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A Legal Guide to Acquisitions and Doing Business in the United States

Abstract
[Excerpt] This handbook provides an overview of several areas of US law that are of significant interest for non-US companies who either plan to enter the US market or already conduct business in the United States, including the following:

• Conducting sales directly and through sales representatives or distributors;

• Acquiring US businesses;

• Types of business entities through which to conduct business;

• Conducting business through branches, joint ventures and subsidiaries;

• The impact of product liability laws;

• The impact of labor and employment laws;

• Strategies for preserving "limited liability" with respect to an investment in a US subsidiary; and

• General income tax issues.

Keywords
United States, foregn investment, trade, commerce, business, law, imports

Disciplines
Other Business

Comments
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A Legal Guide to Acquisitions and Doing Business in the United States

A Legal Guide to Acquisitions and Doing Business in the United States

Baker & McKenzie

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Save where otherwise indicated, law and practice are stated in this book as at January 1, 2007.

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EDITORS' NOTE

Baker & McKenzie was founded in 1949. For more than 50 years, Baker & McKenzie has provided sophisticated advice and legal services to many of the world's most dynamic and successful organizations. The firm today comprises a network of 3,400 locally qualified, internationally experienced lawyers in 38 countries. Working in experienced inter-disciplinary teams to advise on corporate, securities, tax, antitrust/competition, commercial, intellectual property, finance, employment, employee benefits, IT, environmental, real property, trade and other compliance and regulatory matters, Baker & McKenzie is in a unique position to handle complicated transactions that cross industries, areas of law and national boundaries.

This handbook is intended primarily to help non-US clients (lawyers and non-lawyers) understand the breadth and depth of business and legal considerations associated with conducting business in the United States. This handbook is not a comprehensive treatise; it seeks only to provide an overview of several areas of US law that are of significant interest for non-US companies who either plan to enter the US market or already conduct business in the United States. Further, this handbook does not attempt to provide a detailed discussion of the planning and execution of business acquisition and disposition transactions, joint ventures or other business combinations. Baker & McKenzie publishes other handbooks, including the "Related Publications" listed below, that look at other transactions in greater depth.

Related Publications

Cross-Border Transactions Handbook – a guide to major legal issues to consider when embarking on a cross-border transaction.

International Joint Ventures Handbook – a practical guide to assist the business and legal teams when assessing, structuring and implementing joint ventures.

Post-Acquisition Integration Handbook – a guide to major legal issues to consider when integrating an existing and newly acquired business operating in the same field, to save costs, develop synergies and generate value for shareholders.

Rapid Dispositions Handbook – an organized collection of practical know-how, specifically relevant to a situation where a company wishes to dispose of a business or undertake a disposal program.

Acquiring Companies and Businesses in Europe – a country-by-country introduction to the main legal issues to consider when contemplating an acquisition in Europe.

Guide to Mergers and Acquisitions in Asia Pacific – a country-by-country introduction to the main legal issues to consider when contemplating an acquisition in Asia Pacific.

For further details on any of the information contained in this handbook or to obtain copies of any of the related publications listed above, please contact your Baker & McKenzie contact partner. Further details on the firm, our people and our practice may be found at www.bakernet.com.

Editors' Note

This handbook is a product of the efforts of numerous lawyers throughout Baker & McKenzie, including the contributors listed below. The editors are extremely grateful to these knowledgeable lawyers for their hard work.

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SECTION 1
OVERVIEW

This handbook provides an overview of several areas of US law that are of significant interest for non-US companies who either plan to enter the US market or already conduct business in the United States, including the following:

- Conducting sales directly and through sales representatives or distributors;
- Acquiring US businesses;
- Types of business entities through which to conduct business;
- Conducting business through branches, joint ventures and subsidiaries;
- The impact of product liability laws;
- The impact of labor and employment laws;
- Strategies for preserving “limited liability” with respect to an investment in a US subsidiary; and
- General income tax issues.

SECTION 2
DIRECT SALES AND SALES THROUGH SALES REPRESENTATIVES OR DISTRIBUTORS

Companies supplying customers in the United States often choose to sell their products and services either directly to the customer or through sales representatives, distributors, or franchisees. The applicable legal rules may vary depending upon the precise nature of the legal relationship between the parties.

1. Direct Sales

Selling goods directly to customers in the United States creates a bilateral contractual relationship between the non-US seller and the US purchaser. On their face, contracts for sale in the United States and many other foreign countries all involve a common concept – the delivery of goods in exchange for payment of money. There are, however, distinct differences between the common law jurisdiction of the United States and civil law jurisdictions (*e.g.*, Continental European jurisdictions). Although US law in this regard may differ from state to state, the sale provisions of the United States generally are based on Article 2 of the Uniform Commercial Code, or UCC. In many respects, these US rules fundamentally diverge from the rules of European civil law, for example, which are based on Roman Law principles:

- Under the laws of certain civil law jurisdictions, an offer has a binding effect for the time it is held open by the offeror or, in the absence of a fixed period of time, for a time of reasonable duration. Under US law an offer (apart from a so-called “firm offer”) is in principle revocable as long as the acceptance has not yet been dispatched by the offeree;

- Under the laws of certain civil law jurisdictions, the party suffering from the breach of contractual duties by the other party has the right to claim “performance in kind,” as long as such performance is feasible, whereas a decree for specific performance is available in the United States under the UCC only with regard to “unique goods” and in “proper circumstances”;

- Under the laws of certain civil law jurisdictions, a merchant buyer has the duty to inspect a purchased good immediately after delivery and, if it proves to be defective, to give notice of the defect without further delay. The duty is strict and if the merchant fails to protest in as short a time as possible, bearing in mind the circumstances of the case, then the buyer loses all remedies against the seller. In the United States, similar strict time provisions do not apply and the consequences for failure to observe such rules are less severe; and

- Under the laws of certain civil law jurisdictions, one of the remedial consequences to a minor defect of a purchased good is a claim for "reduction in price," which differs from a claim for damages under the US system, among other ways, due to the timing and method for calculating the monetary compensation for defective performance.

Several other differences abound and the above list is intended to illustrate only a few examples and demonstrate that legal advice should be sought by non-US companies when drafting a contract (including standard terms and conditions of sale) for sales in the United States.

2. Sales Representatives, Distributors and Franchisees

A sales representative is appointed to contact potential customers and solicit (but, normally, not accept) orders for goods or services. A sales representative, sometimes called a sales agent, generally is compensated by receiving a commission from the manufacturer. There are few US legal limitations upon appointing sales representatives, and the principal generally may impose territorial, price and other restrictions. Most states do not have specific termination protection laws (in terms of mandatory notice periods or compensation), although principals are under an obligation to deal in good faith with their representatives.

