright ownership. Copyright ownership notice may be given by placing the name of the copyright owner, the year of the copyright and a "C" in a circle (i.e., the symbol "©"). While notice is not required, it would be unwise to forgo it. If such copyright notice is not attached to all copies of a copyrighted work, then the copyright owner will only be entitled to actual damages in a lawsuit, and there are defenses such as fair use and dedication to the public that are easier for the alleged infringer to raise.

While a copyrighted work can be registered in the name of any entity, such as a corporation, there is a large distinction between a copyrighted work created by an employee and a copyrighted work created by a consultant/independent contractor. Creation of a copyrighted work by the latter types of individuals, even for payment of monies, will not vest ownership of the work in the entity or person that paid for the work's creation. Therefore, a formal document evidencing that a consultant/independent contractor is under a legal obligation to assign any created copyrighted work is essential to protect the employer's rights over the consultant's or independent contractor's creations.

Trade Secrets

In contrast to patents, which are obtained in return for the prompt and full disclosure of an invention, trade secrets are maintained by the opposite course of conduct: maintaining the confidentiality of the information for which trade secret protection is sought. Trade secrets confer a competitive advantage on their owners in that their competitors do not have the benefits of the confidential information that is the subject of the trade secrets.

Unlike patents, which have terms of limited duration, the term for trade secret protection is indefinite and theoretically forever—as long as the confidential nature of the trade secret is maintained.

A trade secret is lost, however, upon the public disclosure of the confidential information that is the subject of the trade secret. Accordingly, the trade secret owner must safeguard the trade secret to maintain its confidential nature, as well as take measures to cure any breach of confidentiality should that occur. Note also that if certain information is maintained as a trade secret and used for commercial purposes, one cannot later (any time more than one year after use) seek to obtain patent protection for the subject matter of the trade secret.

It is prudent for an employer to ensure that its confidential information is maintained as such by its employees by requiring each employee to sign a confidentiality agreement at the initiation of the employment, by which the employee agrees to maintain as confidential all trade secrets of the employer. The employer should also have security procedures in place to ensure secrecy of the information, including limiting access to the confidential information to employees who have a need to know. The invention assignment agreement, mentioned above in the patents subsection, should also be worded in a manner to ensure that ownership in any trade secrets developed by an employee vest in the employer.

Each state typically has its own version of trade secret laws.

IP Litigation

As mentioned above, damage awards can be much more significant in the United States than in other countries. Further, litigation expenses generally are much more significant in the United States than elsewhere, for a whole host of reasons. The most significant reason is that the manner in which litigation is conducted is significantly different: rather than being required to independently obtain the evidence needed to win your case as in many foreign jurisdictions, in the United States there is a process called "discovery," where each side is required to provide to the other side (or at least the attorneys for the other side) documents and information relevant to the case. Often, discovery is time-consuming and thus also costly.

Another significant difference is the jury system. Cases in Federal District Court or state lower courts in many instances can be decided by a jury—a group of 6 to 12 individuals who have no specialized training in the law. Once the jury decides, a losing party has to appeal to a higher court to overrule the jury's decision, and the losing party may not succeed in its appeal as the jury verdict is entitled to substantial deference.

Discovery and jury trials are part of the litigation process in federal or state lower courts. While certain administrative courts, such as the Internal Trade Commission (ITC), do not have jury trials, and cases in such courts are decided by judges, these administrative courts still have a discovery process.

We discuss different types of IP litigation in the following pages.

Patents

Patent litigation, as well as the other forms of IP litigation mentioned in the following section, typically begins either formally with a complaint being filed or informally upon receipt of a letter requesting another party to take a license or cease and desist from infringing. Sometimes, an accused infringer can also formally initiate the process through the filing of a complaint for declaratory judgment of invalidity and/or noninfringement. Once a patent owner is aware of an infringement, however, it must take actions to stop the infringement; otherwise, defenses of laches (e.g., the plaintiff's neglect or delay in bringing suit, which caused material prejudice to the defendant) not having an estoppel (e.g., the plaintiff acting in a way that led the defendant to rely on the act and that reliance resulted in material prejudice to the defendant) may arise, in addition to giving up damages that may otherwise be obtainable. While patent infringement is a continuing tort, any lawsuit brought can only recover for claims that predate the filing of the lawsuit by six years at most, and in certain circumstances recovery can only be obtained for infringement that occurs on or after the filing of the lawsuit.

The alleged infringer, the defendant, will typically raise defenses of invalidity and/or noninfringement, as well as others (such as laches or estoppel) depending upon the situation. The defendant may also analyze its financial exposure from the allegations, and determine whether it has any IP of its own, typically patents, to use in its defense or to claim that the complaining party has in fact violated the defendant's own IP.

A typically significant event that takes place during the discovery phase of most patent litigation in the United States is what is referred to as a "Markman" hearing. This is a hearing on claim construction issues where the court, upon briefing by the parties, will issue a Markman Order that provides the court's interpretation of the terms of the patent claims in issue. The court's interpretation of the claim language will ultimately be used in deciding whether infringement exists and whether the claim is valid. This claim construction is, in many instances, dispositive on whether the infringement assertion sought by the patent owner will hold up. Though claim constructions can be appealed to a court of appeals, given the significant costs of reaching an appeal stage (completion of discovery, pretrial and trial, as well as post-trial motions), many patent litigations settle after the initial Markman Order is issued.

Patent litigation in the United States tends to be quite expensive. The fees and costs for discovery alone, depending on the size of the matter and the potential damages involved, range from hundreds of thousands to several million dollars. Costs of pre-trial and trial proceedings are roughly the same. In ITC proceedings, the overall fees and costs are roughly the same as well, just more condensed in time.

In addition to the fees and costs of patent litigation, the damages can be significant, as can the injunctive relief obtained by a patent owner that successfully asserts the patent-in-suit. In addition to permanent injunctive relief that is available at the end of the proceedings, temporary injunctive relief during the pendency of the litigation can also be obtained in the appropriate circumstances.

Somewhat related to fees and costs are issues surrounding damages for "willful infringement." Willful infringement is determined by the court during the trial stage, and discovery on whether infringement was willful occurs during the discovery stage. If a defendant is found to willfully infringe, the court can award up to three times the damages otherwise found, and, more rarely, order payment of the other side's attorney's fees.

Most patent cases are settled prior to trial. Willful infringement will not likely be a factor in reaching settlement. In almost all settlements, each party will pay its own attorney's fees, and the settlement itself will include a release from any allegations of willful infringement.

Trademarks

While not as prevalent as patent litigation, trademark litigation occurs, especially for companies that compete by selling products with names or brands that are purposefully the same or similar as the trademark of their competitors. In many instances, if the alleged infringer agrees to change the name that is being used for the product or service being sold, the case can be terminated quite quickly. If that is not possible, trademark litigation can become expensive. This is particularly due to the use of surveys, many times obtained by each side, to establish or refute whether a "likelihood of confusion" exists, as it is the trademark owner's burden to show that the defendant's use of the mark has created a likelihood of confusion about the origin of the defendant's goods or services.

The defendant can rebut the factors that the plaintiff needs to prove, in particular by showing that there was not use in commerce by the defendant, or that that there is no likelihood of confusion. Additionally, defenses available include laches, estoppel, unclean hands, and fair or collateral use of the mark the defendant is alleged to infringe.

While no deadline exists to bring a trademark lawsuit, if a trademark owner waits too long, this will strengthen the defendant's laches defense considerably.

The trademark law, unlike most other areas of the law, imposes an obligation on the owner to enforce trademark rights against others, though how much enforcement is required is a case-by-case factual analysis. If third parties are infringing on a trademark and the trademark owner does nothing, then the rights in the trademark can be compromised, and possibly lost altogether in severe instances.

The remedy in trademark litigation is typically a permanent injunction preventing further infringement; money damages are not normally awarded. Award of attorney's fees may also be available to a successful trademark owner, and such awards occur in the normal course of trademark litigation, which is different from patent litigation.

Often, claims that are related to trademark infringement are made. These may include dilution (a claim that the defendant's use of a mark dilutes the distinctive quality of the mark (which usually has to be a famous mark), false advertising, unfair competition or counterfeiting claims. Trademark claims are typically directed at eliminating infringing activities. Therefore, trademark litigation is usually different from patent litigation in terms of the end result, as in patent litigation, the goal is often to obtain a reasonable royalty but may otherwise permit the patent to be used by the competitor.

Copyrights

Copyright litigation typically arises either in the media sector, where a photograph, film clip, movie, book or other artistic work has been copied, or in the technology sector, where a computer program has been copied and is being used by someone not having the rights to it. A claim for copyright infringement depends on whether the alleged infringing work is "substantially similar" to the copyrighted work.

In the United States, while copyright ownership exists when the work is created, in order to bring a copyright lawsuit, the copyright must be registered. Early registration of a copyright can be beneficial not only in meeting this requirement, but also in enabling a copyright owner to assert that "statutory damages" exist. If statutory damages are available, the copyright owner will not need to prove actual damages, which can be difficult. By having filed for copyright registration early and having statutory damages available, a copyright owner will have additional leverage during the copyright litigation.

In copyright litigation, as in patent litigation, damages and injunctions are available as remedies to the copyright owner, as are forms of damages for willful infringement. In addition, the copyright owner can demand seizure of the allegedly unauthorized goods. The deadline to bring a copyright litigation lawsuit is three years after the copyright infringement. The alleged infringer's copyright defenses can include: the subject matter is not copyrightable or is in the public domain, that the accused infringer's use is a fair use or that the accused infringer's use is a permitted parody.

In the United States, the Digital Millennium Copyright Act (DMCA) relates to copyright infringement and the Internet. An Internet Service Provider (ISP) can use the DMCA to protect itself from copyright infringement liability for copyright infringement by its users, if the ISP meets certain statutory standards.

Trade Secrets

While trade secret litigation can be brought based upon the overt theft of confidential information, more typically the basis for the action is confidential information that was properly obtained for some limited purpose, and then improperly used for some other purpose. Examples include:

- An employee or group of employees terminating their employment with an employer, then using the confidential information of the former employer in a subsequent employment setting.
- A contractor, manufacturer, developer or joint venture partner using confidential information obtained from a specific customer or vendor for its own purpose or for other customers or vendors.

In order to bring a claim for trade secret misappropriation, a trade secret must be identified and claimed to be misappropriated. Defenses to such a charge range from asserting that the alleged trade secret was not used or that the alleged trade secret is not a trade secret, to asserting that while there is a trade secret, its use was permitted for some reason.

While the law differs from state to state, typically a complaint alleging a defendant has misappropriated a trade secret must be brought within three years after the time the plaintiff should have discovered the misappropriation using reasonable diligence.

Injunctive relief and money damages (including punitive damages), as well as awards of attorney's fees, are possible remedies, although for attorney's fees the courts typically require evidence of some type of willful or malicious behavior by the defendant.

Cost Consideration

As noted above, IP litigation in the United States is generally expensive, irrespective of which type of claim is involved. IP litigation also requires the parties to spend considerable time participating in the discovery process, through producing of documents (which can be and often are voluminous), depositions and the like. Due to the fact-intensive nature of most IP claims, they typically are not settled on summary judgment early in the case; hence, significant fees and costs can be incurred in any event. Attorney's fees and costs will in many instances exceed the perceived as well as actual value of the claim, thus making early settlement of claims an unpalatable but potentially sound business judgment.

Practical Considerations

With respect to protecting one's IP, many companies will likely file their own patent applications and register their copyrights and trademarks in their home country. A company with IP in their home country should determine what particular IP should also be filed in the United States in view of the company's strategic goals, and consult with its IP counsel to determine the various conventions that can be used to make international filings. The company will be well advised to have internal systems in place that will identify any IP before it is publicly disclosed. That will allow the company to make a timely, strategic decision whether such IP should be retained as a trade secret or published in a patent application, for example.

In addition, before entry in the U.S. market, the company should conduct IP due diligence in the United States to ensure that the products and services it plans to market in the United States do not infringe existing IP rights of others, especially the IP rights of its primary competitors. If the due diligence investigation indicates a potential infringement issue, the company may consider designing around existing patents or trademarks. It is also possible to create your own patent portfolio in a manner that will allow it to be used against competitor's products. While such advance planning may not eliminate a lawsuit, at least it allows you to be prepared if one is filed against your company. To this end, the company should seek the advice of experienced U.S. IP counsel.

If your company is sued, then the type of company bringing a lawsuit matters. Non-practicing entities (NPE, also pejoratively known as "trolls") are only interested in a monetary settlement and not in obtaining an injunction or putting your company out of business. So if sued by an NPE, one set of considerations and strategies is needed – typically the considerations include how many defendants have been sued, your financial exposure, the cost of early settlement, based on which you can determine your response strategies. In contrast, your direct competitor's may be interested in obtaining an injunction against you or putting your company out of business, and a different set of considerations and strategies is needed. Here, advance planning can work, as it is possible to review the IP portfolio of your competitor, and make decisions based on that. Your response strategies can include, for instance, obtaining a willfulness opinion or designing around patents or trademarks, or both.

Lastly, we reiterate the importance of advance planning and the need to consult with experienced counsel early, so that you can achieve your business objectives in a cost-efficient manner.

CHAPTER 10

ENERGY REGULATION IN THE UNITED STATES

By Michael G. Lepre and Kimberly A. Harshaw

Introduction

There is no single source of law that can be considered a U.S. energy policy. At the federal level, the Department of the Interior (DOI), the Department of Transportation (DOT), the Department of Energy (DOE) and the Environmental Protection Agency (EPA) play important roles in the development and maintenance of a national energy policy. At the state level, their counterpart agencies, which are often delegated authority by federal legislation, play a similar role.

Over the years, there have been several legislative efforts by the U.S. Congress to develop a general energy policy that promotes the domestic production of sources of energy while also responding to environmental concerns. After 13 years of debate, Congress passed the Energy Policy Act of 2005 (EPAct 2005), which represents the most significant change in U.S. energy policy since the Federal Power Act of 1935 (FPA) and the Natural Gas Act of 1938 (NGA). The act is intended to facilitate the increased domestic production of oil and gas, electricity and other forms of energy.

On the heels of the EPAct 2005, the Congress enacted the Energy Independence and Security Act of 2007 (EISA). The EISA expanded the renewable fuel program established by the EPAct 2005, which required volumes of renewable fuel to be incorporated into gasoline sold in the United States. The EISA, and subsequent regulatory revisions implemented by EPA in 2010, increased the volumes established for renewable fuel and added new specific volume requirements for advanced biofuels, biomass-based diesel and cellulosic biofuel. The EISA articulated a national policy aimed at reducing the country's carbon footprint and dependence on non-U.S. oil through the use of renewable fuels.

Electricity

A number of government agencies are involved in different aspects of the regulatory policies governing electricity. At the federal level, Congress ultimately determines the direction of national energy policy through legislation, but it delegates broad authority to implement legislative mandates to the Federal Energy Regulatory Commission (FERC), an independent regulatory agency within the DOE, and other administrative agencies. At the state level, electric utilities are regulated by public utility commissions (PUCs).

Federal Administration Agencies

FERC is charged with implementing, administering and enforcing most of the provisions of the EPAct 2005, FPA, NGA and other statutes regulating the electric utility industry. FERC has authority to regulate sales of wholesale power and transmission in interstate commerce and to grant and administer licenses for hydroelectric plants on navigable waters. Under the Public Utility Holding Company Act of 2005 (PUHCA 2005), FERC also has authority to grant exempt wholesale generator (EWG) status and foreign utility company (FUCO) status. FERC exercises authority under the Public Utilities Regulatory Policies Act (PURPA) with respect to qualifying small power production facilities and cogeneration facilities (QFs).

FERC has jurisdiction over the disposition of assets subject to its jurisdiction, including through mergers, asset divestitures, corporate reorganizations and other transactions in which there is a change in the control of those assets. FERC also has oversight authority with respect to the issuance of securities (except if regulated by a state) and interlocks among the officers and directors of public utilities and financial institutions, or the utility's suppliers of electrical equipment. Public utilities under FERC's jurisdiction are subject to various requirements with respect to accounting and record retention and are required to satisfy various reporting requirements.

Under PUHCA 2005, FERC has increased oversight over, and access to, the books and records of public utility holding companies and their subsidiaries and affiliates to the extent that such books and records pertain to FERC jurisdictional rates or charges. Any service company in a holding company system providing non-power goods and services to an affiliated FERC jurisdictional public utility or natural gas company must file annual reports disclosing detailed information about their businesses. Public utility holding companies may seek exemptions and waivers from these regulatory requirements. However, an automatic exemption from all of the requirements is available to companies that are holding companies solely with respect to ownership of EWGs, QFs or FUCOs. In addition, single-state holding companies are entitled to a waiver from some, but not all, of the requirements but must seek the waiver from FERC.

Organization of the Market

According to FERC, as of its most recent data from 2007,[29] the U.S. electric industry comprises 3,273 electricity providers, including 2,009 publicly owned utilities, 883 cooperatives, 210 investor-owned utilities and nine federal utilities. The private sector includes traditional utilities that are vertically integrated, generation-owning companies and power marketers, and transmission or distribution "wires-only" companies. These companies may be privately owned or publicly traded. The public sector includes municipally owned utilities, public power districts, state agencies, irrigation districts and other government organizations, and at the federal level, the Tennessee Valley Authority and federal power marketing administrations. Rural electric cooperatives, formed by residents, operate in 47 states and represent about 10% of sales and revenue.

Transmission

The U.S. bulk power transmission system is composed of facilities that are privately, publicly, federally or cooperatively owned, which form all or parts of three electric networks (power grids): the Eastern Interconnection, which stretches from central Canada to the Atlantic Coast (excluding Québec), south to Florida and west to the Rockies (excluding much of Texas); the Western Interconnection, which stretches from western Canada south to Mexico and east over the Rockies to the Great Plains; and the Electric Reliability Council of Texas (ERCOT), which serves a large portion of Texas.

Historically, transmission lines owned by private sector companies were part of vertically integrated utilities. In 1996, FERC issued Order No. 888, requiring each public utility subject to FERC's jurisdiction to:

- file an open-access transmission tariff declaring the terms and conditions for using its transmission system; and
- "functionally unbundle" its services.

29 See www.eia.gov/electricity/archive/primer.

Regulation of Electric Utilities

The siting and construction of electric generation, transmission and distribution facilities has historically been a state and local process, although EPAct 2005 altered this historic arrangement by giving ultimate transmission siting authority to FERC in certain cases. In making siting decisions, state PUCs consider environmental, public health and economic factors. The PUCs exercise their authority in conjunction with state environmental agencies or local zoning boards. A few states have a siting board or commission that provides a single forum where an electric utility or an independent developer can obtain all necessary authorizations to construct the requested facilities. Other states have not consolidated the siting process, and electric utilities or independent developers in those states are required to obtain the necessary permits separately from each of the relevant state and local agencies. State and local permits required for the construction of electric generation facilities include air permits and water use or discharge permits from the state environmental commission, and zoning and building permits from local commissions.

Regulated utilities are required to obtain a certificate of public convenience and necessity from the relevant PUC for the construction of generation, transmission and distribution facilities that will be subject to cost-based rate regulation. No federal certificate of public convenience or necessity is required from FERC for the siting and construction of electric generation, transmission or distribution facilities under Part II of the FPA.

However, a FERC license must be obtained under Part I of the FPA for the construction of hydroelectric facilities on navigable waters. Construction affecting federal lands may also require authorization from agencies such as the Bureau of Land Management, the U.S. Forest Service or the National Park Service. The U.S. Army Corps of Engineers reviews projects affecting wetlands or navigable waters.

Construction

Construction of transmission facilities is primarily a state-regulated function, but federal authorities have jurisdiction over siting on federal lands, and multi-state projects may require the authorization of several states. Historically, this fragmented system for siting new power lines, in addition to other factors such as regulatory uncertainty on the state and federal levels associated with transmission cost recovery, has been a significant barrier to the development of new transmission in the United States. The EPAct 2005 provides tools to facilitate new construction and improvements to the existing transmission infrastructure.

EPAct 2005 directed the DOE to identify areas in which transmission capacity constraints or congestion adversely affect consumers (national interest electric transmission corridors) and gave FERC supplemental permitting authority to ensure timely construction of transmission facilities to remedy transmission congestion in those corridors. The DOE has designated two such corridors, the Mid-Atlantic Area National Interest Electric Transmission Corridor and the Southwest Area National Interest Electric Transmission Corridor. Under authority provided by EPAct 2005, FERC may issue federal permits to construct or modify electric transmission facilities if it finds that states are holding up transmission projects in these corridors.

EPAct 2005 also provides a mechanism for the private use of the eminent domain power of the U.S. government, where necessary, to obtain property for transmission infrastructure projects. In addition, EPAct 2005 requires that the federal government identify rights of way across federal lands that can be made available for siting electric transmission.

Operation

FERC issued a series of orders, beginning with Order No. 890, which were intended to eliminate the broad discretion that transmission providers had in calculating available transfer capacity, increasing non-discriminatory access to the grid and ensuring that customers are treated fairly in seeking alternative power supplies. Since Order No. 890-A, transmission providers have implemented new service options for long-term firm point-to-point customers and adopted modifications to other services. Instead of denying a long-term request for point-to-point service because as little as one hour of service is unavailable in the course of a year, transmission providers are now required to consider their ability to offer a modified form of planning redispatch or a new conditional firm option to accommodate the request. This increases opportunities to utilize transmission efficiently by eliminating artificial barriers to use of the grid. This standardization reduces the potential for undue discrimination, increases transparency, and reduces confusion in the industry that resulted from the prior lack of consistency.

FERC regulations also require the posting of available transfer capacity values associated with a particular path, not available flowgate capacity values associated with a flowgate. With respect to energy and generation imbalance charges, a transmission provider must post the availability of generator imbalance service and seek imbalance service from other sources in a manner that is reasonable in light of the transmission provider's operations and the needs of its imbalance customers. FERC also limited rollover rights to contracts with a minimum term of five years. In Order No. 890-B, FERC reiterated that a power purchase agreement must meet all of the requirements for designation as a network resource in order to be designated by the network customer or transmission provider's merchant functions.

Pursuant to EPAct 2005, FERC has established incentive-based rate treatments to encourage investment in and expansion of the aging transmission infrastructure in the United States. FERC Order No. 679, issued in 2007, includes a number of key provisions to promote transmission investment, including:

- incentive rates of return on equity for new investment by public utilities (both traditional utilities and stand-alone transmission companies);
- a higher rate of return on equity for utilities that join or continue to be members of transmission organizations (e.g., Regional Transmission Organization (RTOs) and Independent System Operators (ISOs)); and
- various advantageous accounting methods, including:
  - full recovery of prudently incurred construction work in progress, pre-operation costs and costs of abandoned facilities;
  - use of hypothetical capital structures;
  - accumulated deferred income taxes for stand-alone transmission companies;
  - adjustments to book value for stand-alone transmission company sales or purchases;
  - accelerated depreciation; and
  - deferred cost recovery for utilities with retail rate freezes.

In Order No. 679 and Order No. 679-A, FERC extended the eligibility for incentive rate treatment to all utilities joining ISOs or RTOs, irrespective of the date they join. However, this incentive does not apply to existing transmission rate base, as its purpose is to attract new investment in transmission.

FERC has jurisdiction over unbundled transmission services (including transmission services provided over low-voltage facilities) provided by public utilities to wholesale customers or to retail customers with direct access. The states have jurisdiction over bundled retail service (i.e., a combined generation and delivery product sold to retail customers) where direct access is not available. Court decisions and the interconnectivity of the transmission grid in the continental United States have led to an expansive view of what constitutes transmission service in interstate commerce in all areas of the United States except Alaska, Hawaii and ERCOT. The FPA, however, reserves to the states jurisdiction over the local distribution of electricity.

Natural Gas

A central feature of U.S. governmental policy for the domestic natural gas sector is to prevent abuse of power by firms with monopoly power. However, this is balanced by policies that support increased gas production and, for limited parts of the sector, deregulation and the promotion of competitive market forces. Policies are set by the legislative and executive branches of both federal and state governments, with significant delegation of authority to administrative agencies that are part of the executive branch, particularly FERC.

Domestic Sector

In the United States, in contrast to the oil sector, in which some companies are active in all segments, it is more common for companies in the natural gas sector to concentrate on two or three segments (e.g., production and gathering, or transmission and storage). The upstream segments of the gas sector are conducted by a variety of private parties, from individual entrepreneurs to large integrated firms, which engage in securing grants of licenses and leases to explore for and produce valuable substances. Processing of gas and fractionation of natural gas liquids (NGLs) can occur in the field by the lessee, or downstream in plants on gathering or trunk lines between the field and the main trunkline pipeline systems. The midstream and downstream segments of gas and liquefied natural gas (LNG) storage, trunkline transportation and local distribution are typically conducted by private entities subject to public utility regulation at the federal or state level, or by municipal utility districts.

The United States (including Puerto Rico) has 11 LNG terminals. Twenty-two terminals have been permitted to be built by utilities, private and publicly traded development firms, and oil companies with gas production in the developing world. There are approximately 305,000 miles of natural gas pipelines in the United States, approximately 71% of which consists of interstate pipelines with an aggregate capacity of about 183 billion cubic feet (bcf) per day.

In the United States, ownership of pipeline transportation capacity is separated from ownership of the natural gas transported via pipeline, although some Canadian producers also own natural gas pipelines that cross from Canada into the United States. The federal government does not participate directly as a party in private natural gas production transactions. It derives value from natural gas production through the royalties, annual rentals and bonus payments it receives for production on federally owned lands. The Minerals Management Service (MMS) is the federal agency that manages the nation's mineral resources on the outer continental shelf and collects, accounts for and disburses revenues from federal offshore leases and onshore leases on federal and American Indian lands. In addition, government agencies impose a variety of taxes and charges. FERC, for example, is authorized to recoup its entire budget appropriation through the imposition of annual charges and filing fees.

Production, Drilling and Supply

Natural gas producers are not directly regulated by the federal government. The prices they charge are no longer regulated by the government but generally are a function of competitive markets. State public utility commissions generally exercise regulatory authority over retail natural gas rates and consumer protection issues.

Transmission

FERC is the primary federal regulatory agency governing natural gas transmission. FERC has jurisdiction over the regulation of interstate pipelines and is concerned with overseeing the implementation and operation of the natural gas transportation infrastructure. In addition, FERC has primary regulatory authority to permit, site and approve onshore LNG import terminals.

Distribution

State regulatory utility commissions have oversight of issues related to the siting, construction and expansion of local distribution systems. FERC's regulatory authority extends to the interstate transportation of natural gas, the import and export of natural gas by pipeline or LNG terminals, and certain environmental and accounting matters. The Office of Pipeline Safety of the DOT has jurisdiction over pipeline safety. State PUCs have oversight of issues related to the siting, construction and expansion of local distribution systems and also have jurisdiction over retail pricing, consumer protection, and natural gas facility construction and environmental issues not covered by FERC or DOT.

The government authorizations required to pursue natural gas exploration and production activities depend on whether the proposed project is to be conducted on federal, state or privately owned land, and whether the associated pipeline transportation and storage of natural gas are conducted by the private sector. According to the U.S. Energy Information Administration (EIA), there are 185 companies operating natural gas pipelines in the United States. Private companies in the United States operate 400 underground storage facilities, mainly in depleted reservoirs, aquifers and salt caverns.

Pursuant to Section 7 of the NGA, interstate pipelines and gas storage facilities must obtain certification from FERC before constructing or expanding facilities. Intrastate gas transmission and distribution facilities are certificated by state and local authorities.

Under applicable statutes, FERC will issue a certificate to a pipeline if there is a benefit to the public, including compliance with environmental standards. Current FERC policy is generally to issue certificates to all pipelines that comply with the statutory standards, but to let the market decide which pipelines will be built.

The location, construction and operation of interstate pipelines, facilities and storage fields involved in moving natural gas across state boundaries must be approved by FERC. The pipeline company proposes the route or location, which is then reviewed by FERC. If a proposed pipeline route is on or adjacent to private land, the company will inform the private landowners and obtain any necessary rights-of-way (or alternative access rights) prior to construction.

There are essentially three major types of pipelines along the transportation route: the gathering system, the transmission pipeline and the distribution system. The gathering system transports raw natural gas from the wellhead to the processing plant. Transmission pipelines use higher-pressure and larger-diameter pipes to move natural gas quickly over long distances, and is typically interstate but can be intrastate. Interstate pipelines carry natural gas across state boundaries, whereas intrastate pipelines transport natural gas within a particular state. Interstate natural gas pipeline networks transport processed natural gas from processing plants in producing regions to those locations with high natural gas requirements, particularly large, densely populated urban areas. Distribution systems deliver the natural gas to homes, businesses and power plants.

Transportation of natural gas is closely linked to its storage. If the natural gas being transported is not required at the time, it can be injected into storage facilities for use at a later time. Natural gas pipeline companies have customers on both ends of the pipeline—the producers and processors that deliver gas into the pipeline, and the consumers and local distribution companies that take gas out of the pipeline. In accordance with FERC rules, access to interstate natural gas transportation and storage services must be provided on a non-discriminatory basis. Generally, purchasers of gas interstate transportation and storage services negotiate individual contracts with pipeline and storage companies, which are subject to the service provider's tariff as approved by FERC. Where there is limited capacity for interstate storage or transportation, capacity is allocated through a bidding process in which the pipeline or storage capacity is generally awarded to the highest bidders. Under FERC rules, the terms and rates charged for all interstate pipeline transportation and storage services must be applied in a non-discriminatory manner, must not be unduly restrictive and must be fair to all parties.

Each pipeline and storage company providing gas transportation and storage services subject to FERC jurisdiction is required to file and obtain FERC approval of a tariff for such services. Each tariff contains the general terms and conditions of service, rate schedules and form agreements. General terms and conditions in both transportation and storage tariffs typically address priority and curtailment of service; nominations and scheduling; receipt and delivery points; quality and pressure; title and risk of loss; measurement; fuel reimbursement; and balancing. Transportation rate schedules typically set forth maximum and minimum rates for the various types and classes of service, and mutually agreed recourse rates that are no less than the minimum tariff rate. Contracts for intrastate transportation and storage of natural gas can also be privately negotiated. In many states, these contracts are subject to the provider's tariff, which has been filed with a state governmental authority, but typically do not require advance approval.

Regulation of Natural Gas Distribution

In addition to interstate and intrastate pipeline companies, which deliver natural gas directly to primarily large-volume users, natural gas local distribution companies (LDCs) transport gas to specific customer groups. LDCs can be investor-owned, municipality-owned, privately owned or cooperatives. Generally, investor-owned LDCs supplied the majority of the total volume of natural gas deliveries.

Regulation of Natural Gas Sales and Trading

Natural gas is supplied and traded by private-sector companies, pursuant to privately negotiated transactions. These companies can be privately or publicly owned and range in size from entrepreneurs to very large organizations, but counterparties value creditworthiness and staying power in their trading partners.

Under the current regulatory regime, only pipelines and LDCs are directly regulated. Interstate pipeline/storage companies are regulated in the rates they charge, the access they offer to their pipelines, and the siting and construction of their facilities. Similarly, LDCs are regulated by state utility commissions, which oversee their rates and construction issues, and which ensure that proper procedures exist for maintaining adequate supply to customers. While there is no direct government agency charged with direct day-to-day oversight of natural gas producers and marketers, producers and marketers must still comply with other laws, including authorization and permitting requirements. The trading of natural gas is largely market-driven; however, rules are in place to ensure that the market is operated fairly. FERC has also implemented “anti-manipulation” rules that prohibit fraudulent or deceptive practices and omissions or misstatements of material facts in connection with purchases or sales of natural gas or transportation services subject to FERC jurisdiction.

The Commodities Futures Trading Commission (CFTC) regulates natural gas futures to prevent similar abusive trade practices. In October 2011, the CFTC adopted final rules imposing speculative position limits for natural gas futures and option contracts, among other futures and swap contracts.

Regulation of LNG

All currently operating U.S. LNG facilities are ultimately owned by U.S. or foreign private companies. Ownership structures vary from project to project and may include direct ownership by a single entity, joint ventures among two or more parties, or many other possible structures. Terminals may be operated either on a “tolling” basis, in which the terminal operator does not take title to the hydrocarbons, or with passage of title to or from the terminal operator or owners before or after completion of the regasification process.

Oil

General

The U.S. oil industry is divided into three sectors: upstream (exploration and production), midstream (processing, storage and transportation) and downstream (refining, distribution and marketing).

Industry participants are categorized as “supermajors,” “majors” and “independents.” Supermajors are the handful of very large integrated companies that account for most of the U.S. oil industry revenues. U.S.-based supermajors include ExxonMobil, Chevron and ConocoPhillips, whereas the overseas-based supermajors BP and Shell have substantial U.S. operations. Smaller-scale integrated firms include Marathon, Hess and Murphy Oil.

A larger number of companies specialize in particular sectors. Independents engage exclusively in upstream activities and include Occidental, Devon, Anadarko and Apache. Midstream specialists include El Paso and Kinder Morgan. Refining and marketing operations are conducted by Valero, Sunoco, Tesoro and Western. The industry is supported by oil service companies led by Schlumberger, Halliburton and Baker Hughes, and by a variety of trade associations, including the American Petroleum Institute (API).

U.S. subsidiaries of national oil companies owned or controlled by non-U.S. governments (NOCs) are important participants in the U.S. oil industry. For example, Venezuelan-based Petróleos de Venezuela SA (PDVSA) owns Citgo’s 13,000 retail outlets and interests in three refineries in the United States.

“Proven reserves” are estimates of the amount of oil that is reasonably certain to be recoverable from known reservoirs under current economic and operating conditions. The United States ranked 13th among nations in proven oil reserves, estimated by the government at 20.7 billion barrels based on January 2011 data.[30] U.S. proven reserves peaked in 1970 and have since declined.

Source of Law

The determination of which laws apply to oil activities at a given surface location depends on whether the underlying resources and location are owned by a federal or state government or by private parties, and whether the location is onshore or offshore. The Mineral Lands Leasing Act governs upstream activities on federal onshore property, while the Outer Continental Shelf Lands Act governs development of federal offshore property. Additional industry-specific federal statutes include the Oil and Gas Royalty Management Act, governing lease and royalty agreements, and the Petroleum Marketing Practices Act, regulating supply agreements and leases held by retailers and wholesalers of trademarked motor fuels. State laws, such as the Texas

30 See www.cia.gov/library/publications/the-world-factbook.

Natural Resources Code and the California Public Resources Code, govern exploration and production on state-owned land, including state offshore property, and privately owned land.

Within the DOI, the Bureau of Land Management regulates oil exploration and production on federal onshore property and, together with the Bureau of Indian Affairs, regulates American Indian land development; and the Minerals Management Service (MMS) regulates federal offshore activities. FERC has jurisdiction over interstate oil pipelines. The DOE administers the Strategic Petroleum Reserve, collects industry data, and funds and conducts other energy research and production programs.

Each of the major oil-producing states has an agency tasked with regulating certain upstream activities, such as the issuance of drilling permits and intrastate pipeline transportation. These agencies include the Railroad Commission of Texas; the California Department of Conservation's Division of Oil, Gas and Geothermal Resources; the Louisiana Office of Conservation; and the Alaska Department of Natural Resources' Division of Oil and Gas. Some state public utility commissions oversee aspects of intrastate oil pipelines.

The EPA and many other agencies enforce police power laws and regulations regarding environmental, health, safety and work conditions.

International

Although the United States is not a signatory to the Law of the Sea Treaty, federal laws and executive orders have promulgated U.S. offshore territorial zones and economic exclusion zones that are comparable to those under the treaty.

The 1978 protocol to the 1973 International Convention for the Prevention of Pollution from Ships (MARPOL) has spawned several U.S. statutes pertaining to oil tankers, including OPA, the Port and Tanker Safety Act and the Act to Prevent Pollution from Ships.

The United States is a member of the World Trade Organization (WTO) and a party to various WTO agreements. These instruments generally require member states not to discriminate against products and services of any member state or between products and services of different member states. However, there is an exception for free trade agreements, such as the North American Free Trade Agreement (NAFTA), which creates zero-duty regimes for imports and exports of products among Canada, the United States and Mexico, specifically including crude oil and refined products.

Nuclear Energy

Role of the Nuclear Regulatory Commission

What the Nuclear Regulatory Commission Regulates

The civilian nuclear energy industry in the United States is closely regulated by the Nuclear Regulatory Commission (NRC). The NRC is an agency of the U.S. government. The U.S. Atomic Energy Act of 1954 (AEA) requires that all civilian uses of nuclear materials and facilities be licensed by the NRC. The NRC's purpose is not to promote nuclear power. Rather, it is empowered to impose and enforce standards governing the use of nuclear materials and facilities as it deems necessary or desirable to protect the public health and safety and the common defense and security.

Specifically, the NRC regulates what is commonly known as "source, byproduct, and special nuclear material."[31] It also regulates facilities that produce, use or possess such materials. Facilities that fall under the NRC's regulatory authority include operating nuclear power plants, nuclear power plants that are being decommissioned, spent fuel storage facilities, uranium mines, uranium mills, uranium conversion facilities, uranium enrichment facilities, fuel fabrication facilities, low-level waste repositories, high-level waste repositories and reprocessing facilities. The NRC's authority does not extend to DOE nuclear facilities or the U.S. Navy's nuclear power program.

The NRC has four regional offices, which play a key role in implementing the NRC's mission. Each region is run by a regional administrator who has considerable authority and flexibility in implementing NRC inspection activities. Regional offices also administer the NRC resident inspector program. The regions play a significant regulatory role in evaluating licensee performance.

The NRC's Enforcement Program

The NRC's enforcement program is designed to emphasize the importance of compliance with regulatory requirements and to encourage prompt identification and prompt, comprehensive correction of violations. Violations are identified through inspections, investigations and licensee reports. The three primary enforcement mechanisms are notice of violations, civil penalties, and orders. Willful violations may be referred to the U.S. Department of Justice for criminal prosecution.

31 Source materials include thorium and uranium not enriched in the isotope U-235. Byproduct material is material resulting from or made radioactive in the process of producing or utilizing special nuclear material. This includes medical isotopes and uranium mill tailings. The NRC recently expanded its definition of byproduct material to include additional materials that are produced, extracted or converted for use in commercial, medical or research activities, such as accelerator-product material, discrete sources of radium-26, and certain discrete sources of naturally occurring radioactive material other than source material. Special nuclear material includes plutonium, uranium-233, and uranium enriched in the isotope U-233 or U-235.

The AEA authorizes the NRC to issue civil penalties of up to $130,000 per violation. Additionally, the NRC can issue orders that modify, suspend, or revoke licenses or require specific actions by licensees or persons. The NRC also has authority to issue an order barring an individual from engaging in NRC-licensed activities. The level of sanctions depends on the significance of the violation. In making such a determination, the NRC will look at the actual safety consequence, the potential safety consequence, the potential for impacting the NRC's ability to perform its regulatory function, and whether the violation was willful.

Regulating Foreign Ownership and Participation in Nuclear Industry Projects

There are several regulatory regimes that influence whether, and the extent to which, a non-U.S. entity can participate in the U.S. nuclear industry. For example, the NRC regulates foreign investment in NRC-licensed facilities. In addition, the Committee on Foreign Investment in the United States(CFIUS), an inter-agency committee chaired by the Department of Treasury, reviews foreign investments in areas vital to national security or the domestic industrial base, including nuclear and other energy-related projects. Finally, the NRC, and the DOE, the DOC, and the U.S. Department of State (DOS) regulate the transfer of nuclear technology to a non-U.S. entity. CFIUS is discussed at the end of this chapter, while the other two regimes are discussed below.

Foreign Investment in a Nuclear Project

Foreign investment in a U.S. nuclear power plant is subject to prior NRC approval. Indeed, the AEA prohibits the NRC from issuing a license to own or operate a reactor to "any corporation or other entity if the Commission knows or has reason to believe it is owned, controlled, or dominated by an alien, a foreign corporation, or a foreign government."

Neither AEA nor NRC regulations provide substantive criteria specifying what type of foreign investments in a reactor licensee constitutes foreign ownership, control or domination, or is inimical to the common defense and security. NRC guidance provides that an applicant for an NRC license is considered to be foreign owned, controlled or dominated whenever a foreign interest has the power, direct or indirect, whether or not exercised, to direct or decide matters affecting the management or operations of the applicant.

In reviewing an application from a potential licensee that has foreign investors, the NRC staff will consider whether additional action will be necessary to negate foreign ownership, control, or domination. For example, the NRC has allowed foreign ownership in NRC-licensed facilities where the applicant has agreed to implement "negation plans" that place control of safety-related activities in the hands of U.S. citizens. Such plans, for example, may require U.S. citizenship for at least half the members of the licensee's board of directors (or the members of special board committees having exclusive authority over nuclear-related operations), U.S.

citizenship for the board's Chairman, and that only U.S. citizens have authority to direct day-to-day decisions regarding health and safety or the common defense and security. In addition, under NRC guidance, further consideration will be given to factors such as:

- The extent of the proposed foreign ownership of the reactor
- Whether the foreign entity is seeking authority to operate the reactor
- Whether the foreign entity has interlocking directors or officers and details concerning the relevant companies
- Whether the foreign entity would have any access to restricted data
- Details concerning ownership of the foreign entity's parent company

NRC guidance states that even if a foreign entity contributes 50% or more of the costs of constructing a reactor, participates in the project review, is consulted on policy and cost issues, and is entitled to designate personnel to design and construct the reactor subject to the approval and direction of the non-foreign applicant, those facts by themselves do not require a finding that the applicant is under foreign control. There are some examples in which the NRC has allowed foreign entities to indirectly own up to 50% of an NRC licensee, and other examples in which the NRC has permitted 100% indirect foreign ownership of a minority interest in an NRC-licensed reactor through a U.S. subsidiary. In addition to applying NRC regulations and guidance, political considerations likely would play a role in whether the foreign investment obtains approval, given the NRC's wide discretion to make such decisions.

U.S. Export Controls

The United States also has established a comprehensive system of controls over the export of commodities, technology and software that can apply to exports in the nuclear industry, including transfers of such items to non-U.S. investors in U.S. nuclear projects.

Several agencies have export control jurisdiction. Shipments of most U.S. products and technical data are controlled by either the DOC or the DOS under two separate sets of regulations:

- The DOC, through its Bureau of Industry and Security, is responsible for implementing and enforcing the Export Administration Regulations (EAR). The EAR regulates the export and reexport of commercial items that it views as having "dual-use," e.g., both commercial and military or proliferation applications.
- The DOS controls the export of defense articles and services under the International Traffic in Arms Regulations (ITAR). These are items and services that, at the time of export, are considered inherently intended for military use. ITAR-controlled defense articles, services and technology are set out on the U.S. Munitions List.