In contrast, a distributor typically buys a manufacturer's products for resale, earning a profit via the markup charged on the goods sold. Accordingly, the distributor is usually considered to be an independent contractor who bears the economic risk of the sales transaction. Thus, absent extenuating circumstances, a manufacturer will not be held liable for the acts and promises of the distributor.

US antitrust laws limit the ability of a foreign company to impose territorial, price or other restrictions upon a distributor. However, most states do not grant distributors any special rights or compensation upon termination.

Finally, a franchisee in the United States involves more than a simple product distribution arrangement. Franchises are not limited to fast-food and retail establishments, but can cover many products and services. Many franchise arrangements include a fully-integrated relationship with the parent company involving marketing strategies, control of operational methods, up-front franchise fees, quality controls and communication systems.

A detailed discussion of US franchising law is beyond the scope of this handbook, but certain general observations can be made. Franchise relationships are governed by both federal and state law. The Federal Trade Commission, or FTC, regulates franchising at the federal level. While the FTC does not directly regulate franchise terms or impose any registration requirements, it does require franchisors to disclose certain information to prospective franchisees. Generally, however, states regulate franchising more extensively than the federal government. Individual states may require:

- Registration of franchises prior to their offer or sale;
- Mandatory disclosure of certain information, delivered to prospective franchisees within certain periods of time before sale;
- Regulation of the advertising for the sale of franchises, terminations of, and refusals to renew franchises, and the registration of franchise sales persons; and
- Regulations regarding misrepresentations and other unfair practices.

3. General Terms and Conditions / Warranties

3.1 Terms and Conditions

Foreign companies doing business in the United States should be cognizant of the fact that the terms and conditions to which they are accustomed or that are set forth in their documentation may not ultimately govern under US law. Moreover, even if they do govern, such foreign-oriented terms may not be sufficient to address the issues

and pitfalls that typically arise under commercial agreements and arrangements in the United States. When purchase documentation of a buyer directly contradicts the sale documentation of a seller, for example, a situation referred to as the "battle of the forms" results. To the extent such disputes are ever litigated in the United States, foreign companies are frequently disappointed with the outcome.

Likewise, foreign companies that are inclined to rely on the documentation of their US counterpart (customer or supplier) to memorialize the business relationship need to understand that such documentation, as a matter of practice, is very favorable to the drafting party, and in the event of a dispute will almost always work to the advantage of their US counterpart. Simply translating or attempting to "Americanize" a non-US company's standard form will in most cases be insufficient to address issues that may arise in the United States. Instead, such companies are best served by preparing a US standard purchase or sales form on the basis of which they may negotiate and define in writing the applicable terms and conditions of the respective purchase/sale arrangement.

3.2. Warranties

A foreign company selling goods in the United States should also be aware of certain warranties that accompany the sale of goods and provide to a buyer certain legal remedies if breached. Article 2 of the UCC governs warranties arising in connection with the sale of goods.

There are two types of warranties under the UCC: express warranties and implied warranties. An express warranty is created by any promise or affirmation of fact made by the seller. If the seller states expressly that the goods sold have certain qualities, but they do not, the buyer could sue the seller for breach of warranty. But even if the seller remains silent as to certain qualities of a product, the seller under US law is still deemed to have made certain implied promises by merely selling the product. An example of an implied warranty is the implied warranty of merchantability – by selling certain goods, a seller under US law represents that the goods are of a quality normally acceptable in the particular trade and fit for their ordinary purpose. In the event that goods fail to conform to this warranty, the buyer, as in all other cases of breach of warranty, is entitled to recover damages (which can include incidental or consequential damages) incurred by the buyer as a result of the breach.

4. Secured Transactions

Another critical and idiosyncratic issue in connection with selling goods in the United States is the law of secured transactions. Unlike some European jurisdictions, for example, US law does not provide for the legal concept of a so-called "retention of title." Generally, a seller in the United States does not retain legal title in the goods sold until receipt of the full purchase price. Instead, under US law, after executing the purchase agreement, legal title passes over to the buyer. Sellers in the United States protect their interest in goods sold (but not yet paid in full) by obtaining a so-called "security interest." The law of security interests in the United States is established by Article 9 of the UCC. A detailed discussion of the innumerable nuances of Article 9 of the UCC is beyond the scope of this handbook. However, a review of fundamental concepts may be appropriate and helpful.

Two key concepts applicable to the creation and operation of security interests under Article 9 of the UCC are "attachment" and "perfection." Attachment is the term of art describing when a security interest is said to exist between a creditor (the seller of the goods) and a debtor (the buyer of the goods). In order for a security interest to attach to a debtor's collateral, five steps are typically required:

- The creditor must give value, usually by advancing money or other funds, to the debtor;
- The debtor must have rights in the collateral;
- There must be a security agreement;
- The security agreement must describe the collateral; and
- Either the security agreement must be in a writing signed by the debtor or there must be some other "authenticating" event to prove that the parties have entered into a security agreement.

While a security interest must first be found to have attached to the collateral, often the true value of the security interest is the priority it grants the secured lender over certain classes of other creditors. The relationship between the secured lender and other third-party creditors is governed mainly by "perfection." Because

a perfected secured creditor is typically granted priority over other, non-perfected creditors claiming an interest in the collateral, having a properly “perfected” security interest is critical to any secured creditor.

Perfection can be accomplished through numerous methods, including the creditor taking possession of the collateral, and may even, in certain circumstances, occur automatically. However, the most common method for a secured lender to perfect a security interest is by filing a financing statement. A financing statement is a public document which at a minimum: declares the identity of the creditor and the debtor; describes the collateral; provides a mailing address for the debtor and creditor; and answers if the debtor is an organization or an individual. Additionally, the filing must be properly communicated and the filing fee must be tendered. Finally, if the collateral is real estate, other restrictions may apply. In all “perfection” situations, the filing requirements need to be reviewed and adhered to carefully.

Another creditor-friendly aspect of perfection can be illustrated by the following hypothetical. Assume, for example, that the holder of a security interest is a Brazilian manufacturer selling a piece of machinery into the United States through a US distributor. What if a US customer buys the piece of machinery from the US distributor and seeks to maintain priority over the Brazilian manufacturer’s security interest in the piece of machinery? Generally, if certain additional requirements are fulfilled, a third party buying goods in the good faith belief that a seller had the capacity to validly transfer legal title will in fact, by operation of law, acquire legal title in these goods. The Brazilian manufacturer will not be left behind with empty hands, however. If it had a perfected security interest in the piece of machinery, the security interest will, in most cases, automatically perfect in the proceeds of the sale, i.e., in a check or cash, giving the manufacturer a potent tool to go after the distributor for the proceeds of the sale.