- In addition, two agencies—the NRC and the DOE—regulate the transfers and retransfers of nuclear equipment, components and technology:
  - The NRC controls the export of certain nuclear equipment, components and materials under the AEA and the Non-Proliferation Act via its regulations at 10 C.F.R. Part 110.
  - The U.S. DOE controls the export of certain nuclear commercial technologies and specific nuclear reactor and nuclear weapons technologies under the AEA and various nonproliferation mandates.

The U.S. government has also imposed economic sanctions against certain foreign countries and entities, which can take the form of either limited or comprehensive embargoes. These sanctions, which include asset freezes; prohibitions on imports, exports or financial transactions; and restrictions on travel, are administered by the Office of Foreign Assets Control (OFAC) within the U.S. Department of the Treasury. OFAC administers and enforces economic and trade sanctions against targeted foreign countries, terrorists, international narcotics traffickers and those engaged in activities related to the proliferation of weapons of mass destruction.

Finally, the U.S. Patent and Trademark Office controls the export to foreign countries of unclassified technology in the form of patent applications or amendments, supplements and modifications to such applications.

It is important to note that most U.S. exports take place under expressly defined exceptions or waivers and do not require a specific export license or other special authorization. However, the export control system is ever-changing, and to simply understand where the controls apply often takes significant analysis and thorough understanding of each agency's jurisdiction and applicable regulations. Furthermore, violations of export control laws administered by all of the agencies cited above carry both civil and criminal penalties, which have risen exponentially in the past few years, underscoring that exports are an increased focus of enforcement. As U.S. government officials often say: "Exporting is a privilege, not a right."

Other Items of Interest to Non-U.S. Investors

As stated above, the NRC has broad authority to regulate many aspects of the U.S. nuclear industry. This chapter is not designed to describe the universe of such regulations. Rather, it is intended to provide a basic understanding of how the U.S. nuclear industry is regulated by the federal government, and how such regulations may impact non-U.S. investors. Accordingly, the following sections highlight two additional topics that may be of interest to non-U.S. entities contemplating investments in the U.S. nuclear industry: how participants in the U.S. nuclear industry are protected from liability for nuclear accidents, and the process for licensing a new nuclear power plant in the United States.

Financial Protection for Nuclear Incidents—Price-Anderson Act

The United States, through the Price-Anderson Act of 1957, has in place a comprehensive scheme for addressing financial liability for personal injury and property damage caused by a nuclear incident in the country. The Price-Anderson Act was the world's first comprehensive nuclear liability law. It is applicable to nuclear incidents that occur at U.S. reactor sites or during transportation to, or from, reactor sites that cause damage within or outside the United States. Since its inception, non-U.S. suppliers of equipment and services to nuclear power plants in the United States have found this system of liability protection to be adequate.

Similar to nuclear liability regimes of other countries, three principles underlie the Price-Anderson Act: (1) liability is effectively channeled to the operator of the nuclear installation; (2) liability for any serious accident is absolute; and (3) the amount of liability for a nuclear incident is limited.

The Price-Anderson Act requires U.S. licensees of commercial power reactors of 100 MW or more to obtain the maximum amount of insurance against nuclear-related incidents; this insurance is available in the market (currently $375 million per plant). Any monetary claims that fall within this maximum amount are paid by the insurer(s). The Price-Anderson fund, which is financed by the reactor companies themselves, is then used to make up the difference. Each reactor company is obliged to contribute up to $95.8 million, plus 5% for claims and costs, in the event of an accident. The maximum amount of the fund is currently more than $12 billion if all of the reactor companies were required to pay their full obligation to the fund. This amount of financial protection is the highest in the world. If a coverable incident occurs, the NRC is required to submit a report on the cost of it to the courts and to Congress. If claims are likely to exceed the maximum Price-Anderson fund value, then the president of the United States is required to submit proposals to Congress. These proposals must detail the costs of the accident, recommend how funds should be raised, and detail plans for full and prompt compensation to those affected.

The Price-Anderson Act requires persons claiming injuries or damage attributable to a nuclear incident to bring those claims in the U.S. District Court for the district where the incident occurred. The Price-Anderson Act's broad umbrella of protection covers any person who may be liable for public liability. Thus, all vendors, suppliers, contractors and investors, as well as anyone else who might be liable for a nuclear incident, are protected under the Price-Anderson Act. The Price-Anderson Act covers both companies and individuals.

The Price-Anderson Act has specific exclusions and areas that are not subject to the protection provided thereunder. These include claims for damage to property located at the site of the facility (which are covered by separate insurance policies as required by the NRC), claims arising out of an act of war (where special governmental measures adapted to the exigencies of war would be expected) and claims by workers on the site (which are covered by federal or state workers compensation laws).

New Reactor Licensing

An entity that desires to build, own and/or operate a nuclear power plant in the United States must first receive a license to do so from the NRC. The NRC has two processes for licensing a nuclear power plant. The current fleet of nuclear plants was licensed under a two-step process, which required the licensee to first obtain a permit from the NRC to construct the plant and later obtain a license from the NRC to operate the plant. This process requires a mandatory hearing before a construction permit is issued, during which opponents of the plant are permitted to raise any concerns. As plant construction approaches completion, the owner files for an operating license. While a hearing is not mandatory at the operating license stage, historically, plant opponents have sought hearings in virtually every case.

The NRC issued new regulations in 1989, which allow for a party to apply to the NRC for a single combined construction and operating license (COL). Under this approach, the COL application (COLA) can be submitted all at once or in phases. COLAs that have recently been filed with the NRC rely on the COL process and utilize standard nuclear reactor designs that are being certified for use in the United States by the NRC in "certification" proceedings. In those proceedings, the reactor vendor submits its design to the NRC for the NRC's detailed review and approval, and for public comment. The design certification process takes many years. COL applicants are entitled to rely in their COLAs on designs that have been certified or are undergoing certification. Challenges to such designs are prohibited in the COLA proceeding.

The COLA approval process involves an opportunity for directly affected members of the public to raise concerns, known as "contentions," regarding the proposed plant, and request a hearing. If those contentions are found worthy of further review, a hearing is held before an Atomic Safety and Licensing Board (ASLB) consisting of three members. At the same time, the NRC staff and the NRC's Advisory Committee on Reactor Safeguards will review the COLA. The NRC staff's review culminates with the issuance of draft, and later final, versions of a report evaluating the proposed project's safety and its environmental impacts.

Even if there are no hearing requests, or if the hearing requests are denied, the NRC must conduct a "mandatory" hearing in which it will receive evidence from the applicant and the NRC staff regarding the adequacy of the staff's safety and environmental reviews. The NRC's five commissioners have conducted these mandatory hearings to determine whether the COL should be issued. The NRC estimates that the process, from filing a COLA to obtaining a COL, will extend for approximately 42 months.

During plant construction, the COL licensee will submit periodic updates to the NRC regarding the schedule for completing the inspections, tests or analyses in the COL. Not less than 180 days before the scheduled initial loading of nuclear fuel into the reactor, the Commission will publish notice of intended plant operation. Any person whose interest may be affected by plant operation may request that the commission hold a hearing on whether the facility, as constructed, complies with the COL. Holding this hearing is discretionary on the part of the commission, and the commission will preside over the hearing. A decision by the commission that the criteria in the COL are met provides final authorization for plant operation. This decision is reviewable in the Federal Courts of Appeal.

Foreign Investments in the Energy Sector; CFIUS

Several current or former U.S. utilities are or have been owned by non-U.S. parties. There are no special requirements or limitations on non-U.S. companies acquiring interests in the U.S. natural gas sector. However, an entity applying for certification of a LNG facility under Section 3 of the NGA and the regulations issued pursuant to that section by FERC is required to disclose on the application any ownership by a foreign government or subsidization by a foreign government. The Mineral Lands Leasing Act forbids aliens and foreign corporations from directly owning mineral leases on federal lands. However, new investors should be aware of more recent changes in U.S. regulatory and political attitudes toward foreign investment in the energy sector.

The Exon-Florio Amendment (Exon-Florio) to the Defense Production Act of 1950 authorizes the president of the United States to block a transaction if foreign persons would gain control of a U.S. business that threatened national security. Exon-Florio authorizes the U.S. president to suspend or prohibit any foreign acquisition, merger or takeover of a U.S. corporation that is found to threaten the national security of the United States. CFIUS, an inter-agency committee chaired by the secretary of the Treasury and including the U.S. Attorney General and secretaries of Homeland Security, Commerce, Defense, State and Energy, administers Exon-Florio. CFIUS is responsible for reviewing proposed foreign investment transactions and making recommendations to the president.

The recently enacted Foreign Investment and National Security Act of 2007 (FINSA) confirms that Exon-Florio applies to acquisitions of "critical infrastructure." FINSA formalizes many CFIUS practices, including explicitly encouraging parties to notify and engage with CFIUS regarding a transaction in order to seek CFIUS clearance. FINSA provides for a 30- to 45-day CFIUS review of covered transactions; reviews are mandatory for covered transactions involving foreign government-controlled entities.

"Critical infrastructure" has been defined as systems or assets so vital to the United States that their incapacitation or destruction would have a debilitating impact on national security. The definition has been applied to ports and oil companies. Although each transaction must be evaluated based on its unique facts, foreign investments in nuclear energy-related projects likely would be subject to review by CFIUS. Currently, it is unclear whether or to what degree electricity generation, transmission or distribution facilities would be considered critical infrastructure.

In general, a CFIUS review addresses such issues as whether the U.S. business has export-controlled items or technology, has contracts or subcontracts with the U.S. military or other government agencies, has facilities subject to security clearances, or is otherwise involved in areas vital to the national security or the domestic industrial base, including energy, telecommunications, certain technologies, natural resources and, since FINSA, whether a transaction involves foreign control or acquisitions of U.S. critical infrastructure. Although each transaction must be evaluated based on its unique facts, transactions involving the foreign acquisition of nuclear-related facilities in the United States likely would be considered "critical infrastructure" and therefore be subject to CFIUS review.

Upon receiving notice of a transaction subject to its review, CFIUS will conduct an initial 30-day review. If CFIUS then determines that further review is warranted, a 45-day investigation would be performed. Following that investigation, the president would have 15 days to take any action deemed appropriate, including refusing to approve the transaction. In total, the current CFIUS review process cannot exceed 90 days, although CFIUS could toll the deadlines at an earlier point by informing the parties that their submission is deficient; it could also indicate that a decision might be unfavorable, allowing the parties to withdraw the application.

Notice of a transaction subject to CFIUS review can be provided to CFIUS by a party to the transaction or by any member of the CFIUS. Filing of a notification is voluntary. It is not a violation for parties to the transaction to proceed without notifying CFIUS, even if a transaction is clearly subject to the law. However, failure to notify CFIUS could expose the transaction to the risk of blocking or a requirement for divestiture or both, and generally is not recommended from either a legal or political perspective.

A notification to CFIUS is expected to identify in detail such items as the U.S. entity's government contracts and activities with any federal agency, items and technology possessed by the U.S. person that are subject to export controls, and other aspects of the U.S. business concern that might relate to national security. CFIUS's acceptance of the formal and complete notice triggers the start of the 30-day initial review. Where the potential acquirer is controlled by a foreign government, there is a presumption that the transaction must undergo the 45-day investigation, unless a determination has been made at the deputy assistant secretary level or above that the transaction does not implicate national security.

A potential result of a CFIUS review is that the parties may be asked to enter into a "mitigation agreement" as a condition for approval. Under such an agreement, the U.S. government could require the parties to make specific adjustments to the transaction or provide special assurances to address threats to national security posed by the transaction. If CFIUS decides not to conduct a full investigation, or if after a full investigation the president decides not to block the transaction, a "safe harbor" is established, and the transaction may proceed. The transaction is thereafter insulated from future blocking under Exon-Florio.

CHAPTER 11

ENVIRONMENTAL LAW

By Jerry W. Ross and Reza S. Zarghamee

Introduction

A non-U.S. company interested in carrying out operations in the United States should consider the potential risks of environmental liability early in the process. Businesses operating in the United States are subject to the numerous environmental restrictions and obligations imposed by federal and state laws enacted for the protection of human health and the environment. The U.S. Environmental Protection Agency (EPA) is the chief government agency responsible for enforcing federal environmental laws. The agency often delegates its enforcement obligations to state environmental agencies.

Environmental Statutes

The following is a brief description of major U.S. environmental statutes:

Clean Air Act

Many industrial activities result in releases of hazardous air pollutants to the ambient air. The Clean Air Act sets forth a complex and intricate mechanism for regulating sources of air pollution and has spawned more than 9,500 pages of federal regulations. In broad strokes, the statute establishes federal standards for air emissions from mobile and stationary sources and works with states to regulate subject entities. Its main goal is to improve air quality in areas of the country that do not meet federal standards and to prevent significant deterioration in areas where air quality exceeds those standards. To this end, the statute establishes a detailed permitting program, and most states have obtained the approval and authorization of the EPA to issue air permits to emissions sources within their jurisdictions. Pursuant to its authority under the Clean Air Act, the EPA has issued regulations requiring certain facilities to install emissions control equipment to reduce the release of hazardous air pollutants from specific types of operations. Outfitting old industrial units with new emissions control equipment can be a major cost driver for owners and operators of regulated facilities.

Clean Water Act

This statute establishes the basic structure for regulating discharges of pollutants to the "waters of the United States" (i.e., all traditional navigable waters, their permanent conveyances and adjacent wetlands). Prior to 1987, the Clean Water Act focused almost exclusively on "point source pollution" (i.e., wastes discharged from discrete sources, such as pipes and outfalls). Amendments in that year authorized measures to address nonpoint source pollution (e.g., stormwater runoff from farm lands, forests, construction sites and urban areas). Consequently, Clean Water Act compliance often plays a role in real estate transactions involving the construction, renovation or demolition of buildings. Under the Clean Water Act, federal jurisdiction is broad, particularly regarding the establishment of national standards or effluence limitations. However, the states play an important role as well, as the federal government sets the agenda and standards for pollution abatement, while states carry out the day-to-day activities of implementation and enforcement. To achieve its objective, the act embodies the concept that all discharges into the nation's waters are unlawful, unless specifically authorized by a permit, which is the act's principal enforcement tool.

Comprehensive Environmental Response, Compensation and Liability Act (CERCLA)

This legislation, also known as the federal superfund statute, represents the main federal statute governing liability for the remediation of chemical releases to the environment, including soil, groundwater and surface water. Specifically, CERCLA liability attaches to current and past owners and operators of facilities that release hazardous materials into the environment. The statute authorizes two types of response actions: (i) short-term removals in which actions may be taken to address releases or threatened releases requiring prompt response; and (ii) long-term remedial actions that significantly reduce the dangers associated with releases or threats of releases that are serious but not immediately life threatening. The second type of response action is only available at sites listed on the National Priorities List.

CERCLA financial liability is directed at recouping federal costs expended in connection with response actions. Although the statute provides for joint and several liability such that any responsible party may be financially liable for an entire cleanup, common practice at cleanup sites involving multiple parties is to apportion liability based on each party's share of the contamination. In this connection, CERCLA authorizes responsible parties to bring cost recovery actions against one another and to identify additional responsible parties not named by the EPA. It also authorizes federal and state officials, as well certain Indian tribes, to assess damages for harm done to natural resources for which they are the legal trustees. Natural resource damage claims have been a major focus of CERCLA litigation in recent years.

Given its broad scope, CERCLA is a statute commonly dealt with in environmental litigation and due diligence practices. Regarding the latter, the EPA has established firm requirements for the due diligence that new owners of real property must perform to avoid CERCLA liability for preexisting contamination. Finally, many states have enacted their own hazardous substance cleanup statutes, modeled after CERCLA.

Resource Conservation and Recovery Act (RCRA)

RCRA represents the federal statute that regulates hazardous wastes from "the cradle to the grave"—that is, from the point of generation to disposal. RCRA imposes numerous storage, handling, recordkeeping, manifesting and disposal requirements on generators of hazardous waste. These requirements have made the statute a main focus of environmental compliance programs at many industrial facilities. RCRA also establishes emergency preparedness, notification and response procedures for any fire, explosion or release of hazardous waste that might threaten human health or the environment outside a facility. The statute is further noteworthy from an environmental compliance standpoint, because it regulates underground storage tanks containing hazardous substances and petroleum products.

Under RCRA, owners of hazardous waste facilities may be liable for investigating and, if necessary, remediating releases of hazardous waste under the statute's corrective action program. To date, the EPA has authorized 50 states and territories to implement their own hazardous waste programs in lieu of RCRA, and 43 have received agency authorization to implement their own hazardous waste corrective action programs.

These federally authorized state programs are usually closely modeled after RCRA and, in all cases, contain requirements that are at least as stringent as those imposed under the federal statute.

Toxic Substances Control Act (TSCA)

TSCA provides the EPA with authority to require reporting, recordkeeping and testing with respect to chemical substances in U.S. commerce. Specifically, TSCA authorizes the EPA to identify potentially dangerous chemical substances that should be subject to federal control. Once these substances have been identified, the federal agency may gather and disseminate information concerning the substances' production, use, and impacts on human health and the environment. For a potentially dangerous chemical substance already within the stream of commerce, the EPA may issue "test rules" requiring manufacturers and processors to conduct scientific studies to fill information gaps in the substance's toxicity profile. For chemicals that have yet to enter U.S. commerce, TSCA requires pre-market screening and regulatory tracking of new chemical products. If the EPA identifies unreasonable risks associated with existing or new chemicals, the agency has authority under TSCA to initiate rulemaking to reduce those risks. Such reduction may be achieved by regulating or limiting the manufacture, importation, processing, distribution, use and disposal of potentially dangerous chemicals. In severe cases, the EPA may even ban the use of a chemical altogether. Finally, TSCA contains specific provisions concerning polychlorinated biphenyls, asbestos mitigation in schools, radon and lead-based paint.

Occupational Safety and Health Act (OSHA)

At the federal level, worker health and safety issues generally fall under the purview of the U.S. Department of Labor, Occupational Health and Safety Administration. This executive agency is responsible for implementing the OSHA statute, which broadly requires employers to research, develop, and enforce health and safety standards to: (1) establish safe and healthful working conditions; and (2) reduce the number of occupational safety and health hazards at places of employment. Among other things, these regulations require the development and enforcement of health and safety plans, such as those pertaining to asbestos, lead-based paint and emergency response. OSHA is commonly implicated in crisis management cases.

State Environmental Requirements

In addition to federal environmental statutes and regulations, state and local governments often have their own laws and rules in this area. Generally, restrictions and obligations imposed by state and environmental laws are at least as stringent, and are frequently more stringent, than those imposed by federal statutes. If a state law provides less protection to the environment or public health than a federal law, the provisions of the state law are overridden by the federal law, and the more stringent federal standards will apply.

Corporate Disclosures

U.S. public companies, including foreign private issuers that file reports or registration statements with the U.S. Securities and Exchange Commission (SEC), must comply with the disclosure requirements of the Securities Act of 1933 and the Securities Exchange Acts of 1934; these requirements extend to environmental liabilities. In broad terms, these federal securities acts require companies to disclose any environmental matter that may have a material effect on the company's business, liquidity or financial condition—a requirement that extends to off-balance-sheet transactions and contractual arrangements. An environmental matter is deemed to have a material effect if it is the subject of any judicial or administrative proceeding that: (i) involves potential monetary sanctions, capital expenditures, or charges exceeding 10% of the public company's consolidated assets; or (ii) involves a governmental authority as a party and may reasonably be expected to result in monetary sanctions exceeding $100,000.

In 2010, the SEC established special climate change disclosure requirements, under which public companies must report on: (i) the direct effects of existing and pending environmental regulation, legislation and international treaties on the company's business, operations, risk factors and executive decision-making; (ii) the indirect effects of such legislation and regulation on the company's business, such as changes in the demand for products that create or reduce greenhouse gas emissions; and (iii) the effect on a company's business and operations arising from physical changes to the earth caused by climate change.

Common-Law Doctrines Related to Environmental Law

The common law of tort is an important tool for the resolution of certain environmental disputes. Before the proliferation of environmental statutes and regulations, the tort doctrines of nuisance, trespass, negligence and strict liability assigned liability for activities that today would be considered pollution. These doctrines remain relevant in toxic tort litigation today, especially in cases involving the off-site migration of contaminated groundwater. Tort doctrines have most recently been used in cases in which plaintiffs have sought damages from industrial corporations for the consequences of climate change.

Real property doctrines, such as riparian rights and prior appropriation, are also frequently invoked in environmental cases concerning water contamination.

Litigation Trends

As noted, recent years have witnessed several lawsuits by environmental activists and state attorneys general against industrial corporations alleging that the corporations have contributed to global warming. The plaintiffs in these cases have sought both injunctive relief and monetary damages. The Deepwater Horizon oil spill will result in a major natural resource damage claim against British Petroleum (the petroleum corporation has already pledged $1 billion toward early restoration projects in response to the disaster) that may set a precedent for similar cases in the future.[32]

Finally, the EPA has announced its enforcement initiatives for 2011—2012. The environmental and public health issues that the agency has highlighted include:

- Keeping raw sewage and contaminated stormwater runoff out of U.S. waters
- Reducing animal waste to protect surface and ground waters
- Reducing widespread air pollution from coal-fired utilities, as well as businesses operating in the cement, glass and acid sectors
- Ensuring energy extraction sector compliance with environmental laws
- Reducing pollution from mineral processing operations

Legal Practices Within the Field of Environmental Law

Environmental law encompasses a variety of legal disciplines involving numerous overlapping federal and state statutes. The economic impact of these statutes on various industries has been profound at numerous levels. The practice of environmental law has also evolved to respond to the economic and cultural consequences of these laws as they have emerged. Areas falling within the purview of environmental law include the following:

Regulatory Compliance

At the heart of environmental law is the role of the lawyer in designing, supporting and auditing environmental compliance systems for clients. This effort often involves participation in the administrative process to encourage sound rulemaking. Environmental attorneys also assist clients in sorting through ambiguities in regulations, which sometimes arise in the context of enforcement proceedings.