From a manufacturer’s perspective, the procedures of attaching and perfecting a security interest probably appear to be cumbersome. Article 9 of the UCC, in accordance with the general ethos of the UCC to provide and accommodate commercial realities, does not aim at inhibiting the free flow of trade. Thus,Article 9 allows a manufacturer selling its goods in the United States to obtain a purchase money security interest, or PMSI, in the machinery that it sells to a distributor on credit. The manufacturer will hold the PMSI until the distributor pays the purchase

price. The PMSI is relatively easy to obtain: if properly attached, a PMSI is perfected automatically by operation of law, sparing the manufacturer from, as the case may be, having to file a financing statement. In addition, the PMSI takes precedence over certain other perfected secured interests of third party creditors, such as banks, making it somewhat of a super-security interest.

In summary, a foreign company selling goods in the United States must be mindful of the intricacies of secured transactions. Article 9 of the UCC is a detailed provision and contains numerous pitfalls. It is relatively easy for a security interest to be improperly attached or perfected, leaving a seller without any priority recourse against a defaulting buyer.

5. Product Liability

Extensive laws regarding product liability and compensation for damages sustained by users of products exist in the United States. Similar to other countries, manufacturers that sell in the United States are liable for any damages sustained as a result of negligence on behalf of the manufacturer (or seller). Additionally, liability may occur for any breach of warranty. Finally, certain manufacturers and sellers may be held strictly liable for damages caused by their products under certain conditions. Most companies selling in the United States obtain product liability insurance, either in the United States or in their home countries. For a more detailed discussion of US product liability law, please see Section 5 (Product Liability Law).

6. Unfair Trade

The Federal Trade Commission Act declares unlawful “unfair methods of competition” and “unfair deceptive acts or practices.” The FTC has been granted authority to promulgate rules and regulations interpreting the provisions of this Act. Pursuant to such authority, it has created many rules and regulations that proscribe misleading or confusing advertising practices, some of which place affirmative duties of disclosure upon the manufacturers of products. Both the FTC and private parties may take enforcement measures against violations. Moreover, many of the individual states have enacted statutes that similarly prohibit unfair competition; these state statutes are also enforceable by either the state or private parties.

7. Restraint of Competition (Antitrust)

Compliance with US antitrust laws impacts a number of distribution and marketing issues. A sample of the different issues facing a foreign company include:

7.1. Territorial and Customer Restrictions

Although a manufacturer may assign a specific territory to a distributor, it may be illegal to prohibit a distributor from selling the manufacturer's products outside the assigned territory. Such limitations are not automatically illegal, but will be weighed as to their reasonableness in light of all relevant facts and circumstances.

7.2. Pricing

A manufacturer may not establish the prices at which its distributors resell its products. However, manufacturers are free to "suggest" resale prices or even unilaterally refuse to do business with a distributor that fails to comply with these suggested prices.

7.3. Product Supply

A requirement that a distributor obtain its entire supply of a particular product from the manufacturer (or similarly, refrain from handling any products that compete with the manufacturer's products) may violate US antitrust law if the arrangement restricts a "substantial amount of trade." A violation will occur if the manufacturer or distributor is a significant player in a concentrated market.

The foregoing limitations generally do not impact foreign companies conducting business through a sales representative.

8. Customs and Import Procedures

The Bureau of Customs and Border Protection, or CBP, which is part of the Department of Homeland Security, enforces all laws relating to goods crossing the US border.

When goods are imported into the United States, there must be a formal "importer of record" who is responsible for complying with applicable laws and paying all customs duties and fees. US law allows a nonresident company to be the importer

of record. However, it is typically in a foreign seller's interest for the US distributor or customer to be the importer of record, because the foreign seller then avoids the burdens of complying with applicable laws and paying customs duties and fees. Which party is the importer of record is a matter of party agreement, and this is usually covered by the delivery term specified in the governing sale-of-goods contract.

While any importer has the right to prepare and file a customs entry for goods that it imports, a commercial importer typically hires a customs broker to file customs entries on behalf of the importer. Only a customs broker, fully licensed by CBP, may act as an importer's agent in this capacity. US law requires an importer to execute a power of attorney appointing a customs broker as attorney-in-fact. However, an importer remains liable vis-à-vis CBP for any errors committed by a customs broker when it prepares import paperwork on behalf of the importer. Also, a commercial importer will need to obtain a customs bond from a surety company. This bond is a third-party guarantee for payment of duties and certain penalties associated with any violations of US import laws.

While there are hundreds of US laws that may apply to any given importation of goods, there are three main areas of substantive customs law with which an importer must comply: classification, valuation, and marking. All imported goods must be classified in the Harmonized Tariff Schedule of the United States, and classification is the chief determinant of the applicable duty rate. All imported goods must be valued in accordance with applicable law, which in many cases will be based on the price paid or payable for the goods. Because most duty rates are expressed as a percentage of the import value, applicable customs duties are typically determined by the combination of duty rate, as provided by a product's classification, and import value. Finally, almost all imported goods must bear a country-of-origin marking, in English, so that the ultimate US purchaser of a product is made aware of the product's origin.

An importer must take seriously its compliance with the import-related laws of the United States. Before 1994, an importer only needed to provide the US government with the correct facts concerning the products being imported. Since 1994, however, an importer has also been required to understand and apply certain law to the facts in order to, for example, determine the correct classification and value of imported goods. The role of the CBP is to confirm the correctness of such determinations

made by the importer. In this regulatory structure, compliance with law is essentially shifted, at least in the first instance, to the importer itself; and an importer may be assessed penalties if it does not use reasonable care to understand the facts or law or when it applies the law to the facts.

SECTION 3
ACQUISITIONS

There has historically existed in the United States a strong tendency to establish new enterprises, which have been the source of much of the growth in the US economy over at least the last decade. Eventually, investors in these enterprises seek to liquidate their interests, often through a sale to a larger company. The result of this dynamic has led to a vibrant US market in business enterprises.

Acquiring a business enterprise is also an attractive possibility for established companies. The target enterprise will typically have overcome most start-up risks. While this will understandably be reflected in a higher price, the buyer will acquire a going concern, with all of its personnel and assets, and usually a profitable operation as well. The advantages of having in place senior managers experienced in the US market, thereby overcoming the principal cultural impediment to entering the US economy, is often a factor that is particularly appealing to non-US investors when contemplating entering the US market via acquisition of an existing business.

As might be expected from the foregoing, the US market for business enterprises is highly developed. It affords the knowledgeable buyer the opportunity to learn about the target enterprise in depth before buying to reduce the risk of post-closing surprises so common elsewhere. Moreover, US buyers use sophisticated documentation to precisely allocate the risks of the business between buyer and seller and to protect the seller against undisclosed liabilities. To take full advantage of these opportunities, a non-US investor will benefit from highly experienced legal and other advisors, beginning in the earliest planning stages of an acquisition. Moreover, those advisors need to be able to explain and interpret the acquisition process in terms that can be fully understood by a buyer from another country.

This section describes several key legal-related aspects of acquiring US businesses. In addition, **Appendix A** contains a checklist of general matters typically addressed by legal counsel in the course of an acquisition of a privately-held US corporation. **Appendix B** contains a sample information request that highlights typical documentary information US buyers often request from privately-held US targets as part of their acquisition (due diligence) review. Neither of these

documents are intended to be comprehensive, and each would need to be appropriately tailored to the particular transaction, but they provide an overview of some of the key issues typically considered by buyers at the outset of an acquisition.

1. Regulatory Framework

1.1. Governmental Approvals

1.1.1 General

Foreign acquisitions of US businesses are assisted by a general absence of exchange controls, government regulation, or licensing of foreign investment or foreign acquisitions in the United States. Foreign-owned enterprises also have equal access to federal and state investment incentives and benefits, except as noted below. Many states have offered significant tax and other incentives to induce non-US manufacturers of automobiles and other items to establish facilities in such states. However, foreign-owned enterprises and certain acquisitions of US companies by non-US entities are subject to some regulations and reporting requirements.

1.1.2 Exon-Florio

The Exon-Florio provision of the 1988 Omnibus Trade and Competitiveness Act authorizes the President of the United States to review certain acquisitions, mergers, and takeovers of US companies or businesses by non-US entities. It applies to any transaction that could result in non-US “control” of a US person or entity. This includes the power to make significant decisions, even where only a minority interest is acquired. The US President is empowered to suspend or prohibit any such acquisition, or order divestment of the acquired company if the acquisition has been completed, if the President finds credible evidence that the non-US person might take any action that threatens to impair US national security. The US President has delegated the authority to investigate to the Committee on Foreign Investment in the United States, or CFIUS, an interagency group.

The definition of national security has been left vague, listing just three factors to consider in making a determination:

- The domestic production needed for projected national defense requirements;

- The capability and capacity of domestic industries to meet national defense requirements, including the availability of human resources, products, technology, materials, and other supplies and services; and
- The control of domestic industries and commercial activity by non-US citizens as it affects the capability and capacity of the United States to meet the requirements of national security.

The last factor could be interpreted to include even non-defense industries, and many acquisitions of companies having no connection to the defense industry have been reported to CFIUS.

The Exon-Florio provisions impose strict time limits for the investigation and review procedures. Review will begin upon receipt by CFIUS of either "voluntary" notice from the parties involved or notice from an appropriate agency of the US government. This notice must contain a significant amount of prescribed information, including the latest available transaction documents. CFIUS has 30 days to decide whether the transaction should be investigated. If CFIUS finds that an investigation is warranted, it has 45 days to conduct the investigation, during which it may request additional documents and personal appearances by the parties, and make its decision. An investigation is mandatory where a foreign government-controlled entity acquires control of a US company and CFIUS concludes that the transaction "could affect national security." The US President then has 15 days to review and approve the decision. Transactions will be allowed to proceed without interference unless action is taken by the government within these time periods. However, unreported transactions will continue to be subject to review at any time. Therefore, in case of doubt, it will make sense to report any sizable transaction to CFIUS before proceeding with an acquisition.

In July 2006, the US Congress proposed several changes to the review process, which are still pending as of the date of this publication.

1.1.3 Exchange Controls

The United States exercises few controls over foreign exchange transactions by US citizens or non-US persons. No approval of the US Department of Treasury or other finance authority is required to make an investment. Subject to applicable tax rules, a foreign-owned enterprise is free to invest capital and to remit profits, repatriate capital and pay interest and royalties to a non-US parent without any

license or restriction. However, the US government monitors foreign exchange transactions of substantial size. Although this monitoring is only for informational purposes, failure to make full and accurate disclosure where required could result in serious criminal penalties under money-laundering and other federal statutes.

1.1.4 Reports

Foreign-owned enterprises are required to make periodic, direct investment reports to the US Department of Commerce pursuant to the International Investment Survey Act of 1976 if 10% or more of a substantial enterprise is foreign-owned. Investment by non-US persons in real estate requires additional reports, particularly to US tax authorities, under the Foreign Investment in Real Property Tax Act. The acquisition and transfer of agricultural land must be reported to the US Department of Agriculture. Real estate acquisitions may also give rise to other, nonfederal, reporting obligations. A non-US buyer of industrial property in a rural area should be careful to ascertain whether any portion of the property purchased can be considered agricultural property, but no specific report is necessary for acquisition of nonagricultural land.

1.1.5 Restricted Industries

Ownership by non-US persons of certain restricted industries is limited or regulated by the federal government or some state governments. Restricted industries include the defense, banking, insurance, domestic air or water transportation, fishing, and radio and television broadcasting industries and in some states the railroad industry and agricultural and other real estate. A non-US buyer contemplating a purchase of a company in one of these industries should consult with US legal counsel at the earliest possible stage about potential restrictions.

Banking is an example of a US industry regulated at both the state and federal levels. A non-US bank may establish either a federal or state-chartered branch to engage in banking directly, a federal or state-chartered agency to engage in more limited international banking services, or a state-chartered representative office to provide limited representation and administrative services in the United States for the foreign bank. The establishment of any such office requires approval by the Federal Reserve Board and, in the case of a state-chartered entity, approval by the relevant state banking authorities. Once licensed, such branch, agency or representative office is subject to on-going prudential supervision by its regulators in the United States. In addition,

a foreign bank wishing to take retail deposits (initial deposits of less than $100,000) in the United States can only do so by obtaining approval for establishing a US subsidiary bank meeting the requirements of the Federal Deposit Insurance Corporation (FDIC) for insured deposits. A non-US bank may also acquire an existing US bank provided it obtains approval of the federal banking authorities and, if the target bank is state-chartered, approval of the relevant state banking authorities. Most state laws do not restrict foreign ownership of state-chartered banks, and state regulatory authorities are increasingly willing to approve takeovers by foreign banks; no state approvals are required, however, in respect of the acquisition of a federally-chartered bank.

In establishing a branch or agency in the United States, a foreign bank must satisfy the Federal Reserve Board that it is principally engaged in the business of banking (rather than in manufacturing or other commercial activities), that it is subject to comprehensive consolidated supervision by its home country regulator, and that it meets various other requirements related to its financial condition, its anti-money laundering practices and US regulators' access to information on an ongoing basis in respect of their prudential supervision of such branch or agency. Upon a foreign bank's establishment of a US branch or agency, its direct and indirect activities and investments in the United States (including non-banking commercial activities and investments) must meet standards established by the Federal Reserve Board.

Similar requirements must be met in the case of a foreign bank's acquisition of a US bank. A foreign bank acquiring or establishing a US bank must obtain approval from the Federal Reserve Board to become a bank holding company which requires, among many other factors, a determination that the foreign bank is subject to comprehensive consolidated supervision by its home country regulator.