Litigation

At the other end of the compliance spectrum is the role of the environmental lawyer in litigation. Environmental litigation can manifest itself in several different forms at both the civil and criminal level. Enforcement litigation with federal and state regulators can occur through administrative adjudications or in court. Most federal environmental

32 See www.restorethegulf.gov/release/2011/04/21/nrda-trustees-announce-1-billion-agreement-fund-early-gulf-coast-restoration-proj. Note that BP may pledge additional money toward natural resource damages in the future.

statutes have citizens' suit provisions that authorize impacted individuals to initiate enforcement litigation on behalf of the government. Adjudications can also occur in connection with the issuance of environmental permits and siting decisions by regulatory bodies. The federal superfund statute has been a source of significant litigation, particularly in the cost recovery area. Other areas of environmental litigation include the toxic tort area, natural resource damages and water purveyor suits involving groundwater contamination.

Business Transactions

Environmental law can play a major role in real estate and corporate transactions, especially those involving industrial facilities. For example, if a facility lacks an entitlement necessary for it to operate in a legally compliant manner, encounters an expensive compliance issue that must be remedied or has significant cleanup liability, then the viability or structure of a deal may be materially altered. Clients depend upon environmental lawyers to construct the parameters of the deal and translate risks to economic terms that can be factored into the valuation process.

Strategic Corporate Planning

The impact of environmental regulation on corporate economic performance has given environmental lawyers a role in the development of long-term business strategies. Depending on how environmental regulations develop, a company could obtain a significant economic advantage over its competitors. Evolving regulations in areas such as greenhouse gas emissions have the potential to alter the business model for certain companies, while creating growth opportunities for others.

Corporate Governance

Corporate governance represents an emerging area of environmental law. Events such as the Deepwater Horizon oil spill and the Texas City explosion—both involving alleged violations of U.S. environmental laws by British Petroleum, a non-U.S. corporation—have redefined the roles that senior executives and directors play in corporate policies and decisions that bear upon environmental and occupational health and safety. These disasters have spawned a new wave of internal controls that many corporations must implement in response to regulatory and shareholder influence.

Crisis Management

Environmental crises can be defining moments in the history of a corporation that bring all of the above-described areas of environmental law to a single intersection. Not only does crisis management often entail response actions aimed at mitigating the effects of harmful releases or catastrophes, but it often results in government scrutiny of a company's overall attention to environmental matters. Government agencies involved in such cases will typically look to assess, among other things, the adequacy of a corporation's communication of health and safety risks to employees, training of personnel involved in environmentally sensitive tasks and corporate decision-making with respect to environmental matters.

Conclusion

The summary above is intended to provide general guidance to non-U.S. companies and to highlight some of the issues that should be addressed by non-U.S. companies in planning to commence business activities in the United States. Involving experienced legal counsel in an analysis of potential environmental risks early on can prevent problems and significantly reduce risks in this important area.

CHAPTER 12

TAXATION IN THE UNITED STATES

By Brian Wainwright

Introduction

The U.S. federal government imposes several important taxes, corporate and individual income taxes, estate and gift taxes, and employment taxes and a wide variety of excise taxes on such things as alcohol, tobacco, firearms, motor and aviation fuels, and medical devices. Most but not all states (and even some local jurisdictions, such as cities and towns) impose some form of corporate and individual income tax, as well as ad valorem property taxes (many times on both real and personal property), sales and use taxes, and a variety of business license taxes. In the United States, there are estimated to be nearly 5,000 local jurisdictions imposing an income tax and nearly 8,000 imposing a sales and use tax.

U.S. federal tax law is contained in the Internal Revenue Code, regulations adopted by the Treasury Department, administrative guidance published by the Internal Revenue Service (IRS) and court decisions. State and local governments (counties, cities, towns, districts) have their own body of tax law in statutes, ordinances, administrative pronouncements and court decisions. The IRS, part of the Treasury Department, is the primary federal tax administrative and enforcement agency. States have their own tax agencies.

Jurisdiction

U.S. income taxing jurisdiction is based on one of two grounds: residence or source. U.S. citizens and residents (U.S. persons) are generally subject to U.S. federal income taxation on their worldwide income. Non-U.S. persons, on the other hand, are generally subject to U.S. federal income taxation on certain types of income (usually passive or investment income) from U.S. sources and on income effectively connected with the conduct of a trade or business within the United States (ECI).

States similarly tax their individual residents, generally on worldwide income, but in some cases on only certain types of income (e.g., investment income) regardless of source. State taxation of business activity and entities is constrained by U.S. constitutional principles and usually requires some minimum connection, or "nexus," with the state seeking to impose the tax. In addition, even with nexus, the state may tax only income "fairly apportioned" to that state. Apportionment of income ordinarily involves apportionment factors (historically a payroll factor, a property factor and a sales factor) which are ratios of in-state versus total amounts. But each state has its own peculiar method of determining what factors are used and how to compute and weigh those factors. And there are large variations among the states in the income subject to apportionment. For example, the U.S. Supreme Court upheld, against constitutional challenge, California's unitary, worldwide combined reporting system. Under that system, all income (whether U.S. or foreign source) of all unitary corporate group members (whether U.S. or foreign) is apportioned to California based on the payroll, property and sales factors of the overall unitary group. California has since adopted both a "water's edge election," under which a unitary group can generally elect to have only U.S. corporations treated as part of its California unitary group, and apportionment based only on a sales factor (but with the traditional three-factor method retained for certain industries, such as banking and financials, extractive, and agricultural).

The minimum level of business activity necessary to establish state taxing nexus is currently very much in flux. Existing U.S. Supreme Court precedent suggests some type of physical presence by or on behalf of a business entity is required (e.g., an office or other fixed place of business or regular presence by employees or agents). In addition, federal law dictates that certain types of activities (e.g., mere solicitation in a state of orders for the sale of tangible personal property when orders are accepted and filled from outside the state) cannot confer nexus. However, many states are introducing an economic nexus concept, under which merely having customers or suppliers within a jurisdiction provides sufficient nexus. Whether this concept will ultimately pass constitutional muster is still an open question. Nexus issues are also present in states' attempts to force out-of-state retailers to collect sales tax on sales to in-state residents.

U.S. Persons

Individuals

An individual is a U.S. person, subject to worldwide U.S. federal income taxation, if he or she is a U.S. citizen (even if living abroad) or a lawful permanent resident (e.g., a Green Card holder) or if he or she meets the "substantial presence test." An individual meets that test for a particular calendar year if he or she is present in the United States for at least 31 days during that calendar year and is present for at least 183 days during the three years ending with that calendar year, applying weighting factors to that calendar year of 1, to the preceding calendar year of 1/3 and to the second preceding calendar year of 1/6. Individuals do not meet the substantial presence test for a calendar year if they are present in the United States for less than 183 days during that year and have a "tax home" (generally, a person's regular or principal place of business) in and a closer connection to a foreign country.

Entities

A corporation or partnership is a U.S. person if it is created or organized in the United States or under the laws of the United States, any of its states or the District of Columbia; otherwise, it is referred to as a foreign corporation or partnership. The U.S. Treasury has the authority to provide different rules for partnerships. Because of the pass-through nature of partnerships, the activities of a partnership and the tax residence of its partners are often more important than the tax residence of the partnership itself. The United States does not (yet) use the place of management and control to determine corporate or partnership tax residence.

An Example of U.S. Tax Complexity

Even the simple place of incorporation rule used to determine if a corporation is a U.S. person has exceptions. An otherwise foreign corporation can nonetheless be treated as a U.S. person under so-called anti-inversion legislation enacted in 2004. If the foreign corporation directly or indirectly acquires substantially all the properties of a U.S. corporation, and after the acquisition, the former shareholders of the U.S. corporation own at least 80% of the stock (by vote or value) of the acquiring foreign corporation by reason of their holding of stock of the U.S. corporation, then the foreign corporation is treated as a U.S. person (and accordingly subject to U.S. federal income tax on its worldwide income), unless the foreign corporation and its affiliates have substantial business activities in the jurisdiction where the foreign corporation is incorporated. Under these rules, for example, a Cayman Island holding company interposed between a U.S. corporation and its shareholders would (absent substantial Cayman business activity) be taxable by the United States as if it were a U.S. corporation.

In a somewhat circular definition, an estate is a U.S. person if it is subject to U.S. federal income taxation on its worldwide income regardless of source. Whether an estate is so subject is determined by the facts and circumstances of an estate's situation, with particular emphasis on the situs of the estate's assets, the nationality and residence of the executor or administrator, and the location of the estate's administration. Other, lesser factors include the nationality and residence of the decedent, the country the laws of which apply to the estate's administration, and the nationality and residence of beneficiaries. These factors determine tax residence of an estate for income tax purposes only. The United States imposes its estate tax on the worldwide estates of decedent U.S. citizens and domiciliaries. An individual is domiciled in the United States if he or she is living in the United States with no present intention to leave.

A trust is a U.S. person if (i) a court within the United States is able to exercise primary supervision over the administration of the trust and (ii) one or more U.S. persons have the authority to control all substantial decisions of the trust. This rule was enacted in 1996; prior to that time, the rule for trusts was the same as for estates. Accordingly, trusts in existence on August 20, 1996, that were treated as U.S. persons immediately prior to the 1996 change under the prior rules can elect to remain U.S. persons.

Taxpayers and Entity Classification

U.S. federal and state income taxes are imposed directly on individuals and corporations. Partnerships generally are not subject to the income tax; rather, their items of income, gain, loss deduction and credit "pass through" to their partners. In general, the activities of partnerships are imputed to their partners for tax purposes. For example, a non-U.S. enterprise having no connection with the United States other than being a partner in a partnership engaged in a U.S. business and having a fixed U.S. place of business is treated as itself being engaged in a U.S. business and as having a permanent U.S. establishment.

Trusts and estates are quasi-pass-through entities. The income and gains of a trust or estate are taxed either to the trust or estate or to their beneficiaries, depending on the terms of the governing instrument of the trust or estate and the distributions made to beneficiaries.

The income tax laws deal only with individuals, corporations, partnerships, trusts and estates, even though other forms of entities, most notably limited liability companies, can be formed under state law. But these other entities must be classified for income tax purposes, usually as either a corporation or a partnership. Under the federal classification rules for business entities, followed by most states, certain U.S. organizations are always classified as corporations (e.g., business entities organized under a statute that describes the entity as "incorporated" or as a "corporation," "body corporate," or "body politic"; insurance companies; most state-chartered banks; and business entities wholly owned by a state, a political subdivision of a state or a foreign government). In addition, the implementing regulations list for many countries include one or more types of business entities that are always classified as corporations (e.g., Canada (Corporation or Company), China, (Gufen Youxian Gongsi), European Union

(Societas Europaea), Germany (Aktiengesellschaft), Japan (Kabushiki Kaisha), Mexico (Sociedad Anonima or Sociedad Anonima de Capital Variable), Netherlands (Naamloze Vennootschap), and United Kingdom (Public Limited Company).

Other business entities are allowed to choose their classification as either a corporation or a partnership. If the entity has only one owner, it must choose between a corporation and a disregarded entity. As the name suggests, a disregarded entity is not treated for tax purposes as an entity separate from its owner; rather, it is treated as a division, branch or sole proprietorship of that owner (depending on the nature of the owner).

"Check-the-Box" and Default Classification

Eligible business entities (e.g., those that are not always classified as corporations) choose their federal tax classification by checking the appropriate box on a timely filed IRS Form 8832 (hence the term, "check the box" election). The default classification for eligible U.S. business entities that don't file an election is a partnership (or disregarded entity for entities with one owner). For eligible non-U.S. entities, the default classification is a partnership (or disregarded entity) if any member of the entity does not have limited liability and a corporation if all members have limited liability. A member has limited liability unless the member has personal liability, under the laws under which the entity is organized and by reason of being a member, to creditors of the entity for the entity's debts and obligations.

Source of Income

Whether income is derived from sources within the United States often determines whether it is subject to U.S. federal income tax. Non-U.S. persons are generally not subject to U.S. federal income tax on foreign-source income. Sourcing rules are also important to U.S. persons, as they are used to determine the extent to which foreign income taxes may be credited against U.S. federal income tax. Some of the more generally applicable sourcing rules include:

- Sale of goods—The place where title to the goods passes.
- Services—The place where the services are performed.
- Interest—The tax residence of the obligor.
- Dividends—Tax residence of the corporate payor, with special rules for foreign corporations having ECI in excess of certain thresholds.
- Rents—Location of the rented property with allocation rules for movable property.
- Royalties—Jurisdiction covered by the licensed rights, again with possible allocation issues.
- Guarantees—U.S. source if the guaranteed obligation is of (i) a noncorporate U.S. resident or any U.S. corporation or (ii) any non-U.S. person relating to indebtedness connected with ECI.

There are also special sourcing rules covering such items as vessels and aircraft, international communications income, and space or ocean activities.

Sales of personal property (not including inventory) are considered U.S.-sourced income for U.S. persons and for non-U.S. persons with a U.S. "tax home." Otherwise, sales of personal property (other than inventory) give rise to foreign source income. This general rule applies to the sale of intangibles only if the payments are not contingent on productivity or use; if the payments are so contingent, they are sourced in the same manner as royalties. The sale of depreciable personal property is sourced, in part, based on any prior U.S. depreciation deductions. And except for inventory, depreciable personal property and noncontingent sales of intangibles, personal property sales are treated as foreign-source for sales attributable to an office or other fixed place of business in a foreign country and taxed at 10% or more by a foreign country. Also, income of a U.S. person from sale of stock of a foreign corporate affiliate (80% ownership test, by both vote and value) is foreign source if the sale occurs in a foreign country in which the affiliate is engaged in the active conduct of a trade or business and more than 50%the affiliate's gross income during the three taxable years preceding the sale was derived from that foreign country.

U.S. Income Taxation

U.S. persons are subject to U.S. federal income tax on their worldwide income. The tax is imposed on net income, after allowance of deductions, at graduated rates that currently reach 39.6% for individiuals and 35% for corporations. Long-term capital gains of noncorporate taxpayers are currently subject to federal income taxation at reduced rates; capital losses are subject to limited deductibility. State and local income taxes are imposed at various rates that in some cases can exceed 10% (although state and local income taxes are generally deductible against federal taxable income). Many states (e.g., California) do not have reduced rates applicable to long-term capital gains. Most business expenses are deductible against income, but there can be limitations. For example, under an "earnings stripping" provision, the deduction for interest paid by a U.S. corporation to a foreign affiliate can be subject to reduction based on the U.S. corporation's taxable income (with adjustments).

U.S. Ownership of Non-U.S. Corporations

The United States does not directly tax the non-U.S. income of foreign corporations, and generally does not tax any U.S. owners of those foreign corporations on those earnings until they are repatriated. However, the United States also has an extensive anti-deferral regime to accelerate the imposition of the U.S. tax on those U.S. owners, especially on certain types of income, such as passive investment income and income from transactions with or on behalf of related parties. The rules apply extensively to U.S. owners of foreign corporations classified as controlled foreign corporations (CFCs) and passive foreign investment companies (PFICs). As a result of these rules, and the generally high U.S. tax rates, foreign taxpayers with U.S. corporate subsidiaries are usually advised to avoid ownership of non-U.S. corporations by those U.S. subsidiaries.

Because the United States imposes its federal income tax on the worldwide income of U.S. persons, U.S. taxpayers often realize income subject to both a foreign and U.S. income tax. The U.S. mitigates this double taxation through a foreign tax credit system, allowing a U.S. person a credit against federal income tax for foreign income taxes paid to source countries. However, the credit is generally limited to the amount of U.S. tax imposed on the double-taxed income; this limitation is determined by a comparison of the taxpayer's foreign-source income to total income. This limitation is computed on a category-of-income basis, with three categories or baskets: a passive income basket, a basket for income the source of which is changed under an applicable U.S. income tax treaty, and a general basket for everything else.

Under the Affordable Care Act (Obamacare), a 3.8% tax is imposed on the net investment income of high-income individuals, estates and trusts. No credit for foreign taxes is allowed against this 3.8% tax.

U.S. Income Taxation of Non-U.S. Persons

Non-U.S. persons are subject to U.S. federal income tax on (i) U.S. source fixed or determinable annual or periodic income (FDAPI) and (ii) ECI. Non-U.S. individuals are not subject to the 3.8% net investment income tax.

FDAPI

FDAPI includes interest, dividends, rents, royalties, salaries and the like (but does not include capital gains) and is subject to a gross 30% U.S. tax (that is, without deductions) enforced through a withholding obligation imposed on the payor of the income. The obligation to withhold does not apply, however, to ECI (the recipient provides IRS Form W-8ECI to the payor to perfect this exemption), interest on certain "portfolio debt" (IRS Form W-8BEN is used to perfect this exemption) and interest on bank deposits. Portfolio debt specifically excludes most related party or intercompany debt. The 30% withholding rate can be reduced or eliminated under an applicable income tax treaty for recipients eligible for the benefits of the treaty. Recipients provide IRS Form W-8BEN to the payor to claim the benefits of an income tax treaty.

ECI

Except in certain special circumstances, ECI will not include foreign–source income. ECI of a non-U.S. person is subject to U.S. federal income taxation on a net basis (that is, after applicable deductions) at the same graduated rates applicable to U.S. persons. U.S. income tax treaties generally provide that in addition, ECI must be attributable to a permanent establishment maintained in the United States in order to be subject to U.S. federal income taxation. ECI is not subject to U.S. federal income tax withholding, but again, the recipient provides IRS Form W-8ECI to the payor to perfect that exemption.

A foreign corporation with effectively connected earnings and profits (e.g., earnings derived from ECI) can also be subject to a branch profits tax of 30% of its effectively connected earnings and profits not retained in the United States. The 30% rate can be reduced or eliminated by an applicable income tax treaty. The idea is to mimic the dividend withholding tax that would have applied to repatriated U.S. earnings if the U.S. operations had been conducted by a U.S. subsidiary rather than a U.S. branch of the foreign corporation. In addition, a foreign corporation having interest allocable to ECI or to income treated as ECI can be subject to a branch interest withholding tax, as such allocable interest is generally treated as if paid by a U.S. corporation.

Treaty Branch Profits Exemption

Residents eligible for the benefits of a treaty with limitation of benefits provision entering into force after 1986 can be exempt (under nondiscrimination clauses) from both the branch profits and branch interest withholding taxes. Residents of jurisdictions with treaties with no or only a pre-1987 limitation of benefits provision must also satisfy a "qualified resident" test to apply their treaty to eliminate or reduce the rate applicable to those taxes.

U.S.-Source Capital Gains (Excluding Real Property Gains)

U.S.-source capital gains of non-U.S. individuals are subject to U.S. federal income tax if the individual is present in the United States for 183 or more days in the taxable year of disposition. This rule predates the substantial presence test (see "U.S. Persons–Individuals" earlier in this chapter) and is often rendered moot by that test because an individual meeting the substantial presence test becomes a U.S. person. In addition, a non-U.S. person must also have a U.S. "tax home." Otherwise, the gains will be foreign source and so not taxable by the United States regardless of an individual's presence in the United States. U.S.-source capital gains of individuals that are subject to U.S. federal income tax under these rules are taxed on a gross basis at 30%, but a deduction for U.S.-source capital losses is allowed. Non-U.S. persons are taxable under the normal ECI rules on U.S.-source capital gains that constitute ECI.

Foreign Investors in Real Property Tax Act of 1980 (FIRPTA)

Gains from dispositions of U.S. real property interests by non-U.S. persons are treated as ECI. Even though FIRPTA gains are considered ECI, they are subject to a separate withholding regime of 10% of gross proceeds (not gains). Whether an asset constitutes real property is generally determined by local law concepts, but real property can include personal property associated with real property.

A U.S. real property interest includes any interest (other than solely as a creditor) in a U.S. real property holding corporation. Generally, a U.S. corporation is a U.S. real property holding corporation if at least 50% of its worldwide business assets and real property is U.S. real property at any time during the shorter of the five preceding years or the interest holder's holding period. The FIRPTA rules do not apply if the corporation has disposed of all its U.S. real property interests in taxable transactions and also do not apply to publicly traded interests held by less than 5% stockholders.

In order to prevent FIRPTA withholding, a seller can provide a certificate to the buyer to the effect that the seller is not a foreign person or, where stock of a corporation is being sold, the corporation can provide a certificate to the buyer to the effect that the corporation is not and has not been a U.S. real property holding corporation at any time during the relevant period. In the latter circumstance, a copy of the certificate must be provided to the IRS using a prescribed form of transmittal.

IRS Withholding Certificates

FIRPTA withholding (10% of gross proceeds) can often lead to overwithholding as only FIRPTA gains are ECI and subject to the underlying tax. Accordingly, taxpayers can obtain withholding certificates from the IRS eliminating withholding (e.g., for dispositions at a loss) or specifying a reduced amount to be withheld. Obtaining withholding certificates can take a fair amount of time, so advance planning in these circumstances is essential.