The Gramm-Leach-Bliley Act of 1999 significantly expanded the non-banking activities in which banks, including non-US banks, can engage (e.g., insurance, merchant banking and other financial activities) provided that such institutions qualify both as bank holding companies and financial holding companies. Banks in the United States, however, are still generally prohibited from engaging in commercial activities.

A non-US bank's worldwide structure and long-range plans should be examined in detail before it attempts to establish a presence in the United States or to acquire a US bank.

1.2 Other Regulations and Legal Considerations

Other legal matters that a non-US buyer must consider in connection with an acquisition of a US company include antitrust notification requirements, federal and state securities regulations, and regulations regarding mergers.

1.2.1 Antitrust Regulations

US antitrust law prohibits any acquisition or merger that would have the tendency to lessen competition or create a monopoly. However, this restriction has rarely been used to block acquisitions if the buyer is foreign and has no, or limited, existing operations in the United States.

If a US acquisition meets certain minimum size levels, a Hart-Scott-Rodino pre-merger notification must be filed with the US Department of Justice and the Federal Trade Commission, or FTC. (The filing thresholds are revised periodically but as of the date of this publication, in general, a filing is required for acquisitions having a value of $226.8 million or more without regard to the size of the parties involved; or a value of less than $56.7 million if the parties are of a certain size.) Detailed financial and descriptive information concerning the ultimate parent of the acquiring and target corporations, their product lines, and the transaction itself must be included. The ultimate parent will be the corporation that is highest in the chain of ownership if the actual buyer is a subsidiary. If the ultimate parent corporation is privately owned (as would be the case with many family-owned enterprises), the ultimate parent may be the family itself. Although the notification may appear burdensome and unnecessarily intrusive, buyers can normally comply with the law by disclosing only a reasonable amount of business information.

The parties must wait 30 days after the filing to complete the acquisition, although early termination of the waiting period may be requested. It is not permissible to proceed with the acquisition prior to expiration of the waiting period even if the transaction is made expressly subject to divestment in case the government later objects. Managerial and financial control of the target must remain with the seller until expiration of the waiting period. However, the effective date of the acquisition may be made retroactive to a date prior to such expiration, thereby giving the buyer the financial benefit of the target company's operations during the waiting period if the transaction ultimately proceeds.

The Department of Justice or FTC may request additional information at any time during the waiting period, in which case the waiting period will be suspended until the information is provided. Such a second request can be very burdensome and time consuming. Therefore, the parties are usually quite willing to discuss the transaction and provide additional information to the government to avoid a second request. Parties should ensure that all information provided is accurate and complete, especially if the timing of the acquisition is important.

Hart-Scott-Rodino filings are confidential. US government authorities will not even confirm or deny if a filing has been made (unless the parties have requested an early termination of the waiting period). Therefore, filing a notification generally should not jeopardize an acquisition or create unwanted publicity in the United States or in the buyer's home country.

1.2.2 Securities Laws

The purchase and sale of securities, including the shares of a corporation and ownership interests in many other entities, are strictly regulated by both federal and state governments.

Issuance of Shares

A non-US corporation may issue shares or other securities in the United States to finance an acquisition, for example by exchanging its shares for the shares or assets of the target company. However, the shares or other securities must be issued pursuant to a registration statement filed with the SEC (containing or incorporating detailed information regarding the issuer's business affairs and financial condition), unless an exemption from registration is available. The most commonly used exemption in acquisitions is the private offering exemption, that is, an offering to a limited number of sophisticated investors. In many cases, the buyer is required to make full disclosure concerning its business affairs and financial condition to the seller if it issues securities to the seller, even in certain private transactions. Strict antifraud provisions apply to any issuance or sale of shares or other securities.

Tender Offers

A tender offer is subject to regulation under federal securities law, including the antifraud rules. As a threshold matter, a notice must be filed with the SEC once more than 5% of any class of a publicly held target's securities are acquired. It must include a statement of the purchaser's intentions. A detailed discussion of the rules

that apply to tender offers is beyond the scope of this handbook. However, effective December 2006, the SEC amended the so-called "best price rule" for tender offers to, among other things, make it clear that the rule does not apply to consideration offered and paid to employees and directors of the target company in accordance with compensation, severance or other employee benefit arrangements. These amendments clarify the tender offer process and should put tender offers on more equal footing with other forms of business combinations, including mergers, as a means for structuring acquisitions of US publicly-held companies.

Certain states have adopted legislation to make hostile tender offers to domiciliaries more difficult. Furthermore, corporations have adopted restrictions in their articles of incorporation and have taken other defensive measures for the same purpose.

1.2.3 Mergers

A merger is a joining together of two or more corporations by operation of law. A non-US buyer will not merge directly with the target but will typically establish a US subsidiary to act as the merger partner. A merger with a public company will require the approval of the target's stockholders and so will be subject to securities law regulations. Public stockholder approval must be obtained through a proxy statement that must contain certain prescribed information, including financial information on the proposed merger partner and often on its non-US parent.

2. Structuring an Acquisition

Many factors must be considered in structuring the acquisition. Many of these apply in domestic transactions, although they tend to be more complicated in a cross-border acquisition.

2.1. Shares or Cash

The use of cash to acquire shares or assets or to effect a merger offers no legal difficulties. This is the form normally used by a non-US buyer.

There may be tax advantages (especially to the sellers) to using shares or other securities to acquire the shares or assets of a target enterprise. The use of shares for this purpose is subject to securities law regulation. As noted above, shares or other securities may be issued only pursuant to a registration statement unless an exemption from registration is available. In addition, the target's stockholders

will be interested in taking shares only if there is a significant public market for the shares offered. This limitation severely hinders the possibility of non-US buyers using shares unless they have shares or other securities traded on a US stock exchange or on NASDAQ, including perhaps US Depository Receipts, or ADRs, or the seller is willing to accept securities traded on a foreign exchange.

2.2 Acquisition Vehicle

A non-US buyer may acquire shares or assets directly. As noted above, more often, a non-US buyer will establish a US acquisition vehicle in the form of a partnership or corporation to acquire assets and, often, shares.

2.2.1 Partnership

A US partnership may be a general partnership, with unlimited liability for all partners, or a limited partnership, with limited liability for the limited partners. Corporations may be partners in either type of partnership. A partnership will often be used if the acquired business is to be conducted as a joint venture, since such a structure may offer tax advantages for both US and non-US participants. A partnership may be used if the target business primarily involves real estate or natural resources. An investment in partnership form may also have advantages for investors from certain countries, such as Germany, where income earned through a US partnership might not be subject to taxation outside of the United States. For more information on limited partnerships, please see Section 4 (Business Entities).

2.2.2 Limited Liability Companies

Limited liability companies have come into use in the United States fairly recently but are now used regularly in place of corporations in US practice. A limited liability company offers the informality of a partnership while (as the name implies) providing a limitation on the liability of all of the members to their investment in the company. A limited liability company may be structured so as to be taxed in the United States as if it were a partnership, which can be very advantageous to a non-US acquirer. A limited liability company is also very attractive for joint ventures or any situation in which the target is to be owned by two or more unrelated parties. For more information on limited liability companies, please see Section 4 (Business Entities).

2.2.3 Corporation

A corporation is the traditional acquisition vehicle used by non-US buyers. The corporation is the only form of share company in the United States. A corporation may be organized in any state, territory or the District of Columbia. A US corporation may be organized very quickly, since organization does not require prior approval of any governmental authority or involve prolonged review or processing of documents or outside valuation of contributions. There is no limitation on non-US persons acting as stockholders in a US corporation except for certain regulated industries discussed above. For more information on US corporations, please see Section 4 (Business Entities).

2.2.4 Holding Company

A new corporation or limited liability company may be used to acquire shares, thereby establishing a holding company structure. A US holding company may be used if assets are to be acquired or if the acquisition is to be effected through a merger. Such a structure is permissible and comparatively simple in the United States, since a US corporation and most limited liability companies may have a single stockholder or member. US corporate members of the corporate group may file a consolidated income tax return. A holding company structure is likely to give the non-US buyer greater flexibility in tax and business planning in the future, especially if it plans to make other US acquisitions.

2.3 Share Acquisitions

The acquisition of shares or membership interests is the simplest form of acquisition, especially if there are only a few stockholders and all are willing to sell. As in any other sale of securities, the seller will be subject to the antifraud provisions of US securities law, but it is customary to include the same full set of disclosure provisions in either a share or an asset acquisition agreement.

2.3.1 Advantages

Where shares are acquired, all assets remain in the target company and few transfer documents are required. Thus, the acquisition may be completed fairly quickly, even if a public tender offer is required, as discussed below. Transfer taxes may also be limited or avoided, although such taxes are relatively low in most states (Florida is an exception for real estate), so using a share acquisition for the purpose of avoiding transfer taxes is generally less of a concern in the United States compared

to many other countries. The target company will retain all of its assets, including its licenses, permits, and franchises. In an asset transaction, these can be difficult to transfer because of the need to obtain consents from the issuing government agencies. In a share acquisition, important contracts and leases may be unaffected by the transfer. These matters must be investigated, however, to make certain that a change of control of the target will not bring about termination of permits or contracts.

2.3.2 Disadvantages

In a share acquisition, the target company will usually retain its tax attributes, both favorable and unfavorable, assuming that the business is continued. There are, however, limitations on the future use of some attributes, such as net operating losses. A higher purchase price paid for the business may not be reflected in the tax basis of the target corporation's assets after the acquisition, unless the seller consents to certain elections. Since these elections are usually disadvantageous to the seller, they are rarely made where the seller is a US taxpayer. The target company will retain all of its tax and other liabilities, whether disclosed or undisclosed, although, in a US transaction, the seller will typically indemnify the buyer against any undisclosed liability of the target, as discussed below in this Section under heading 4.2 (Documentation – Acquisition Agreement). A share acquisition can also be cumbersome if the buyer does not wish to purchase the target company in its entirety. In certain cases it may be possible for the target to rid itself of the unwanted business or assets prior to a share acquisition. However, both the legal and tax aspects of a de-merger (or corporate split) are complicated in the United States.

2.4. Asset Acquisitions

2.4.1 Advantages

If assets are acquired, the buyer's tax basis in the assets may be increased to reflect the actual purchase price. Also, not all the assets of the target company need be purchased. Thus, if one is interested in only one line of business or one division of a corporation, an asset purchase is the most straightforward way to accomplish the transaction.

Another benefit of an asset acquisition is that not all liabilities need be acquired. However, certain liabilities may pass to the acquirer in any case. For example, certain state property taxes will constitute a lien on the assets acquired.

Environmental liabilities may become the responsibility of any subsequent owner. Substantial pension liabilities may pass to the purchaser under some circumstances. A few states will impose responsibility on the acquiring company for product liability claims even for products sold prior to the acquisition. In the United States, the seller will usually indemnify the buyer against any such liabilities in the acquisition agreement, which may be sufficient protection if the seller is financially sound.

In a few states, assets may also remain subject to attachment by creditors of the seller for a period of time after the transaction is closed unless certain bulk sales procedures, including notices to all creditors of the seller, are followed. These procedures are quite inconvenient and are often ignored when the seller is a substantial corporation, in which case the buyer will rely on the seller's indemnification against any claims of creditors. A number of states have abolished such bulk sales laws. If the selling company is insolvent, great care must be taken to avoid any charge of fraudulent conveyance, that is, a disposition of assets for inadequate consideration while a company is insolvent or that causes it to become so. Fraudulent conveyance can be actionable by a company's creditors.

2.4.2 Disadvantages

Favorable tax attributes of the target corporation will normally be lost in an asset acquisition. An asset acquisition is also more complex than a share acquisition because all assets must be transferred. Consents to the transfer of certain valuable assets, such as licenses, permits, or contracts, may not be obtainable or may be obtainable only at a significant price. However, it is not usually difficult to obtain consents from public or private parties merely because the ultimate buyer is a non-US person.

2.5 Mergers

All state laws provide for the merger of corporations and most states now provide for the merger of limited liability companies and other entities (including a merger of different forms of entity). In a merger, two entities are joined by operation of law, that is, all assets and liabilities become the property of the surviving entity (or a new entity) solely by filing a certificate of merger. Normally, one entity disappears and the other continues as the successor to both lines of business. To be effective, a merger requires the consent of the board of directors and stockholders (in a corporation) or the members (in a limited liability company) and a public

filing with the state. Any form of consideration may be used in a merger. Thus, equity interests in the target may be converted to cash, to equity interests in the acquiring entity, or to equity interests in any other entity. The target entity may also be the survivor, often termed a reverse merger. In this case, it is still possible to eliminate the target's stockholders by automatically converting their shares to cash or to shares in the buyer or any other corporation.

2.5.1 Advantages

The principal advantage of a merger is that the transfer of assets and the exchange of target corporation shares are automatic. Stockholders of the target corporation have no option to retain their shares (although dissenting stockholders may have the right to obtain an appraisal of their shares and recover the appraised value in lieu of the amount offered to them in the merger). No separate transfer documents are required. Transfer taxes normally do not apply in a merger.

Valuable permits, contracts, and the like may also be easier to transfer in a merger than in an asset sale, but these do not remain in the same corporate entity unless the merger is accomplished through a reverse merger.