Foreign Account Tax Compliance

As part of a new addition to the IRS arsenal in its attack on offshore accounts of U.S. persons, on July 1, 2014 a new withholding regime (commonly referred to as "FATCA") became effective for certain payments to non-U.S. persons. Although the primary focus of FATCA is financial accounts at foreign financial institutions, the rules also provide that "withholdable payments" to a "non-financial foreign entity" will be subject to 30% withholding if the beneficial owner of such payment is such entity or any other non-financial foreign entity unless:

- the payee or the beneficial owner of the payment provides certification that such beneficial owner does not have any substantial U.S. owners or the name, address and U.S. taxpayer identification number (TIN) of each substantial U.S. owner of such beneficial owner;
- the withholding agent does not know, and does not have reason to know, that any information provided to the withholding agent is incorrect; and
- the withholding agent files with the IRS the names, addresses and TINs of the substantial U.S. owners provided to the withholding agent.

Except as otherwise provided by the IRS, the non-financial foreign entity rules will not apply to any payment beneficially owned by certain exempt payees, including a corporation the stock of which is regularly traded on an established securities market or any affiliate of such corporation, any entity which is organized under any possession of the United States and wholly owned by one or more residents of such possession, any foreign government, any international organization or any foreign central bank of issue.

A "withholdable payment" is defined to include not only most U.S.-source payments that are subject to withholding under current law, including, among other items, U.S.-source interest (including original issue discount), dividends, rents and royalties, but also interest paid by foreign branches of domestic financial institutions and any gross proceeds from the sale or other disposition after December 31, 2016 of any property of a type that can produce U.S.-source interest or dividends. The term does not include any item of income that is ECI of a foreign person. A "substantial U.S. owner" is a U.S. person (subject to certain exceptions, such as for publicly traded corporations and their affiliates) holding 10% or more of the stock of a corporation (by vote or value), holding 10% or more of the profits or capital interests in a partnership, treated as the owner of any portion of trust property under the grantor trust rules, or holding 10% or more of the beneficial interests in a trust.

The United States claims that it is not abrogating any of its treaty obligations in enacting FATCA because a foreign person suffering FATCA withholding at 30% is entitled to seek a claim for refund from the IRS if an applicable income tax treaty specifies a lower rate on the payment (such as for interest or dividends). However, FATCA specifically provides that no refund is allowed unless the beneficial owner of the payment provides the requisite information regarding U.S. ownership of the beneficial owner.

None of the FATCA rules will apply to payments on or gross proceeds from disposition of obligations outstanding on July 1, 2014.

Transfer Pricing

The United States adheres to the arm's length standard for establishing appropriate transfer pricing between commonly controlled parties. Transfer pricing is of heightened importance in cross-border transactions because commonly controlled parties can use transfer pricing to attempt to "move" income or expenses from one taxing jurisdiction to another. Most states use apportionment instead of transfer pricing to assign income of multi-jurisdictional enterprises, but transfer pricing can be relevant in state taxation, for example in calculating certain apportionment factors.

Although the U.S. statute on transfer pricing (Section 482) is relatively short and simple, the implementing Treasury Department regulations are lengthy and complex and contain various permitted methods for different situations. The table of contents for the Section 482 regulations is more than eight pages long.

Tangible Personal Property

In the case of transfers of tangible personal property, the specified methods are:

- Comparable uncontrolled price method—Prices are based on comparable transactions between uncontrolled parties. This method is generally controlling if available.
- Resale price method—Pricing is based on subtracting gross profit margin in comparable uncontrolled transactions from reseller's sale price to third parties to obtain price to be paid by reseller. This method is best used for resellers not adding substantial value by physically altering goods before sale.
- Cost plus method—Again, pricing is based on gross profit margin in comparable uncontrolled transactions, but in this case, the taxpayer's gross profit margin in comparable uncontrolled transactions is applied to costs.
- Comparable profits method—Pricing is based on profit level indicators (e.g., return on capital or other financial ratios) of comparable uncontrolled parties.
- Profit split method—Prices between various controlled parties are established by allocating the combined operating profit based on the relative value of each controlled party's contribution to that combined operating profit. This method is primarily used where comparable uncontrolled transactions or financial indicators (e.g., gross margins or returns on capital) are not available, particularly involving transfers of intangibles.

Services

Regulations promulgated in 2009 broadly define a controlled services transaction to include any activity (including performance of functions, assumption of risks, or use of tangible or intangible property or other resources, capabilities or knowledge) by one member of a controlled group that results in a benefit for one or more other members of that group. The specified pricing methods for services are (i) the simplified cost method (permitting pricing at the service provider's cost but available in only limited circumstances), (ii) the comparable uncontrolled price method (analogous to the comparable uncontrolled price method applicable to transfers of tangible property), (iii) the gross services margin method (analogous to the resale price method), (iv) the cost of services plus method (analogous to the cost plus method), (v) the comparable profits method and (vi) the profit split method.

Loans or Advances

The regulations provide an interest rate safe harbor of between 100% and 130% of the applicable federal rate (AFR) for the month of the loan or advance. The IRS announces monthly short-term (three years or less), mid-term (more than three but no more than nine years) and long-term (more than nine years) AFRs for annual, semi-annual, quarterly and monthly compounding. The AFRs are available at the IRS Website and can also be found at the Pillsbury Tax Page (**www.pmstax.com/afr**).

If a related party loan is made from proceeds of a loan obtained by the lender at the situs of the borrower, then the arm's length rate is the rate paid by the lender increased by the lender's costs in borrowing the funds and making the loan. The regulations contain special rules permitting short interest-free periods for trade receivables and in certain other situations.

Cost Sharing

Cost sharing is a transfer pricing method that allows sharing of costs of development of intangibles between or among controlled parties and consequent joint ownership of those intangibles by those controlled parties. The regulations generally require development costs to be shared based on anticipated benefits (income) from exploitation of the developed intangibles.

A typical arrangement would have a non-U.S. enterprise or an offshore affiliate and a U.S. affiliate split research and development costs based on relative anticipated U.S. and offshore income with the U.S. affiliate owning the U.S. rights to the intangibles and the non-U.S. enterprise or offshore affiliate owning the non-U.S. rights. Where one controlled party has already developed intangibles, the other controlled party must make a "buy-in" payment under the cost-sharing arrangement. In many typical situations, an offshore affiliate may be required to make a substantial payment to a U.S. affiliate or vice versa, producing significant income for the recipient.

Contemporaneous Documentation

The IRS can impose special, and potentially large, penalties in the case of audit adjustments under the transfer pricing rules. Some of these penalties can be reduced or eliminated only if the taxpayer demonstrates the existence of pricing studies or other appropriate documentation of its pricing methodology in place when the transfer prices at issue were actually established.

Advance Pricing Agreements (APAs)

Adversarial, after-the-fact audits are the principal tool for IRS review of transfer pricing issues. But APAs permit taxpayers and the IRS to agree in advance to transfer pricing methodology for a transaction or group of transactions involving the taxpayer and some or all of its affiliates. IRS APAs can be most effective when combined with a similar agreement with the tax authorities of a foreign jurisdiction; most of these parallel agreements have involved countries with which the United States has an income tax treaty. APAs can avoid effective double taxation of income arising from inconsistent transfer pricing adjustments by the IRS and the foreign tax authorities. Although U.S. income tax treaties generally provide for a competent authority procedure to resolve, among other items, transfer pricing inconsistencies, that process is time-consuming and expensive.

Basic Structuring

A non-U.S. enterprise establishing operations in the United States will most commonly do so through a wholly owned U.S. corporate subsidiary. If the non-U.S. enterprise operates in the United States through a branch or through a wholly owned limited liability company (treated as a branch under the “check-the-box” rules, see “Taxpayers and Entity Classification” earlier in this chapter), the non-U.S. enterprise will have ECI and a U.S. permanent establishment and, because the branch or limited liability company would not be treated as a separate taxable person for U.S. tax purposes, all of the non-U.S. enterprise’s worldwide activities would potentially be subject to scrutiny by the IRS or by state taxing authorities in order to determine the income effectively connected with the U.S. branch operations and attributable to the U.S. permanent establishment or the amount of apportionable income and the applicable apportionment factors. Using a U.S. corporate subsidiary avoids this potential U.S. worldwide tax scrutiny; where U.S. operations take place in California, the U.S. subsidiary would typically make a water’s edge election to limit the scope of its California unitary group to U.S. corporations (see “Jurisdiction” earlier in this chapter). If the nature of the U.S. operations is such that multiple corporations are required, it would be common for the non-U.S. enterprise to organize a U.S. corporate holding company so that all of its U.S. subsidiaries could join in one consolidated U.S. federal income tax return. Consolidated groups are composed of chains of U.S. corporations satisfying an 80% (by both vote and value) stock ownership requirement; most intercompany transactions are either eliminated or deferred in the tax consolidation.

Where the U.S. activities involve participation in a U.S. joint venture, the non-U.S. enterprise would also ordinarily form a wholly owned U.S. corporate subsidiary to be its joint venture participant when the joint venture vehicle itself is not a corporation, but rather a partnership or limited liability company classified as a partnership. As noted earlier (see “Taxpayers and Entity Classification” earlier in this chapter), participation in a non-corporate U.S. joint venture directly by the non-U.S. enterprise could, because of the attribution of partnership activities and permanent establishments to partners, cause the non-U.S. enterprise to become subject to U.S. federal and state income reporting and payment requirements.

The level and scope of U.S. activity will generally influence capitalization decisions. Where the U.S. activities will essentially be ancillary in nature (e.g., sales, marketing or customer support services), a modest equity contribution may suffice. For more extensive activities, the non-U.S. enterprise would ordinarily consider capitalizing its U.S. subsidiary with a combination of equity and debt. Debt allows the tax-free return of principal and an income tax deduction for interest paid (subject to related party earnings stripping limitations), the latter at the cost of a withholding tax. The United

States does not have any hard and fast "thin capitalization" rules, but debt-to-equity ratios of 3:1 or less are generally regarded as quite safe, and ratios of up to 5:1 are not uncommon.

Employment Taxes

In the United States, wages paid to employees are subject to income tax withholding and to a number of employment taxes, both federal and state, imposed on both employee and employer. Payments to independent contractors are not subject to these taxes. Although independent contractors are subject to analogous tax regimes (e.g., self-employment taxes), income tax withholding is usually not required, and there are generally no independent contractor-related taxes imposed on the person or company hiring an independent contractor. Hiring independent contractors rather than employees can thus be beneficial, as companies thereby avoid withholding of federal and state and local income tax and the employer's share of state unemployment, Social Security (including Medicare) and federal unemployment taxes. In addition, company-sponsored benefit plans and wage and hour laws do not apply. However, if a company misclassifies an employee as an independent contractor, the penalties can be severe. A company may be liable for employment taxes, interest, penalties and retroactive benefits. Penalties may also be imposed for failure to file required tax forms.

IRS Factors for Classifying Workers

In determining whether a worker is an employee or an independent contractor for federal tax purposes, the general IRS rule is that an individual is an independent contractor if the person for whom the services are performed has the right to control or direct only the result of the work and not the means and methods of accomplishing the result. On the other hand, anyone who performs services is an employee if the employer controls what will be done and how it will be done. Essentially, if an employer controls the details of how a worker performs the services, then the worker is likely an employee.

The IRS breaks the control analysis into three categories:

- Behavioral control—Whether there is a right to direct or control how the worker does the work. The behavioral control factors generally include the type and degree of instructions given, the amount of training that is provided, and whether an evaluation system is in place that measures the details of how the work is performed rather than just the end result.

- Financial control—Whether the company has the right to control the economic aspects of the worker's job. The financial control factors generally include whether the worker has made a significant investment in the equipment used, has an opportunity for profit or loss, makes his or her services available to the market, and whether the worker is paid a regular wage for an hour, week, or other period of time or a flat fee for the job.
- Type of relationship—How the worker and the company perceive their relationship. The relevant factors include, among other things, whether a written contract is in place, whether benefits are provided and whether the worker has been retained with the expectation that the relationship will continue indefinitely.

All of the factors must be evaluated to determine a worker's status as an independent contractor or employee, but there is no specific number of factors that makes a worker an employee or an independent contractor.

Exceptions to General IRS Rule

There are specific statutory exceptions to the IRS analysis described above. For example, certain workers (such as corporate officers and certain salespersons) must be classified as employees for Social Security tax purposes. In the event of an IRS audit, Section 530 of the Revenue Act of 1978 may provide some protection against retroactive reclassification of independent contractors as employees, even when the worker has otherwise met the requirements for employee status. Determination of employee status under other federal laws, such as the Fair Labor Standards Act, may also differ in some respects from the general IRS rule.

In addition, there are various state tests for independent contractor/employee classification that, of course, vary among the states. For example, in California, courts apply an "economic realities" test adopted by the California Supreme Court to determine worker status under several labor statutes. In general, the economic realities test focuses on factors that suggest whether a worker is indeed in business for himself or herself. Some of the relevant factors include whether the work consists of furnishing a personal service, whether the worker has made a substantial investment in equipment or employees, whether the worker works for more than one company at a time, whether there is an exclusive contract, and whether the worker generally holds himself or herself out to be running his or her own business. Further, in California, various state agencies are involved in determining independent contractor status, depending upon which laws are involved. For example, the California Division of Labor Standards Enforcement is concerned with whether the wage, hour and workers' compensation insurance laws apply while the California Employment Development Department is concerned with employment-related taxes. Since different laws may be implicated in a particular situation, it is possible that the same individual may be considered an employee for purposes of one law and an independent contractor under another law.

CHAPTER 13

LITIGATION AND OTHER DISPUTE RESOLUTION MECHANISMS IN THE UNITED STATES

By Kirke Hasson

Introduction

Litigation in the United States is frequently used to resolve business disputes of all kinds. Among the places where such disputes are resolved are the federal and state courts, private arbitrations, and specialized agencies and tribunals.

All of the American states except Louisiana are common-law jurisdictions, derived from the English common-law system. Common law is judge-made law. When a judge decides a case, the decision has the status of law and becomes a precedent for future cases involving similar facts and issues. There are also enacted laws: constitutions, statutes and administrative regulations. Over the years, statutes have replaced much of common law, especially in the commercial and criminal law areas, but courts still apply common-law doctrines in interpreting statutes. Procedurally, the common-law system is often referred to as an "adversarial system." In an adversarial system, the courts serve as an impartial place for resolution of private disputes in civil cases and of prosecution by the government in criminal cases.

In this chapter, we will provide a general discussion of the structure of the court systems in the United States as applied to civil (e.g., not criminal) cases, the terminology and procedure generally used in U.S. courts, enforcement of court judgments, and specialized tribunals, arbitration and mediation. We will conclude with a few comments about examples of substantive areas of law that may be particularly relevant to foreign companies doing business in the United States.

Structure of the U.S. Court System for Civil Cases

Relationship Between Federal and State Courts—Subject Matter Jurisdiction

The U.S. federal government operates a set of federal courts. Each state operates a set of state courts, as does the District of Columbia. Although the subject matter of the cases federal and state courts hear sometimes overlaps, there are some cases over which only federal courts have jurisdiction and some cases over which only state courts have jurisdiction. The question of whether a particular dispute properly belongs in a federal court, a state court or either one can be quite complex and sometimes uncertain.

Federal courts are courts of "limited subject matter jurisdiction"; that is, they can only hear certain kinds of cases. Although there are some rather obscure pockets of federal court jurisdiction, the ones most frequently seen are:

- Cases arising under a federal statute, including federal securities law, patent laws; copyright and trademark laws; federal civil rights laws; federal criminal laws; admiralty laws; antitrust laws; and bankruptcy laws, of which some can only be litigated in federal courts, such as patent and federal bankruptcy cases
- Cases that do not implicate federal law, such as a contract dispute, but where the parties are of "diverse citizenship," e.g., a citizen of one state suing a citizen of another state or a citizen of one state suing (or being sued by) a citizen of a foreign nation, provided the amount in dispute involves more than $75,000

Only a small percentage of cases (approximately 3%) in the United States are filed in the federal courts. In general, cases in the federal courts are larger and more important, although sometimes small cases are handled in federal courts (such as cases concerning personal injuries occurring on federal lands), and sometimes very important cases are handled in state courts.

Federal Courts

U.S. District Courts

There are 94 U.S. district courts, each of which has as its territory all or a part of a state's territory. For example, in the state of California, there are four U.S. district courts, with different geographical territories. The district courts are courts of original jurisdiction, meaning most cases begin in the district courts.

U.S. Courts of Appeals

There are 12 geographically organized U.S. Circuit Courts of Appeals. There are also certain Courts of Appeals that have exclusive jurisdiction over specialized subject matters. For example, in patent cases, the decisions of the district courts generally are appealable only to the Court of Appeals for the Federal Circuit in Washington, DC.

In almost all cases, the losing side in a district court has a right to appeal to the appropriate U.S. Court of Appeals. The Circuit Courts of Appeals do not generally review any new evidence in a case. Rather, they usually review the record of the district court to determine whether there was an error of law.

In general, only final District Court decisions are appealable. However, certain matters may be appealed immediately (such as the grant or denial of an injunction). In certain extreme cases, a party may ask the appellate court to issue one or another of certain orders known as "writs" to control the action of the trial courts.

U.S. Supreme Court

The Supreme Court of the United States is the highest court in the country. With very few exceptions, no one has a right to have an appeal decided in the Supreme Court, and the Supreme Court takes only the cases it chooses to hear.

The Supreme Court hears only a limited number of cases each year. In its 2010 term, the Supreme Court issued 85 opinions. Its decisions are binding on all federal courts, and as to matters of federal law, are binding on all state courts.

State Courts

State Courts of Limited Jurisdiction

Many states have courts of limited jurisdiction, such as small claims courts and family law courts. These courts usually are not important to companies doing business in the United States.

State Courts of General Jurisdiction—Trial Courts

All states have courts of general jurisdiction, meaning that they can hear cases without limitation as to the size of the dispute. These are the courts where significant actions are initially filed and where trials occur.

State Appellate Courts

All states have at least one level of appeal; many have two levels. Usually in a state where two levels of appeal exist, appeals from the trial courts are heard in the intermediate courts of appeals, and appeals from the intermediate courts of appeals are heard in the state supreme court, which is the state's court of last resort where the law of the state is concerned. Where a state has no intermediate court of appeals, the state's court of last resort reviews trial court decisions on appeal. With the exception of certain cases (e.g., death penalty cases in California), generally, courts of last resort have discretion to choose which cases to hear and do not grant every request for review.

Many states, such as California, allow an appeal only once there is a final determination in the trial-level court. Other states, such as New York, allow appeals from interim rulings of trial-level courts without waiting for the trial court's final determination.

Terminology and Procedure for Civil Litigation

Initiation of a Civil Action

A lawsuit, or "action," is initiated in a federal court by one or more persons, called the "plaintiff" or "plaintiffs." The plaintiff files a document called a "complaint," which names the "defendant" or "defendants," the party or parties against whom relief is sought. The complaint includes a short summary of the facts of the case. The same or similar terminology applies in most states' courts.

The plaintiff does not need to provide proof of the claim at the time of filing. The complaint must generally satisfy certain format and filing fee requirements. Once the complaint is properly filed, the court issues a summons, and the plaintiff is responsible for delivering (or "serving") the summons and a copy of the complaint on the defendant. If the defendant resides in the jurisdiction, this can be relatively simple. If the defendant resides outside the United States and does not have a representative in the United States, the procedure to serve the summons and complaint can be complex and involves consideration of whether treaties exist between the defendant's country and the United States governing such service.

The Concept of "Personal Jurisdiction"

A person can only be required to defend a claim in a court if that person is said to be within the "personal jurisdiction" of the court where the action was filed. Principles of personal jurisdiction can be complex, but the basic idea is that a person can only be forced to defend a lawsuit in a court in a location with which the person has sufficient connection to support personal jurisdiction in the courts there. Generally, a person will be found to have sufficient connection with a place if the person either (a) resides or regularly and substantially does business, or (b) had sufficient contacts with that place that relate to the facts on which the lawsuit is based. For example, if a Chinese person signed a contract in California agreeing to perform certain obligations in California, that person would normally be said to be within the "personal jurisdiction" of a court in California for the enforcement of the contract, even if the person had few other contacts with California or the United States.

The issue of personal jurisdiction goes to the power of the court to determine the matter as to the individual defendant. Lack of personal jurisdiction can be a defense. If a defendant questions the court's jurisdiction over the defendant, it must challenge personal jurisdiction at an early stage, or the defendant may be deemed to have waived the defense.

Even if personal jurisdiction is present, there is a separate concept known as "venue," which addresses whether the court should hear the controversy, as compared to a different court that would also have jurisdiction. Venue is generally a more discretionary analysis.

Even where there is proper jurisdiction and venue, the common-law doctrine of "forum non conveniens" allows a court to withhold exercising its jurisdiction. If the court finds that its jurisdiction amounts to an inconvenient forum and there is a more suitable jurisdiction to hear the controversy, then the court may in its discretion dismiss the case and allow the parties to litigate in a more convenient forum.

Motions to Dismiss

Once served, a defendant must either file an "answer" to the complaint and proceed with pretrial procedure, or file a motion to dismiss the complaint, either on procedural grounds (such as the lack of personal jurisdiction, improper venue or forum non coveniens) or on substantive legal grounds.

The most important early substantive motion is a motion to dismiss for failure to state a claim on which relief may be granted—sometimes called a "demurrer" in state court practice. This motion assumes that the material facts of the complaint are true, but asks the court to rule that even if those facts are true, the plaintiff has no valid claim for relief. Even if such a motion is granted, the plaintiff is usually allowed to file an amended complaint to try to cure the defect. However, if a motion to dismiss is granted "with prejudice," the plaintiff is generally precluded from alleging the same or substantially similar claims against the defendant in the future.