2.5.2 Disadvantages

A merger with a publicly held corporation may be time consuming because of the need to hold a meeting of the stockholders and to comply with US proxy rules. If the publicly held target is attractive to other potential bidders, the delay in effecting a merger may allow these other bidders to compete for the target, increasing the price of the shares and, possibly, frustrating the acquisition. While contested takeovers have become more common in Europe in recent years, non-US clients are often reluctant to battle, or even compete, with other bidders. In such cases, a friendly tender offer for sufficient shares to approve a merger may be effective. This process may be completed quickly. If the tender is successful, timing will no longer be important, and any remaining stockholders can be eliminated through a "cash out" merger of the acquisition vehicle with the target.

2.6 Financing an Acquisition

It is increasingly common to finance an acquisition with the target's assets or future profits. This method is called a leveraged buyout. The assets of the target company may be pledged to a bank or other financial institution, or the buyer may issue high

interest, subordinated debt instruments, normally referred to as junk bonds. Such bonds constitute securities and must be registered with the SEC unless an exemption from registration is available. Unlike the case under many European corporate laws, the use of the target's assets to finance the acquisition is not illegal or even disreputable in the United States. Nonetheless, non-US buyers rarely use local US debt financing (leveraged or otherwise) for an acquisition, although this is affected by interest rates in the United States.

Non-US buyers are more likely to use stockholder loans to finance an acquisition, especially if they have borrowed in their own countries. This approach is another form of leveraged buyout, since it is the target that will effectively repay the borrowing. Since dividends are not deductible by the US target payor, it is generally advantageous to treat payments to non-US stockholders as interest. However, such loans must bear a US market interest rate, be treated as loans, and not constitute too great a portion of the company's financing versus its share capital. Interest payments (and dividends) to non-US persons may be subject to US withholding tax.

3. Investigating the Target Company

In the United States, it is generally assumed that the buyer of a company is entitled to complete information regarding the company, its operations, financial situation, and prospects. This information is typically acquired in two ways. First, at the very outset of the transaction, often prior to the execution of a letter of intent, the potential buyer will provide to the seller an extensive list of information and documentation that it wishes to examine. (See, for example, the sample information request included as Appendix B.) This will usually be supplemented by inquiries focused on the specific target company. This process is generally referred to as "due diligence."

The information requested will cover all aspects of the target business, including the legal organization of the target company, its financial condition, its principal contracts, its environmental condition, its employment and employee benefit compliance, and the like. Since the information that will be produced will be similarly broad, it may be examined and analyzed not only by the buyer and its legal counsel but also by its other advisors, particularly its investment bankers, if any, and its accountants. Furthermore, these other advisors may supplement the legal due diligence request with requests for information of particular interest to them.

Second, the information produced in the due diligence process often will be supplemented and confirmed through the representations and warranties in the acquisition agreement itself. These representations and warranties will constitute factual statements about the target company. Any exceptions to those statements will have to be disclosed in schedules to the agreement. Certain representations and warranties will call for affirmative disclosures. Thus, the information provided in a due diligence process often will become a contractual guaranty and undertaking on the part of the seller for which the seller may be liable in damages in the event that any of the representations or other information is incorrect.

4. Documentation

4.1 Letter of Intent

The letter of intent sets out the principal points upon which the parties have reached tentative agreement. It is useful in identifying important issues between the parties. Its disadvantages are that it may delay the preparation and signing of a definitive contract and, in the case of public companies, prematurely trigger the need for public disclosure of the transaction.

Except for certain matters, such as confidentiality, standstill, and the like, a letter of intent is typically not legally binding between the parties. However, a US party will be most reluctant to make important changes in the terms set out in the letter of intent absent a significant change in the target or in the circumstances of the transaction. A letter of intent may also create legal liabilities if one of the parties fails to negotiate the definitive agreement in good faith. Finally, the letter of intent may address significant matters, such as limitations on the liability of the seller, that should be carefully analyzed before being agreed to. Thus, it is important that all matters of importance to the non-US buyer, especially the material terms and the structure of the transaction, be considered and reviewed with legal counsel before a letter of intent is signed.

4.2 Acquisition Agreement

With or without a letter of intent, the parties and their attorneys must prepare and negotiate a definitive acquisition agreement. It should set out all of the rights and obligations of the parties, both before and after the closing. A non-US buyer should expect an explanation of all aspects of the acquisition agreement, since that

is typically the key document setting forth the allocation of risks between the parties. A non-US buyer should never fear to appear unsophisticated and should take nothing for granted. Many non-US buyers make unwarranted assumptions based on business and legal practices in their own countries. Lawyers should try to explain all elements of the acquisition agreement and related agreements in terms that take into account the buyer's own experience and draft documents that make the terms of agreement easier for the client to understand, avoiding unnecessary legalese or lawyer's terminology. Nonetheless, questions from clients are always appropriate and welcome.

Acquisition agreements in the United States tend to be fairly long. The principal features of a US acquisition agreement are described below.

4.2.1 Subject of Acquisition

The property to be acquired by the buyer, whether assets, shares, or a combination of both, should be specified. Any assets or business to be excluded must also be identified. If a merger is contemplated, this will be described.

4.2.2 Price

The price paid for a US enterprise may be fixed, subject to adjustment, or contingent. The cash price in a share acquisition or merger may be fixed, although the seller may represent that the target's net working capital, or other financial statement or operating item, will be a certain minimum, with post-closing downward, or sometimes upward, adjustments to the price for amounts above or below such minimum figure. Net working capital or other measuring rods are often determined by a post-closing audit. Such audits, usually conducted by an independent accounting firm, are quite customary in the United States and would only rarely be resisted by a US seller. An audit affords the non-US buyer substantial protection, but an audit should only supplement the buyer's own pre-closing due diligence investigation, discussed below.

In an asset transaction, the seller's cash is normally excluded. The price paid for property, plant and equipment, and non-balance sheet intangibles, such as intellectual property or good will, will be fixed, but the price for current assets, particularly inventory and receivables, will depend on the level of such assets as of the closing. These and any other items subject to adjustment are often determined by an audit conducted immediately after the closing.

If a target's earnings history is short or subject to question, the parties may make part of the purchase price contingent on future earnings performance. Such an earn-out arrangement is fraught with difficulty, since the buyer wishes to operate the purchased business freely, but the seller will have a continuing interest in it and therefore wishes to impose significant limitations on the buyer.

4.2.3 Allocation of Price

In an asset transaction it is advantageous to allocate the purchase price to specific assets so as to avoid the parties' taking inconsistent positions. The parties will normally agree to use these allocations for all tax purposes. The parties are not completely free to make any allocation they wish, for allocations are subject to challenge by tax authorities, who have an interest in allocating as much of the purchase price as possible to non-depreciable items, or items depreciable only over long periods, such as goodwill.

4.2.4 Payment

An acquisition agreement normally calls for payment by wire transfer at the closing, although bank (cashier's) checks are sometimes used. The mechanics of payment are discussed below in this Section under heading 8 (Closing).