Discovery in General

Once the defendant has filed an answer—and sometimes during the early motion practice stage—the parties may proceed with pretrial procedures. The most prominent pretrial procedure is "discovery," the pretrial disclosure of evidence or potential evidence to the other side, largely through which a litigant builds its case.

In several courts, including the federal courts, some disclosure to the opposing party is obligatory even if not requested. For example, in federal courts, each party must provide certain relevant information to the other side without awaiting a formal discovery request, such as names of witnesses, copies of documents, expert witness information, damage computations and liability insurance.

However, most discovery occurs through requests for discovery. The party seeking information in support of its case may request that the other side (or third parties) produce non-"privileged" (see below) relevant documents in its possession, submit to questioning by its counsel in an out-of-court procedure called a "deposition," and answer written questions in writing under oath called "interrogatories." Unless a "privilege" protects a document included in a discovery request (as discussed further below), the recipient of the request must deliver a copy of the document to the other side.

By far the most costly feature of activities before trial in many cases now in the United States is demands for and production of electronic documents—emails, text messages, and other information produced or stored or both electronically. The quantity of such information is staggering given modern technology.

Two established principles in the law on duties to produce documents are:

- As soon as it becomes apparent that a dispute may be heading toward litigation, each party has an obligation to preserve its paper and electronic documents, whether they may be favorable or unfavorable to that party's case.
- When requested by the other side, a party must produce non-privileged electronically stored information to the requesting party for its use in the case.

The two principles mean that servers must be imaged, hard drives copied and other actions taken to preserve the electronically stored information and that both external and internal email messages may become some of the most important evidence in the case.

Courts are increasingly willing to punish parties that do not preserve and produce their documents, including electronically stored information, in a fulsome and complete manner. Privileged material may be withheld. Communications between lawyer and client for purposes of obtaining or giving legal advice are generally privileged, meaning the other side cannot demand access to documents recording such communications. Other kinds of documents may also be privileged, such as attorney work product that is prepared in anticipation of litigation. However, courts generally take a narrow view of what is privileged material. Even privileged material needs to be preserved. Parties may agree to waive such privileges.

The obligation to preserve and produce often extends to information that is located outside the United States. In Societe Nationale Industrielle Aerospatiale v. United District Court for the Southern District of Iowa, the U.S. Supreme Court held that a U.S. district court had jurisdiction to order a French company to produce documents even though the requested documents were physically located in France.

Non-U.S. companies are often unfamiliar with the obligation to preserve and to produce very large quantities of emails to the other party, but U.S. courts take it seriously, and may impose significant penalties on a party that does not observe that obligation. In DSM Desotech Inc. v. 3D Sys. Corp., the Northern District of Illinois did not take issue with plaintiff's request for the production of "hundreds of gigabytes" of documentation, stating that the request did not represent "any greater volume of documents than in a typical patent case."

Motions for Summary Judgment

At any time during pretrial, a party may move for "summary judgment" establishing part of its case or its defense. Typically, the parties do not make such a motion until the discovery phase concludes, because a court can postpone its consideration of the motion until the parties have more or less completed the necessary discovery.

A motion for summary judgment in a federal court requires the moving party, or "movant," to show "that there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law." This is a significant burden, because the motion is made on a written record and the court cannot make credibility determinations. If the record shows there is a genuine issue of material fact, the case must proceed to trial, even if the evidence submitted on record may later be shown to be unconvincing or even false. Because the burden is so high, one rarely sees a summary judgment motion by a plaintiff. Almost always, such a motion is filed by a defendant, trying to dispose of some or all of the action before trial.

Trials

Time to Trial

It can take a long time for a civil case to get to trial in a U.S. court. In part, this is because many U.S. courts hear both civil and criminal cases, and certain priorities are given to criminal proceedings, especially where the accused is in custody.

The time to trial varies substantially from one location to another. For example, the Eastern District of Virginia completed 43 civil trials from September 2009 to September 2010, and the median interval from filing to trial was 9.3 months, while in the same time period, the median interval in the Northern District of New York, which completed 52 civil trials, was 44.7 months. The federal median interval was 24.3 months. In California, 70% of civil cases where the amount in controversy exceeded $25,000 over the fiscal year 2008—2009 were disposed of within 12 months, 86% within 18 months, and 92% within 24 months.

Jury Versus Bench Trials

The U.S. Constitution requires that juries, rather than judges, determine the facts in certain kinds of cases, if either party so demands. A jury may be six persons (as in a federal court) or more (such as 12 persons in a California court). After the jury hears the evidence under the auspices of a presiding judge, the judge will instruct the jury in the law that applies, and ask the jury to decide the facts and any appropriate monetary relief: for example, in a contract case, whether the defendant breached the contract, and if so, what amount of money the defendant should pay to compensate the plaintiff.

In some courts, the jury must rule unanimously, or a retrial may need to occur. In other courts, a ¾ majority will suffice for a jury's decision, or "verdict."

Even if the jury hears the case and renders a verdict, the judge has certain authority to set aside the jury's verdict and order a retrial or, in extreme cases, order judgment contrary to the jury's verdict.

If the matter is not one that requires a jury trial, or if neither party demands a jury trial, the judge will hear the evidence and determine both the facts and the law. This form of trial is commonly referred to as a "bench" or "court" trial.

Whether entered on a jury's verdict or after a court trial, the ultimate outcome of the trial is a judgment—who wins, and what relief is granted.

Limitation on Evidence at Trial

Both federal and state courts adopt rules of evidence that limit the information that can be introduced as evidence at the trial. Although the rules differ from federal to state courts, and from state to state , usually some common principles apply.

For example, before a witness can testify over the objection by the other side to a particular occurrence or event, it must be shown that that witness has a personal basis, or "foundation," for knowing that fact—such as having personally seen or heard the occurrence, or having recorded it in writing at the time in the regular course of a business activity.

As another example, statements made outside the courtroom by persons not present in the courtroom may be inadmissible to prove the truth of the statements because the person making the statement is not present in person. This rule, known as the rule excluding "hearsay," is quite complex, with a number of exceptions.

There are many more rules of evidence, including those governing such issues as when documents can be considered authentic and when expert opinion evidence is admissible.

Post-Trial Motions

State and federal procedure allows litigants to challenge a verdict. In federal court, a party may file a Motion for Judgment as a Matter of Law (JMOL), which essentially is a request to the court to enter a judgment contrary to the verdict. To succeed on this motion, a movant must either show that there is no evidence supporting the verdict such that the jury's findings could only have been the result of sheer guesswork, or an overwhelming amount of evidence in favor of the movant such that reasonable and fair-minded persons could not arrive at a verdict against the movant. Some state courts grant similar motions that are often referred to as a Motion for Judgment Notwithstanding the Verdict (JNOV).

A party may also file a motion to set aside the verdict and order a new trial. The federal standard for setting a verdict aside and ordering a new trial considers whether the verdict is against the clear weight of the evidence, based on false evidence or will result in a miscarriage of justice.

Under some circumstances, a party may file a motion to alter or amend the judgment. Such motions can be brought in federal court when, for example, new evidence becomes available or there is a change in the law.

Other post-trial motions available in both state and federal courts include motions to stay enforcement of judgment, motions to correct judgment because of a clerical error and motions for attorney fees. In the case of attorney fees, the general American rule is that each party in a civil action pays its own attorney fees. Nevertheless, several state and federal statutes provide exceptions to this rule, and allow for motions for payment of attorney fees. Also, contracts often provide for attorney fees to be awarded to the prevailing party.

In rare instances, a court may reduce the amount of damages awarded by the jury. Such action is called a “remittitur.” Some states, such as New Jersey, allow courts to impose an “additur,” whereby judges increase the amount awarded by the jury. Although remittiturs are available in the federal system, federal courts do not award additurs.

Appeals

Parties may appeal a trial court’s decision, at least after a final judgment is rendered disposing of all claims as to all parties. Following a judgment in a trial court, a party dissatisfied with the result may file a notice of appeal. Parties might also be able to file an “interlocutory appeal” before the final judgment in limited situations in a federal court; such appeals generally challenge the grant or denial of a preliminary injunction or class certification. Some states, such as New York, allow interlocutory appeals broadly in many situations.

An appeal is generally based on the “record below,” meaning that no new evidence is presented on appeal. The appellate court reviews a written record of the trial and evidence below and briefs prepared by the parties, and may hear oral arguments.

The standard of review by the appellate court differs depending on the court and the issue being reviewed. In federal courts, for example, issues of law—such as the grant of a summary judgment—are reviewable “de novo,” that is, without any deference to the district court. Other rulings, such as an order regarding documents that a party must produce, are reviewable only under a much more deferential standard, such as whether the court "abused its discretion."

The courts of appeals apply different standards of review and deference depending on a case's procedural posture in the court below. For example, where the district court has heard the evidence and found the facts, the Ninth Circuit will only set aside the lower court's factual determinations if there was a clear error.

Settlements

Notwithstanding the procedures outlined above for summary judgment, trial and appeal, the vast majority of lawsuits are settled. Even where a lawsuit has been filed and the court has issued rulings, these are often called "out-of-court" settlements because the parties reach agreement for the terms of settlement and discontinue the lawsuit. Most cases are settled before trial, but some are settled after trial, but before all appeals are exhausted. Importantly, the discovery process and pretrial court rulings frequently motivate the parties to reach a settlement.

Enforcement of Court Judgments

After a money judgment has been awarded, the successful party may enforce the judgment. If a losing party refuses to honor a court's judgment, the plaintiff may seek a writ, often called a "writ of execution." The writ, for example, may order an officer of the court to seize the defendant's personal property. In such a situation, the officer of the court would then sell the property at auction to the highest bidder. The proceeds of the sale generally first pay off the costs incurred by the officer of the court, and the remaining proceeds go to the plaintiff, up to amount of the judgment.

A plaintiff may also obtain claims to assets owed to the defendant by third parties. For example, the plaintiff may obtain claims to the defendant's wages or checking account. Also, if the defendant possesses real property, the plaintiff may obtain a lien on that property by recording the judgment in the appropriate land record office.

Judgments are enforceable only against property in the jurisdiction of the court issuing the judgment or of a court that will recognize the judgment. Federal courts recognize judgments from other federal courts, state courts, some international courts and other tribunals. Federal courts will often recognize foreign court decisions, but will consider whether the foreign court afforded sufficient procedural rights (usually referred to as "due process") to the losing party such that enforcement would be fair. This due process requirement does not mean that the foreign court must follow the exact procedures instituted in U.S. federal courts.

A losing party can file a motion to stay enforcement pending an appeal. A stay of enforcement is not automatic, and a money judgment may be collectable during the appeal. American courts may stay money judgments by accepting a defendant's appeal bond, also known as a "supersedeas" bond. In considering a stay pending an appeal, courts have the power to make whatever order is deemed necessary to ensure effectiveness of judgment.

Specialized Tribunals, Agencies and Programs

Specialized courts deal with specific areas of law that may present unique and complex issues. For example, bankruptcy matters are litigated in federal bankruptcy courts. These courts oversee the liquidation and reorganization of entities that file for bankruptcy pursuant to the federal bankruptcy code. The bankruptcy courts also can hear disputes between creditors and the bankruptcy estate (i.e., the debtor). The bankruptcy court's decision may usually be appealed to the U.S. district court, and then to the U.S. Court of Appeals. Sometimes a bankruptcy court's decisions may be directly appealable to the Court of Appeals.

Also, much federal and state litigation occurs before administrative agencies. Hearings before administrative agencies aim to expedite matters and provide specialized knowledge of certain kinds of disputes. At the same time, agencies tend to have limited jurisdiction and remedial powers. Often, parties may appeal an administrative ruling to the courts. Examples of administrative agencies that adjudicate disputes include the National Labor Relations Board, the Federal Trade Commission, the Securities and Exchange Commission and the International Trade Commission (ITC). The ITC, for example, conducts hearings before administrative law judges to determine whether certain goods that are imported to the United States infringe someone's intellectual property. The ITC may only bar infringing imports from entering the United States and issue cease-and-desist orders in exceptional circumstances. Remedies for other patent disputes are available in the federal courts.

Special programs also serve to settle disputes. At the state level, employer-funded workers' compensation programs compensate injured and disabled workers. The central tenet of workers' compensation programs is the principle of "strict liability," meaning that claimants do not have to prove an employer's fault for the cause of the injury. The programs are formed and operated according to state statute. In most states, legislative acts created state compensation boards that handle employee claims. Generally, the compensation boards' decisions may be appealed to the state court system.

Arbitration

Arbitration is the reference of a dispute by consent of the parties to a third-party arbitrator or panel of arbitrators for a binding decision. Arbitration generally consists of four basic elements. First, the arbitrator is a third-party decision-maker. The third-party decision-maker may be a single neutral arbitrator or a panel of arbitrators. If two parties agree to arbitrate before a panel of three arbitrators, they generally each select one arbitrator; thereafter, the two arbitrators agree to select a third arbitrator known as a "neutral." Second, there must be some mechanism for ensuring the arbitrators neutrality. Third, both sides must have an opportunity to be heard before the arbitrator. Fourth, the arbitrator's decision is binding.

Parties may agree to arbitration for several reasons, which include efforts to reduce litigation costs, obtain a speedier decision and maintain confidentiality during disputes. Unlike court documents, which are usually accessible to the public and the media, arbitration materials are generally kept private between the parties.

Parties may submit various matters to arbitration. Contractual interpretation is a common issue that is arbitrated. Statutory violations may generally be arbitrated as well, so long as the statute does not clearly say otherwise.

Parties may select arbitrators at the initiation of a contractual relationship or at the commencement of a dispute. Some contracts designate arbitration organizations to handle any or certain disputes arising out of the contract. There are several leading U.S. organizations that facilitate arbitration, such as the International Institute for Conflict Prevention and Resolution (CPR Institute), the American Arbitration Association (AAA) and JAMS, Inc. (formerly known as Judicial Arbitration & Mediation Services). Each organization promulgates its own rules governing its arbitration services that parties agree to when contracting for their services.

If a party that has previously agreed to arbitrate refuses to go to arbitration, the disputing party may file a motion in court to compel the other party to arbitrate. Such a motion is similar to an action for an injunction to require performance of a contract. Both state and federal laws provide enforcement of contractual arbitration clauses. Furthermore, agreements calling for arbitration in a foreign country or under foreign law are generally enforceable. Federal courts give great deference to arbitration agreements involving international commerce, reflecting a strong federal policy favoring arbitration of international commercial disputes.

An arbitration award is not directly enforceable until it is confirmed in a court proceeding. Therefore, a successful party may petition a court to confirm an arbitration award while the losing party may petition a court to vacate or modify the award.

However, courts may vacate or modify arbitration awards only in limited circumstances. Such circumstances include when a party was substantially prejudiced by the arbitrator's misconduct or when arbitrators exceeded their powers and this cannot be corrected without affecting the merits of the decision. Federal courts may vacate an award where the award signals "manifest disregard of the law." For example, a court might vacate an award if the court finds that the arbitrators knew the governing legal principle yet refused to apply it or ignored it, and that the governing legal principle was well-defined, explicit and clearly applicable to the case. It is extremely rare for courts to overturn arbitration awards based on these standards.

Mediation and Other Alternative Dispute Resolution Programs

Alternative Dispute Resolution (ADR) programs include a range of techniques designed to facilitate settlement between disputing parties prior to final adjudication in public courts. ADR is prominent in the United States as more than 95% of all federal cases are resolved before trial. More and more, parties are encouraged to settle their disputes by ADR. All federal district courts must have ADR procedures for use in all civil cases. Some state trial courts require parties to participate in a court-administered ADR program prior to trial. Also, some courts conduct settlement conferences where the court staff tries to facilitate a settlement.

A common form of ADR is mediation. Mediation is a procedure where a neutral third person acts as a facilitator to help the parties voluntarily settle a dispute. Unlike an arbitrator, a mediator is not a decision-maker and may not impose a binding settlement on the parties. Mediation is a voluntary process in that parties can decide when to end mediation, and they are not forced to enter into an agreement.

Examples of Important Substantive Areas of Litigation

Certain areas of law are particularly relevant to foreign companies because of their tendency to lead to litigation. Examples of substantive U.S. law that foreign companies should consider as they enter the U.S. market include the following.

Antitrust Litigation

Foreign companies that plan to or already do business in the United States should be aware of federal antitrust laws, which can be enforced with suits by the Department of Justice (DOJ), the Federal Trade Commission (FTC) and private parties. The federal antitrust laws, primarily codified in the Sherman Antitrust Act, seek to protect consumers by preserving competitive markets. The laws generally target monopolization, attempts to monopolize and unfair restrictions on competition. Both the DOJ and the FTC have the power to investigate and prosecute violations of the federal antitrust laws. The FTC also has some adjudicative powers. Antitrust violations may result in both civil and criminal liabilities, and injured private parties may sue for treble damages (e.g., three times the calculated damages).

In addition, the DOJ and the FTC may investigate foreign companies. Whether a foreign company can be investigated by the DOJ or the FTC depends largely upon the effects of the anticompetitive conduct in question on the American market. This includes effects on competition in the United States and impacts on American exporters. Therefore, conduct among non-U.S. companies outside the United States may still be investigated by the U.S. government if such conduct is directed at the United States. Despite this broad international reach, typical problems of international law arise in the antitrust context such as service of process, obtaining adequate discovery and obtaining judgments from U.S. courts that are enforceable against foreign corporations and provide adequate relief.

Intellectual Property Litigation

The U.S. Constitution empowers Congress to protect intellectual property (IP). There are four general areas of IP law in the United States: patents, trade secrets, trademarks, and copyrights. Trade secret and trademark disputes may be litigated in both federal and state courts. Federal courts have nearly exclusive jurisdiction over the litigation of patents and copyrights.

IP litigation can be highly specialized, in particular the area of patents. This specialization is due to the complexity of the subject matter as well as the unique procedures resulting from this complexity. Many of these unique procedures are developed by local rules in each District Court. There are typically two stages prior to a patent trial, which distinguish patent disputes from most other litigation.

First, judges often require a “tutorial” to help them understand the background concepts relevant to the invention at issue. Judges may appoint their own neutral experts, or judges may elect to hear from the parties’ experts. The testimony presented in a tutorial may not be entered into evidence but can serve to influence the judge. Furthermore, the tutorial may help the parties’ experts to gain credibility with the judge.

Second, an important aspect of a patent litigation is a pretrial hearing before the judge called a “Markman hearing.” Patents give their owners certain exclusive rights as defined in “claims,” such as a “claim” to a particular drug substance or device. In a Markman hearing, the judge defines the proper interpretation and scope of the claim language. This hearing may determine the outcome of a case. At trial, the jury is tasked with comparing the scope of the plaintiff’s patent (as defined by the judge) with the accused infringer’s product or activity.

CHAPTER 14

PRODUCTS LIABILITY

By Jeffrey R. Gans

Introduction

U.S. products liability law creates potential liability for those who make products available to the public (manufacturers, distributors, suppliers and sellers). If a product causes personal injury or property damage, the harmed individual often has the option to sue for monetary damages. Because the monetary damages can be very significant, products liability has developed into the fastest-growing branch of tort law. Moreover, each of the 50 states in the United States has its own products liability law, so staying informed regarding the most recent developments in any state in which you do business is critical.

There are three primary liability theories associated with products liability.

Negligence

A company can be held responsible if it failed to act reasonably in designing, manufacturing, labeling or selling a product, even if it does not have a contract with the claimant. The claimant only has to prove that it was foreseeable that a person or property could be injured by the product.

Breach of Warranty

A company can be held responsible if it failed to properly warn the buyer of the product's capability or intended use. Under this theory of liability, an injured claimant will be successful in a breach of warranty suit against the company if it can show that the seller represented that the product would meet certain standards, the claimant relied on this representation when he or she purchased the product and the product failed to meet the representation.

Warranties can either be express or implied. An "express warranty" is when a seller expressly warrants, either verbally or in writing, that the product has certain qualities. If, however, the purchaser later discovers that the product does not have the qualities advertised by the seller, the purchaser, or anyone else affected by the product, may sue the seller for misrepresenting the product.

An "implied warranty" is based on the circumstances of the sale and not on the seller's verbal or written representations. When a merchant ordinarily deals with products of a particular type, this merchant is automatically warranting that the product is fit for its ordinary purpose and is free from any defects that will cause it to be dangerous. In addition, an implied warranty is when the seller recognizes the purpose for which the purchaser is purchasing the product. By recommending the product, the seller is implying that the product is fit for a particular purpose.

Strict Liability

"Strict liability" focuses on the product itself and not on the actions of the manufacturer or seller. Under this form of liability, the manufacturer is responsible for its defective product even if it was not careless when creating the product. Therefore, a claimant does not have to prove that the actions of the manufacturer fell below the required standard of care.

Standards of Care

Negligence

Negligence is a major part of tort law in the United States. A plaintiff will be successful under a negligence claim if the plaintiff can prove that the defendant failed to exercise the care that a reasonably careful person would exercise in a similar circumstance, and the plaintiff suffered some injury because of it. Negligence comes into play in the products liability arena because a manufacturer of a certain product will be liable for any injury resulting from its product if the manufacturer was not careful and responsible when it created the product. For example, if a manufacturer creates a toy for small children with sharp glass edges that injure children, the manufacturer will be held negligent because a reasonable and careful manufacturer in a similar situation would not create this type of toy for little children.

Warranty

In the United States, a purchaser of a product has the ability to sue the seller if the product turns out to be not as advertised or warranted. These types of lawsuits are considered breach of warranty actions. If a buyer can prove that warranties, either express or implied, made by a seller regarding the quality of a certain product are actually false, this buyer can successfully sue the seller for breach of warranty. And for the most part, it is not necessary that the purchaser bringing the lawsuit actually purchased the product directly for that seller.

Express Warranties

An express warranty is when a seller specifically represents, either verbally or in writing, that its product has certain qualities. If an individual relies on the seller's express warranty and purchases the product, the purchaser can later sue the seller for breach of warranty if the product does not actually have the characteristics that the seller warranted. For example, if a seller advertises that its product does not contain lead paint, a purchaser who hears or reads this representation will be successful in a breach of warranty lawsuit against the seller if the product actually contains lead paint. Because it is not necessary for the purchaser to have contracted with the seller, the seller's warranty extends to the general public, and anyone harmed by the product can sue the seller. Furthermore, as long as a plaintiff can prove that the seller's representation was false, it is inconsequential whether the seller knew that its representation was untrue. Thus, as discussed in more detail below, a seller's liability for breach of an express warranty is a form of strict liability, or liability without regard to fault.

Implied Warranties

The second form of warranty is an "implied warranty." The existence of this type of warranty is implied simply from the fact that the seller offered the buyer its product. If a seller regularly sells a certain product, this seller is warranting that the product is fit for its ordinary purpose and is free from defects that will render it dangerous. This type of implied warranty is the warranty of merchantability. For example, if a seller specializes in selling bicycle tires for road racing, this seller is warranting to the buyer that the tires are intended for road racing without making any verbal or written representation—the warranty is implied simply from the fact that the seller regularly sells this type of bicycle tire. If either the buyer or a bystander is later injured because the purchased tires are not intended to travel at racing speeds, the injured buyer or bystander can sue the seller for breach of warranty. The only way a seller can hope to avoid the warranty of merchantability is to expressly disclaim it.

A second example of an implied warranty is the warranty of fitness for a particular purpose. If a seller knows the purpose for which the buyer wants the product, the seller is giving an implied warranty that the product is fit for the buyer's particular purpose. In the example above, if the seller knows that the buyer wants tires for road racing, the seller is giving an implied warranty of fitness by recommending particular tires to the buyer.

No Contract Necessary

It is important to recognize that a plaintiff does not need a direct contract with the defendant in order to sue. Anyone who consumes a manufacturer's tainted food product and becomes ill can sue the manufacturer for breach of an implied warranty because all food manufacturers made implied warranties that their products are of reasonable quality and safe to consume. Similarly, an individual who borrows a friend's car and then injures himself in an accident after the gas pedal malfunctions can personally sue the car manufacturer for breach of an implied warranty. Additionally, anyone else injured in the car accident can sue the same car manufacturer if the defective gas pedal caused the accident.

Because of the increase in strict liability lawsuits (discussed immediately below), however, breach of warranty lawsuits are less common today.

Strict Liability

Over the years, strict tort liability has gradually replaced implied warranty lawsuits. Although both are premised on the idea that the plaintiff does not have to prove that the defendant was negligent and that a defendant can be liable without fault, implied warranty lawsuits become more complicated when there is no contract between the plaintiff and the defendant. Thus, plaintiffs now rely more on strict liability when suing manufacturers, retailers or sellers.

In order to recover against a defendant under strict liability, a plaintiff simply has to prove that the product had a defect that ultimately caused the plaintiff's injury. Under strict liability, therefore, a seller is liable for selling a defective product even if it went to great lengths to ensure the product's safety when designing, manufacturing and marketing the product. As discussed in more detail below, three types of defects exist: (i) manufacturing defects; (ii) design defects; and (iii) instruction or warning defects.

The Unreasonably Dangerous Test

The American Restatement of Torts, Second is an influential treatise. Issued by the American Law Institute in 1965, the treatise summarizes the general principles of tort law. Adopted by the majority of jurisdictions, the most influential section by far is Section 402A, which addresses the principle of strict liability:

- (i) One who sells any product in a defective condition unreasonably dangerous to the user or consumer or to his property is subject to liability for physical harm thereby caused to the ultimate user or consumer, or to his property, if (a) the seller is engaged in the business of selling such a product, and (b) it is expected to and does reach the user or consumer without substantial change in the condition in which it is sold.
- (ii) The rule stated in Subsection (i) applies although (a) the seller has exercised all possible care in the preparation and sale of his product, and (b) the user or consumer has not bought the product from or entered into any contractual relation with the seller.

Therefore, a product's condition is considered to be defective if the manufacturer creates the product not according to its specifications, thereby making it unsafe to the consumer. If the defective product is sold in the same condition as it was when it left the manufacturer's factory plant, the manufacturer is strictly liable for the damage created by the defective product. It is worth noting that strict liability does not apply only to the manufacturer of the product—it applies to every person in the product's distribution chain, including the manufacturer, distributor, retailer and wholesaler. Although not a necessary test for all jurisdictions, a product is "unreasonably dangerous" if, in the opinion of an ordinary consumer, the product is more dangerous than anticipated. In California, for example, the product does not have to pass an "unreasonably dangerous" test, but simply has to fail ordinary consumer expectations. Because every state has adopted its own products liability laws and tests, strict liability claims are more difficult to defend in some jurisdictions than in others.

Burden of Proof

Overall, strict liability cases are increasing in number because an injured plaintiff's case is not difficult to develop or prove— a plaintiff merely has to prove that his or her injury resulted from a defect in a product that caused it to be unreasonably dangerous in the opinion of an ordinary consumer. Because the plaintiff does not have to prove whether the defendant's actions were negligent, the plaintiff can focus solely on the defective product and the resulting injury. Furthermore, because a plaintiff is the ultimate user or consumer, there is no contract necessary between the plaintiff and the defendant—the plaintiff simply must use the product or be in the vicinity of danger created by the product. As in the example above, the friend who borrowed the car with the defective gas pedal or the bystander who was injured in the resulting car accident can sue the car manufacturer or the gas pedal manufacturer based on strict liability. The fact that neither individual purchased the vehicle is inconsequential because "privity" (a contractual relationship between plaintiff and defendant) is not a precondition for recovery.

Unavoidably Unsafe Products

One category of products that greatly varies from jurisdiction to jurisdiction is "unavoidably unsafe products." Although these products are free from design flaws and do what the average consumer expects them to do, these products are inherently dangerous no matter how they are designed or produced. A few examples of products commonly considered unavoidably unsafe are prescription drugs, cigarettes and handguns. The Third Restatement takes a risk-utility view: an unavoidably unsafe product is not considered defective if its utility outweighs its risks. Again, it is up to the trier of fact to decide whether an ordinary consumer would consider the product to be more of a benefit or more of a danger.

Unknowably Unsafe Products

Somewhat related to unavoidably unsafe products are products that are "unknowably unsafe" at the time of design and production. Fortunately for defendants, the majority of jurisdictions agree that a manufacturer cannot be liable for a danger that, given the state of technology at the time of design and manufacturing, could not have been reasonably foreseen. Because, according to the restatement, a design defect only exists when the product's foreseeable risk of danger could have been avoided or decreased by the implementation of a reasonable alternative design, an unknowable danger cannot create a design defect. However, a plaintiff only has to prove that his or her injury resulted from a foreseeable danger to overcome this strict liability defense. If the plaintiff can prove that similar products in the market are not causing harm to the general public, a manufacturer will have a tough time asserting that the danger of its product was unforeseeable.

Product Defectiveness

There are three types of product defects that create the foundations for claims in strict tort liability: (i) manufacturing defects; (ii) design defects; and (iii) instruction or warning defects.

Manufacturing Defects

Manufacturing defects occur during the production or construction of the product. A product has a manufacturing defect when the product is unsafe because it is not produced according to its intended design or specifications. This is the result of either a deviation from the manufacturer's standard process or an overall manufacturing defect—because something went wrong in the manufacturing process, the product injured the plaintiff. Overall, a manufacturing defect can create a lawsuit when a feature of the product that was unintended by the manufacturer causes an injury.

Burden of Proof

In order to prevail in a strict liability suit based on a manufacturing defect, the plaintiff has to prove that the product fails to conform to the manufacturer's specifications. A common way for a plaintiff try to prove that a manufacturing defect caused his or her injury is to compare the allegedly defectively manufactured product to a properly manufactured product produced by the same manufacturer. Again, the plaintiff does not have to prove that the manufacturer failed to exercise due care—the focus is only on whether the plaintiff's injury was the result of a defectively manufactured product.

"Consumer Expectation" Test

A manufacturer is also liable for random defectiveness. Therefore, as seen continuously in lawsuits throughout the United States, plaintiffs can sue if a foreign object is found in a food product. For food products, the most common standard applied by the various jurisdictions is the "consumer expectation" standard. Under this test, if a food product contains an ingredient that a reasonable consumer would not expect the product to contain, the product is considered defective, and the consumer can sue under strict liability. Obviously, an ordinary consumer would not expect bacteria like E. coli to be present in a bag of lettuce and, therefore, the consumer has a very strong case to hold the manufacturer strictly liable. But what happens when a bone is found in a can of chicken soup? In these cases, the defendant's liability is in the hands of the everyday consumer, and the outcome can vary from case to case and jurisdiction to jurisdiction. Thus, a manufacturer or seller can never be too careful in ensuring that its products are free from harmful and unexpected objects. A company's added expense for quality control can ensure that lawsuits are limited.

Intended Purpose

In both manufacturing and design defect cases, a plaintiff cannot be successful if he or she did not use the product for its intended purpose. In that case, the defective product was not a direct cause of the plaintiff's injury because no reasonable consumer would agree that the plaintiff injured himself or herself while utilizing the product for its intended purpose.

Design Defects

A design defect is when the design specifications are flawed, causing the product to be defective before it is even produced. Once produced, all similar products have the same design defect, causing the product to be unreasonably dangerous to the general public.

Burden of Proof

In design defect cases, to impose strict liability, the plaintiff must prove that the product's design creates an unreasonable risk of danger to the consumer when the product is put to its intended or reasonably foreseeable purpose. Thus, even if the product has a design defect, the plaintiff's case will be unsuccessful if the defendant can prove that the plaintiff's injury resulted from not utilizing the product for its intended or foreseeable purpose. Design defect cases, however, vary from jurisdiction to jurisdiction because courts have not agreed on a uniform test for determining whether a product has a design defect.

Negligence and Various Strict Liability Tests

Although plaintiffs tend to frame design defect claims in strict liability terms, in some jurisdictions, design defect claims are often intertwined with negligence. Often, the primary issue at trial is whether the defendant consciously chose a design that created an unreasonable danger to consumers when safer but more expensive and burdensome designs were also available. If it was not unreasonable for the manufacturer to design a safer product, the plaintiff will have a stronger argument that the product that caused his or her injury had a defective design and that safer options were available.

Utility vs. Risks

A test adopted by some courts, which appears to be based purely on a negligence standard, is weighing the product's utility against the product's risks. When this negligence standard is used, the overall issue is whether the manufacturer acted reasonably when it offered the product to the general public. When applying this reasonability test, factors to consider include whether the product is necessary to the public, the probability that the product will cause injury, and, as stated above, the manufacturer's ability to have chosen a design that was safer and affordable.

Consumer Expectations

In other states, a product can be considered to have a design defect if, in the opinion of the average consumer, the product is more dangerous than one would expect. In these states, however, a defendant cannot rely solely on consumer expectations as a defense. Sometimes, a manufacturer's design could have included an easy remedy to the dangerous component of the product that the general public could never have anticipated.

Combined Test

Another test that is used in various states, including California, to decide whether a product has a design defect combines concepts from strict liability and negligence. Under this test, a design defect is present if either the product design's risks outweigh its benefits to the public at large, or the product's design creates dangers that an ordinary consumer should not expect when utilizing the product for its intended or foreseeable use.

Current Trend

In recent years, the trend in some jurisdictions has shifted away from strict liability for design-defect cases and more toward a negligence assessment. This trend is partially due to the restatement's influence on product liability law. The Third Restatement suggests utilizing a risk-utility test when addressing design-defect cases. A product's design is defective "when the foreseeable risks of harm posed by the product could have been reduced or avoided by the adoption of a reasonable alternative design by the seller or distributor, or a predecessor in the commercial chain of distribution, and the omission of the alternative design renders the product not reasonably safe." This definition asks the judge or jury to compare the design's foreseeable risks of harm to the alternative designs that were available to the defendant. If a reasonable alternative design was readily available to the defendant, the claimant will succeed in a lawsuit premised on a design defect. In deciding whether a "reasonable alternative design" was available, courts compare similar products from other manufacturers, determine whether the alternative was practical and affordable, and analyze how the average consumer would choose between the available products. Overall, because this negligence assessment of design defects includes subjectivity, manufacturers, distributors, and retailers are never fully protected from potential design-defect lawsuits.

Types of Cases

There are three general categories for most design-defect cases: (i) structural defects; (ii) lack of safety features; and (iii) suitability for unintended but foreseeable purposes.

Structural Defects

A company can be liable for structural defects if it constructed the product out of inferior materials, causing the product to be weaker than anticipated. Accounting for the price and anticipated life span of the product, inquiry will focus on whether the product meets the strength expectations of the average consumer. Because products vary in price, every manufacturer is not expected to produce the strongest product on the market. Rather, a manufacturer must produce a product that is not unreasonably weak and is what a reasonable consumer would expect for the price tag.

Lack of Safety Feature Defects

A company can be liable for the lack of safety features if it could have included an affordable safety feature in the design but chose not to. Under this test, the additional cost of the safety feature is balanced against the harm. A manufacturer cannot defend its product by comparing it to similar products on the market—if the safety mechanism was affordable and simple to incorporate into the design, a defendant is still liable no matter how its competitors designed their products. Furthermore, a plaintiff can often counter the assertion that the safety mechanism would have prevented the product from performing properly by proving that the decision was based on saving money and not on preserving functionality.

Unintended but Foreseeable

A company can be liable for injuries even when its product is misused, if the misuse was foreseeable. When the misuse of the product is foreseeable, a manufacturer must take reasonable steps in the product's design to protect the average consumer from injuring himself or herself during this foreseeable situation. A common example of this is protecting drivers and passengers from injuring themselves from the interior of a car during an accident. Although courts used to hold that collisions were not an "intended" use and car manufacturers had no duty to make a crash-proof car, courts now hold that car manufacturers have an obligation to take reasonable steps to ensure that the car is reasonably safe in an accident since accidents are foreseeable. So, while car manufacturers design cars with strong exteriors to protect individuals involved in an accident, these manufacturers must also take reasonable precautions to protect the driver and passengers when colliding with the interior of the car (the so-called "second collision"). Car manufacturers must ensure that no interior features can reasonably be made more safe for foreseeable accidents.

Duty to Warn

The third theory of strict liability addresses a defendant's failure to warn a consumer of a product's potential dangers. A manufacturer or seller's duty to warn is an additional obligation beyond ensuring that the product is free from manufacturing or design defects. Thus, a company cannot adequately warn the public of the potential defect to avoid liability since no warning can protect a defendant from liability for manufacturing or design defects.

Necessary Warnings

Overall, a product can be considered defective based on whether it includes a warning as to the possible dangers or whether the product's directions include the proper warnings. Therefore, a product can be free from manufacturing or design defects but can still be considered defective if the defendant failed to warn the consumer of the product's potential risks, and the consumer is injured while using the product for its intended or reasonably foreseeable purpose.

To protect against these types of product liability lawsuits, a seller or manufacturer must include warnings in the included labels or instructions to consumers and potential users of the product's conditions that could possibly lead to injury or damage. These instructions and labels must provide information on how to use the product safely while also including warnings for the non-obvious risks associated with the product.

In addition, if it is probable that a reasonable consumer might misuse the product and consequently suffer injury or damages, these instructions and labels must properly warn consumers on how to use and how not to use the product.

Warnings are not sufficient unless they can reach the product's ultimate user. It is not adequate that an industrial company receives warnings from the manufacturer or seller—the employees who utilize the products are the ultimate users, and they must also be aware of the product's warnings. Therefore, a warning must stay with the product and cannot simply be information printed on the product's original box.

Duties After the Sale

It is also important to note that if a seller becomes aware of a dangerous defect after marketing and selling the product, this seller has a legal duty to warn existing users of the possible dangers associated with the product. Therefore, it is common in the United States for companies to recall products after they discover the dangerous defect in order to avoid more product liability lawsuits.

Tests and Inspections

In order to determine the product's potential dangers, the manufacturer is responsible for inspecting and testing its products. Additionally, if the manufacturer is constructing a product out of various components produced by others, the manufacturer has a responsibility to inspect and test the individual components. Because the product liability cases vary with each individual case, there is no set formula for how much inspection or testing a manufacturer or seller should perform before offering the product to the general public.

Negligence

While some courts believe the duty to warn falls under the strict liability area of products liability, other courts and jurisdictions apply negligence principles when addressing a defendant's failure to warn. Similar to the design-defect tests stated above, jurisdictions that apply a negligence analysis focus on a risk-utility test. When applying the risk-utility analysis, it is necessary to consider whether the defendant should have foreseen the potential harm of its product, the incidence rate and the level of injury, the affordability of including a warning, and the likelihood that the average consumer would consider the warning provided. The Third Restatement recommends a risk-utility analysis when addressing a defendant's failure to warn. Under the restatement, a party's failure to warn causes a product to be defective "when the foreseeable risks of harm imposed by the product could have been reduced or avoided by the provision of reasonable instructions or warnings … and the omission of the instructions or warnings renders the product not reasonably safe."

Damages

In the United States, a plaintiff injured by a product can sue for both compensatory damages and punitive damages.

Compensatory Damages

Compensatory damages include both economic losses and non-economic losses. If a product causes a plaintiff to suffer personal injury or damage to his or her property, the available economic losses are the actual monetary losses the product caused the plaintiff to incur. For property damage, these monetary losses can include diminution in value of the product, cost to replace or substitute the product, and damage to other property. For personal injury, these monetary losses can include medical expenses, lost wages, future lost wages, impaired earning capacity, property damage and even the value of household services that the plaintiff cannot now perform.

In certain jurisdictions, plaintiffs can also sue for noneconomic losses, which are the non-monetary losses that can result from the injury. Courts can put a dollar figure on these losses. Almost exclusively awarded in personal injury cases, these noneconomic damages can include compensation for pain and suffering and emotional distress.

Although most countries allow plaintiffs to recover compensatory damages in product liability litigation, these damages in the United States come with a much higher price tag. Generally, plaintiffs in the United States who are successful in products liability litigation have the potential to recover a large amount of compensatory damages. For serious physical injuries, it is common that plaintiffs can successfully collect damages ranging from hundreds of thousands of dollars to millions of dollars.

Punitive Damages

Within the U.S. court system, an injured plaintiff also has the ability to collect damages beyond compensatory damages. These additional damages are meant to punish the defendant and send a warning sign to other possible defendants that the same mistakes should not be repeated. These punitive damages are generally awarded only when the defendant knew of the product's potential damages but failed to warn the general public or take any precautionary measures to protect the general public. Because punitive damages are unavailable in jurisdictions outside of the United States, non-U.S. manufacturers or sellers must be aware of the possibility that a products liability lawsuit could include great compensatory and punitive damages.

Conclusion

With the possibility of significant recoveries that show no signs of slowing, products liability litigation continues to expand within the United States. Plaintiffs' lawyers advertise their services constantly and are always searching for their next clients. Because the laws vary greatly between jurisdictions, it is difficult for non-U.S. companies to navigate the products liability requirements. Therefore, Pillsbury's expertise in products liability law and our crisis management capabilities can be tremendous assets to any company wanting to sell its products within the United States.

CHAPTER 15

INSURANCE

By Michael S. McNamara

What Is Insurance? Why Should a Company Buy It When Doing Business in the United States?

Insurance is a risk-shifting device that most American companies use to manage risks to their business and prevent an unplanned event or accident from causing harm to the business. It is a type of contract where one party, the insurer, agrees to accept the risk borne by another party, the insured, of a loss caused by a particular event. For example, an insurer may accept the risk that an insured's vehicle will be damaged in an accident. If an accident happens and the vehicle is damaged, then the insurer will reimburse the insured for the costs to repair or replace the vehicle.

There are many different types of insurance policies available in the United States. This chapter will explain how American insurance works, identify the most common types of insurance policies that American businesses use, and that businesses entering the American market should consider. It will then explain how the policies work, enabling the reader to decide whether to buy insurance, what types and amounts of coverage to buy and how to find the best insurer.

In the United States, the insurance contract is known as an insurance policy; the insured buys the insurance policy from the insurer by paying a premium, which is usually a small amount of money in comparison to the amount of risk that the insurer agrees to bear. The insurance policy will place limits on the amount of money that the insurer is obligated to pay in the event the insured suffers a loss covered under the policy.

The types of insurance available in the United States vary widely. They are limited only by the types of accident or fortuitous event that may cause a loss. When deciding what types of insurance to buy, companies should look first at the risks of loss and liability related to their assets and operations in the United States. For example, if your company owns property in the United States, you should consider buying property insurance to protect against damage to your property. If your company sells products or services in the United States, then you should consider buying insurance to protect against liability for damages caused by your products or services.

How Do Insurance Policies Work?

Insurance policies are a type of contract. The insured pays a premium to the insurer and in exchange, the insurer agrees to bear a certain type and amount of risk. To understand in more detail how insurance policies work, you should become familiar with some insurance-related terms.

Insured

The first term is "insured." An "insured" is a person or company that is entitled to "coverage" under the insurance policy. The company that pays the premium is usually an insured, but there can also be other insureds. For example, assume that your company operating in the United States is called "Acme Parent" and it has several subsidiaries, "Acme Sub 1," "Acme Sub 2," and "Acme Sub 3." Acme Parent may buy property insurance to provide coverage for its assets in the United States. But if the Acme Subs also own assets in the United States, Acme Parent may want to buy insurance to cover the risk to those other assets. In order to do this, Acme Parent will want its Acme subsidiaries to be "insureds" or "named insureds" under its property policy.

Insuring Agreement

The next step after identifying the companies that are named insureds is to identify what is known as the "insuring agreement." That part of the policy describes what losses the insurance policy insures against and what causes of loss are insured against. For example, the insuring agreement for a typical commercial property policy may say, "We cover direct physical loss to covered property at the premises described on the declarations caused by a covered peril." It is very important to carefully read the words used in the basic insuring agreement (i.e., direct physical loss, covered property, premises described on the declarations, covered peril) because they will be applied very specifically to any claim for insurance proceeds. Usually, the basic insuring agreement is very broad and if you stopped reading the insurance policy after reading that part, you might think that the insurer had agreed to very broad coverage and the insured had struck a fantastic bargain by buying that insurance.

Exclusions

But you must read the entire policy. There is another section in every insurance policy called "exclusions." The "exclusions" section usually follows the basic insuring agreement, but not always. In the "exclusions" section, the insurance policy removes from coverage certain losses or causes of loss for which the "basic insuring agreement" seemed to provide coverage. For example, the basic insuring agreement of one policy covering commercial general liability provides that the insurer "will pay those sums that the insured becomes legally obligated to pay as damages because of 'personal and advertising injury' to which this insurance applies." ("Personal and advertising injury" in the same policy is defined as injury arising out of false arrest, malicious prosecution, the use of another's advertising idea in your advertisement, or infringing upon another's copyright, trade dress or slogan in your advertisement.) That policy, however, excludes coverage for "personal and advertising injury" arising out of a criminal act committed by or at the direction of the insured.

If you see that the policy excludes coverage for the type of risk you want to insure, do not despair. Instead, keep reading. In addition to exclusions, many policies also have "exceptions" to exclusions, which restore coverage for losses that seem to be excluded in the "exclusions" section. You are right if you think that the policies are complicated, but it is worth spending the time to read them. Sometimes, the "exceptions" to the "exclusions" restore coverage for losses that would have been a significant expense for the insured.

Take a popular example. Assume your company owned a manufacturing facility in California and an earthquake caused damage to the facility; during the earthquake, electrical transformers exploded and caused a fire which completely destroyed the facility. The property policy you bought for the facility covered losses caused by damage to your property so the damage to the facility would seem to be covered.

But the policy excludes coverage for damage to property caused by earthquake. You might despair, thinking that you had no coverage and would have to absorb the entire costs of the lost facility. However, the policy provided an "exception" to the exclusion for damage caused by earthquake. Under the exception, the policy provides coverage for damage caused by earthquake when damage by a "covered cause of loss" results. "Fire" is a covered cause of loss. So, the complete loss of the facility caused by the fire is covered. This is an example that insurers use to illustrate how exceptions to exclusions can in fact make exclusions which initially seemed quite broad to be rather narrow. In the example above, the insurer would pay for the loss of the manufacturing facility and the insured would have the funds to rebuild the facility and therefore experience a much smaller impact to its business.

Another reason not to despair when you see that an exclusion bars coverage for the type of risk that you want to insure is that you can "buy back" coverage for many risks excluded in exchange for paying a higher premium. Let us continue with the earthquake example. If you want to buy insurance for a manufacturing facility in an area that experiences frequent earthquakes, you may want to have insurance coverage for damage caused by earthquakes. If the property policy being offered by the insurer contains an exclusion for damage caused by earthquakes, ask the broker whether you can buy an "endorsement" (explained below) to that policy that provides coverage for damage covered by earthquakes.

Many carriers will offer this type of endorsement. Remember, insurance is about shifting risks. The carrier may decide that the risk of damage caused by earthquake is so high that they will insist on charging a much higher premium in exchange for providing that coverage.

When done right, the insured strikes a good, but fair, bargain when buying insurance. Insurers carefully evaluate whether to sell insurance through a process called "underwriting." They consider the likelihood that different risks will occur and they use their analysis to decide what premium to charge in exchange for taking on certain types of risk.

First Party Versus Third Party

Another aspect of insurance that businesses should consider is that some types of insurance are known as "first party" insurance and other types of insurance are known as "third party" insurance. "First party" insurance provides insurance coverage for the insured's own losses. The simple example of "first party" insurance is property insurance where the insurance covers loss to the insured's own property. The loss covered by first party insurance does not need to be to the insured's own property; it can be a different loss suffered by the insured. As discussed in Section III, "Business Interruption" insurance is a type of first party insurance that covers lost business [income] [is it income or revenue?] suffered by the insured due to some insured risk.

Third party insurance, on the other hand, is purchased to protect an insured from claims made against it for the losses suffered by another party—a party who is not a party to the insurance contract, which is why it is commonly called third-party insurance. In addition to providing coverage for a particular loss, third party insurance requires the insurer to provide a defense to a lawsuit filed against an insured. In the United States legal system, private parties can file lawsuits against each other. When an entity sues another in that system, the entity being sued must hire lawyers to defend itself and the cost of those lawyers and the other defense costs can be substantial. If the insured has third party insurance for certain types of claims and is sued for one of those types of claims, then the insurer must pay for the defense of that lawsuit. The primary defense cost is the cost of the lawyers to defend the insured in the lawsuit, but it also includes other defense costs, such as expert witness fees, travel and copying expenses, all of which can become substantial.

If the lawsuit is successful on a claim covered by the third party insurance, then the insurer must pay the cost of the judgment against the insured. For example, take a company that manufactured drywall and sold that drywall in the United States. If that company has commercial general liability insurance (described in more detail in Section III.C. below) and is sued by the owner of a house in Florida that contains drywall manufactured by the company because the drywall caused damage to the homeowner's house, then the general liability insurance policy may be triggered. If the homeowner is successful in its lawsuit and obtains a judgment against the company, then the insurer must pay the amount of the judgment, subject to the monetary limits of the insurance policy. So if the policy limit is $1 million per occurrence and the homeowner obtains a judgment for $250,000, then the insurer must reimburse the company for the amount of that judgment.

It should be emphasized that this is a simplified example. There are other reasons that the judgment may not be covered. It may have been caused by an accident that took place outside of the policy period – i.e., the damage occurred while the policy was not in effect. Or the policy may contain an exclusion which bars coverage even though the basic insuring agreement is applicable to the situation. Or to the extent the amount of the judgment exceeds the policy's limits. These limitations should not cause a company to choose not to buy insurance. Insurance is a very valuable product for any company doing business in the United States. Instead, the point of raising these limitations is to caution companies buying insurance to carefully examine the details and to educate themselves about the policies so they can maximize their risk management program and maximize coverage when a loss or claim does occur.

The insurer's duty to defend under a third party policy provides a significant benefit to insureds because it is triggered by the third party claimant's allegations – regardless of whether those allegations are true. Continuing with the example above of the drywall manufactured by a company, assume that the American homeowner files suit against four drywall manufacturers because the homeowner determined that its home contained drywall manufactured by four different companies. The company is just one of those four companies and so it is a defendant in the lawsuit. But what if the company's drywall did not cause the damage to the home, but instead the drywall manufactured by one of the other three defendants in the lawsuit caused the damage? You might think that the general liability policy does not provide coverage for the company because it was not the company actually responsible for the damage. But the insurer's duty to provide a defense on a third party insurance policy is triggered by the third party claimant's allegations, even if they are not true.

In other words, when the third party claimant makes a claim against the insured, the issue for the insurance company is not whether the third party claimant's allegations against the insured are true. That issue will be resolved in the lawsuit. The determinant question is whether the claimant's allegations trigger coverage under the policy assuming that they are true. So in the example above, where the company is a defendant in a lawsuit where the claimant alleges that the manufactured defective drywall, the insurer's duty to defend is triggered and the insurer must provide a defense. That defense can be expensive. If the homeowner files suit claiming that the defendants' defective drywall caused $250,000 worth of damage, it is possible that the defense costs could be more than $250,000. This may seem incongruous, and it is. But it is an unfortunate reality of the American legal system. And this reality emphasizes one important aspect of the benefit of buying insurance. A company that buys third party insurance buys not just indemnification for losses suffered by some third party; it buys, in effect, insurance against some of the major costs of being sued for the loss. That is why many American lawyers refer to third party insurance as "lawsuit insurance."

Policy Period; Occurrence Versus Claims-Made Policies

Insurance does not apply forever. Insurance policies cover time periods in two basic forms: "occurrence" and "claims made." An "occurrence" based policy will only provide coverage for accidents that happen during the policy period. So if a general liability policy provided coverage from January 1, 2009 until January 1, 2010, and a third party files suit against the insured for an accident that happened in March 2010, then the insurance policy will not provide coverage to the insured, even if the accident and resulting damage would otherwise entitle the insured to coverage under the policy. However, if the occurrence takes place during the policy period, once that happens, coverage attaches even though the claim may not be made for some time, even years, thereafter. But assume that the same insured had bought a general liability policy on a "claims made" basis with a policy period from January 1, 2010 until January 1, 2011; under those circumstances, the insured would have coverage for the suit filed in March 2010 because the "claim" was "made" during the policy period. Under this form, it is the making of the claim that triggers coverage rather than when the accident took place.

Certain types of insurance are typically issued on an occurrence basis while other types of insurance are typically issued on a claims made basis. For example, commercial general liability policies and property policies are most often issued on an occurrence basis. Directors and officers liability and professional liability policies are typically issued on a claims made basis. However, these are not absolute rules. Commercial general liability policies are sometimes issued on a claims made basis.

Forms

Many types of insurance policies are issued on standard forms. An insurance industry organization called the Insurance Services Office (commonly referred to as ISO) issues standardized forms that are widely used in the insurance industry for certain types of insurance. Many insurers, however, prefer to use their own forms which are known as manuscripted forms.

Endorsements

Insurance policies often have "endorsements" attached to them, which change the policy terms. The endorsements are as important to read as the policy itself because they often delete or add coverage. So, for example, your property policy may exclude coverage for damage caused by flood, but you may have an endorsement which adds coverage for damage caused by flood.

Governing Law

When doing business in the United States, it is important to know what law governs your transactions. Some issues are governed by the law of the federal government while others are determined by the laws of the individual states. Insurance coverage is usually determined by the law of the individual state. There are areas of insurance law where disputes arise between insurers and insureds over the meaning of certain policy terms and whether a particular policy of insurance applies to the particular loss. When the parties look to the judicial system to resolve those disputes, the courts apply the law of a particular state. Unfortunately, different states have reached different results when deciding insurance coverage issues. To make matters more complicated, it is not always clear which state's law governs a particular insurance policy.

Take an example. Assume that an insurance company based in New York issues a policy to a company based in Florida for work performed in Florida. However, the particular employee who formally issued the policy, thereby finalizing the contract, happened to be in California. This is a real example in which disputes arose about the insurance coverage and a judge in Florida had to decide which state's law applied. The insurer argued that Florida law applied and the insured argued that California law applied. The judge agreed with the insured and applied California law, even though the project and the lawsuit were in Florida. The result was important because in that case under Florida law a particular exclusion was interpreted very broadly so as to bar coverage while under California law, the same exclusion was interpreted very narrowly so as not to bar coverage.

What are the Types of Insurance a Company Should Consider Buying?

The types of insurance that a business should consider buying depends on the risks likely to be faced by the business.

Insurance is part of any business's risk management strategy. If a business merely exports products to the United States and has no employees in the United States and no property in the United States, then it does not need to buy, for example, workers compensation insurance (insurance compensating employees injured while on the job) or property insurance. On the other hand, if that same business starts operations in the United States that require it to have property in the United States, then the business needs to evaluate whether to buy insurance. That leads to more questions: How much property does the business have? How much would it cost to replace that property if it were damaged? How would the business be impacted if the property were lost due to an unforeseen event? The answers to those questions may lead the company to the conclusion that it is a good business decision to buy an insurance policy to provide insurance coverage for that property.

To assist in making this decision, below are the most common types of insurance policies that American businesses use, and ones that businesses entering the U.S. market should consider.

Property Insurance

Property insurance is one of the most common types of insurance in the United States. It is a "first party" insurance policy that insures against a loss directly to the insured. (It is not a third party policy insuring against a type of liability.) It insures against loss to physical property owned by the insured. The decision whether to buy property insurance depends on the amount of property that the insured owns. If your business is building a manufacturing facility in the United States, then you should buy property insurance both to protect against losses to the property suffered during construction of the facility, as well as to protect that property once it is built and operational.

Workers' Compensation Insurance

Workers compensation insurance is paid for by businesses and protects against claims by workers for injuries they suffer or occupational disease they develop while working for the companies. State laws require companies to buy this insurance if they employ workers, so your company may be required by law to buy this insurance. Texas is the only state that does not make workers compensation insurance mandatory. There is a benefit to the company buying the insurance: the laws also make the insurance proceeds the exclusive remedy for the employee against the employer. In other words, this kind of insurance covers medical care and compensation for lost wages for employees who are injured at work in exchange for the employee relinquishing his/her right to sue the employer for negligence.

Take an example: An employee suffers a catastrophic injury in an accident while working for your company and loses his legs when a piece of equipment malfunctions. Under the legal system in the United States, the employee would normally be able to file suit against any person or business responsible for the injury he suffered. For an injury as severe as this one, resulting in amputation of his legs, the employee would likely recover several hundred thousand dollars and perhaps more than a million dollars. However, if the employer has workers compensation insurance, then that insurance will provide compensation to the employee. The employer is immune from any claim by the employee that the amount of workers compensation insurance is inadequate to compensate the employee for the severity of his injury.

Workers compensation insurance provides coverage without regard to fault. The only requirements for coverage are that (a) the worker suffers bodily injury by accident or disease; and (b) the injury arises in the course of employment during the policy period and is caused or aggravated by the conditions of employment. It does not matter whether the worker, the employer and/or a third party is at fault. Again, the policies provide coverage regardless of fault.

A second type of insurance for employment-related injuries or illness is Employer's Liability Insurance. This insurance is a type of workers compensation and provides additional coverage for claims for bodily injury or illness to employees that for certain reasons do not fall under the workers compensation law. Examples of claims by employees that might not be covered by workers compensation insurance are when the injuries occur outside the policy's coverage area, or the gravity of the injury is statutorily exempt under that state's workers compensation laws. Another risk not typically covered by workers compensation insurance is the risk that an employee's family members sue; for example, when a spouse sues the employer for loss of consortium or companionship as a result of the employment-related injury. Finally, this parties who are sued by an injured employee may sue the employer for indemnity. Employer's Liability Insurance is intended to cover exposures created by employee claims that are not covered by workers compensation insurance.

General Liability Insurance

General liability insurance provides coverage for the various types of liability to which a business may be exposed, including liability arising from the (i) ownership and maintenance of business premises, (ii) conduct of business operations, (iii) use of the business products, (iv) business contractual relationships, and (v) completed operations of the business. The most common form of liability insurance purchased by businesses is called comprehensive general liability insurance; it protects businesses from most liability exposures other than automobile, workers compensation or employers', directors' and officers', and professional liability. This type of insurance is third party insurance and provides coverage for the obligations imposed on an insured that becomes legally liable, or is threatened with legal liability for accidents resulting in bodily injury or property damage.

In the United States, general liability coverage is normally structured with a primary policy written on a standard ISO occurrence based form to which endorsements are added. A primary policy provides the initial coverage for a given loss up to a stated limit. To provide additional limits of coverage for a given policy period and for a particular loss occurrence, businesses add excess or umbrella coverage (described immediately below) on top of that primary layer of coverage.

Excess or Umbrella Insurance

Excess insurance provides a secondary layer of coverage to protect the insured from loss that exceeds the limits available under a primary policy. Depending on the type of business the company is engaged in, it may be important to secure additional layers of coverage beyond what is available under a primary policy. Generally speaking, the risk of needing insurance at a higher level decreases as the limit of liability increases. In this way, premiums for excess insurance are usually lower than those for primary policies, which are more likely to be impacted for any given loss occurrence. It is also important to note that although excess and umbrella policies are typically written to follow the terms of the underlying primary policy, it is not always the case. Because there may be additional exclusions or endorsements added to the excess policies which limit coverage, it is necessary to review all the policy terms.

Business Interruption Insurance

In addition to insurance coverage for direct loss to a business' property, most businesses also have insurance coverage to protect against loss of income suffered by a business when damage to its premises by a covered cause of loss results in a slowdown or suspension of its operations during the time required to repair or replace the damaged property. The most common type of insurance for this type of loss is called business interruption or business income coverage. This kind of coverage covers the insured against actual loss sustained, meaning it is designed to keep the insured in essentially the same position that it would have experienced if there had been no interruption. Specifically, it protects the insured against a loss of earnings during that period of time necessary to restore normal operations after a covered physical loss has taken place.

Directors' and Officers' Liability Insurance

Directors and officers (or D&O) insurance provides protection for those persons whose business decisions, made by them in their capacity as the management of a corporation, subject them to the risk of personal liability for losses which the corporation or its shareholders may incur. D&O policies are like all other insurance policies in that they begin with a coverage grant, in the form of the insuring agreement.

Typical D&O policies include three separate insuring agreements to provide for what is called Coverage A (coverage applicable to the individual liabilities of directors and officers where the corporate entity does not indemnify them, for example when the corporation is insolvent), Coverage B (for the corporation's obligation to indemnify the directors and officers in conjunction with their service to the corporation), and Coverage C (for the liabilities of the corporate entity itself rather than those of its individual directors and officers)

Professional Liability Insurance

Professional liability insurance is intended to protect professionals (e.g., physicians, lawyers, architects, and engineers) against liability incurred as a result of errors and omissions committed while carrying out professional services. Although this type of policy is generally intended to complement, rather than duplicate the coverage provided under a general liability policy, some claims can be covered by both types of policies. Generally speaking, damages covered by professional liability policies are broader than those covered by general liability or other policies; those other types of policies are often limited to claims arising out or bodily injury or property damage. Professional Liability Insurance, in contrast, will include non-physical or purely economic damages. Professional liability policies are commonly written on a claims made basis.

Pollution Liability Insurance

Because general liability policies usually exclude coverage for most types of environmental damages, a company may want to purchase a pollution liability policy specifically to fill those gaps. In general, a pollution liability policy should provide coverage for most claims based on environmental issues, including cleanup costs (such as costs for investigation, maintenance, monitoring, permitting and oversight costs), bodily injury (which may include medical monitoring when accompanied by physical injury and also emotional distress), property damage (including coverage for trespass, nuisance, and natural resource damages claims), and business interruption. Although the same types of coverage are generally available, insurers offering environmental coverage typically do not use industry-wide forms, which means that the specific terms are highly negotiable. Pollution liability policies are commonly written on a claims made and reported basis, which means that the claim must be made against the insured and reported to the insurer during the policy period.

Health Insurance

Most U.S. employers offer health insurance as a fringe benefit to attract employees. Health insurance provides coverage against the risk of incurring medical expenses on account of accident, sickness, hospitalization, and disability.

Life Insurance

Life insurance is a form of insurance by which the insurer promises to pay a designated beneficiary a sum of money upon the death of the insured person. Depending on the insurance contract, other events such as terminal illness or critical illness may also trigger payment. Life insurance, like health insurance, is a typical component of employee benefit plans in the United States.

How Does a Company Buy Insurance?

To purchase insurance, a company should contact an agent, broker or similar insurance consultant who is familiar with the company's business. These advisors can provide advice as to the amount, type and cost of coverage that the business might need, seek proposals for that coverage from the available insurance market, and work with the company's risk manager to finalize the insurance purchases.

What Should a Company Do When It Has an Insurance Claim?

Providing notice of a claim to the insurers is a critical step in recovering for a loss. Most policies will require that the insured promptly provide the insurer with notice of any claim. Policies use terms such as "as soon as possible", "as soon as practicable" and even "immediately." Most policies also require that notice be given of any incident which has the potential to result in a claim, as soon as knowledge of the incident is known to an executive officer of the company (e.g., a risk manager or other senior officer). Providing prompt notice to an insurer allows the insurer to investigate the claim in a timely manner, the absence of which may prejudice the insurer in its ability to respond to the claim and protect its own interests. The timeliness of notice is an issue commonly litigated between insurers and their insureds. Some policies may even provide that an insured's failure to give prompt notice may result in forfeiture of coverage for that particular loss.

Because of the frequency with which the issue of notice is litigated, a general rule of thumb is that notice of a claim, or accident or event which has the potential to result in a claim, should be given as quickly as possible to all insurers "on the risk", i.e., who have issued policies that may be applicable to the loss.

The particulars of how and where (i.e., to whom and at what address) to provide notice is usually stated within each policy. Depending on the circumstances of the claim or incident which could give rise to a claim or claims, a company may also look to its brokers or legal counsel for assistance in providing notice to its insurers.

Conclusion

Doing business in the United States, like anywhere, carries a wide array of risks and exposes the business to risks of loss from a variety of sources. It is important for the business to clearly understand the risks it faces, determine what and how much risk it is willing to tolerate, and analyze the strategies available to manage those risks. Insurance is an important tool for managing those risks. The particular forms of insurance available are highly specialized and are difficult for any non-insurance professional to understand. Thus, it is imperative to work with a professional who understands the risks inherent in your business and can assist you in securing the proper coverage from the insurance market for your particular business needs.