A portion of the price may be paid on a deferred basis through the issuance of a promissory note. This will permit the purchase to be more easily financed out of the assets and future profits of the acquired business. It may also provide a means for satisfying any claims that the buyer may have after the closing. A portion of the purchase price may also be placed in an escrow account established with a bank or other third party. The funds are held in the account for an agreed period of time and disbursed to satisfy buyer's claims after the closing. A non-US buyer should always consider these alternatives, even though they may not be customary in the buyer's own country.

4.2.5 Assumption of Liabilities

In a sense, all liabilities are assumed in a share transaction or merger, since after the closing the buyer will own the debtor corporation or a successor in interest to it. Normally, only the target's assets are exposed to such liabilities, although this may be of little solace to the buyer if undisclosed liabilities appear after the closing. As noted above, this risk is somewhat mitigated by the seller's indemnity against any undisclosed liabilities that one customarily finds in US acquisition agreements.

In an asset acquisition, the liabilities to be assumed and excluded should be described in considerable detail. The buyer will have to assume post-closing obligations under all contracts assigned to it but should expressly exclude pre-closing breaches of those contracts. The buyer should also consider assuming trade payables, since it is the buyer who will have the greatest interest in seeing that suppliers of goods and services are paid. The amount of the liabilities assumed should be considered a part of the overall purchase price. Generally, liabilities not specifically assumed by the buyer are retained by the seller.

4.2.6 Representations and Warranties

Representations and warranties are usually quite extensive and cover the areas of greatest concern to the parties. These areas are discussed below in this Section under heading 5 (Principal Legal Concerns of the Buyer). Acquisitions in the United States are made on the basis of full disclosure of all aspects of the purchased business. Representations and warranties are primarily designed to provide disclosure of information about the target enterprise but, they, along with the indemnification provisions, also allocate the risks of the business between the parties and can form the basis of claims after the closing.

4.2.7 Covenants

In a typical acquisition of a US enterprise, the acquisition agreement is negotiated several weeks (or more) prior to the actual closing, when the business – and consideration – changes hands. Any matters to be carried out between the signing of the contract and the closing (or beyond it) will be set forth as the specific covenants of one party to another. One of the most significant covenants, therefore, is that which requires the seller to conduct the business in the ordinary course between contract and closing. It will typically prohibit the seller from engaging in any major transactions without the advance approval of the buyer, and the obtaining of any key consents or approvals to the transactions.

4.2.8 Conditions

The preconditions to closing the transaction will be set forth in the acquisition agreement. Typically, conditions are included as to the continued accuracy of the seller's representations and warranties, the performance of the seller's covenants,

the rendering of legal opinions, the execution of ancillary agreements, the absence of any material adverse change in the seller's business, and the obtaining of any key consents or approvals to the transaction.

4.2.9 Closing

The transfer documents to be executed and delivered at the closing, as well as the method of payment of the purchase price, should be specified. The mechanics of closing a US acquisition are described below in this Section under heading 8 (Closing).

4.2.10 Indemnification

An indemnity is a form of guaranty under which one party undertakes to reimburse another party for a specified loss or liability the other party may suffer. Insurance is a common form of indemnification. Indemnity provisions are commonly used in the United States to allocate risks of a target business between seller and buyer.

If a public company is acquired, it is impractical in most cases to obtain any continuing indemnity from the public stockholders after the closing, and the target's management and controlling stockholders, if any, will generally refuse to accept the responsibility alone. In this situation, the representations and warranties will expire at the closing and there will be no ongoing indemnity obligation. The burden is on the buyer to verify all facts about the target before closing. The buyer will be aided in this by the fact that the target has been subject to the public disclosure obligations of US securities law.

If the target is privately owned, the acquisition agreement typically will require the seller to indemnify the buyer for any misrepresentations, or breaches of warranties or covenants. The buyer will be subject to a similar obligation in favor of the seller. The indemnification provisions will allocate responsibility for liabilities or losses arising from the conduct of the business both before and after the closing.

An indemnification provision will also specify the period following the closing during which the seller will be responsible to the other party. The parties have a natural desire to end their indemnification obligations as soon as possible. "Survival" periods are typically between one and three years, but one full year of operation plus a complete audit of such year are essential (and often sufficient)

to identify possible indemnification claims. As noted below, environmental indemnification obligations and claims with respect to title to the shares or membership interests or, perhaps, assets are often unlimited in time.

Indemnification provisions may specify that claims may be made only after the aggregate amount of all claims reaches a certain minimum level. Once this level is reached, the agreement may permit a party to assert all claims or only those in excess of the minimum. It is increasingly common for an agreement to provide a maximum for claims that may be asserted, typically with carve-outs from this amount for various matters including taxes, capitalization, intentional misrepresentation and fraud.

4.3 Other Agreements

The acquisition agreement may provide for a variety of ancillary agreements to be signed at the closing. These may include non-competition agreements, employment agreements with one or more of the sellers or key employees of the target, and ongoing leases and licenses. These are discussed below in this Section under heading 8 (Closing).

5. Principal Legal Concerns of the Buyer

The representations and warranties in the acquisition agreement focus on matters of great legal and business concern to the buyer. As noted above, representations and warranties are designed to elicit information about the target company. Thus, they play a vital role in the buyer's investigation of the target. The disclosures made in the acquisition agreement will be based in part on the due diligence investigation performed by counsel and others for the seller and will be further verified by the investigation of the buyer and its counsel. This investigation may be more far-reaching than would be encountered in the non-US buyer's home country. The expense involved should be weighed against the added protection afforded the buyer.

Each acquisition agreement will be tailored to the particular transaction and, accordingly, the scope of the representations and warranties will vary from deal to deal. The following is a general discussion of some of the more common representations and warranties that often appear in a US acquisition agreement.

5.1 Corporate Authority and Organization

The seller will represent that the selling entity is properly organized and that the persons acting on its behalf are duly authorized to do so. There is no commercial register or the equivalent in the United States. Therefore, the buyer and its counsel typically will independently verify the seller's authority through examination of the target's books and records, as well as public filings of publicly held targets, and may also obtain a legal opinion from the seller's counsel concerning the seller's and target company's organization and authorization.

5.2 Financial Statements

The acquisition agreement will state that the financial statements that have been presented to the buyer (which may or may not be attached to the agreement) have been prepared in accordance with generally accepted accounting principles on a basis consistent with prior periods and "fairly present" the financial condition of the target. Financial representations will be included even if all financial statements have been audited by a reputable accounting firm. They may also be supplemented by specific representations as to certain assets, such as inventory and accounts receivable. Where the buyer is subject to the Sarbanes-Oxley Act, representations may also be included with respect to internal controls and certification requirements arising under this particular law.

5.3 Compliance with Law

5.3.1 Environmental Compliance

In the United States, the buyer will inherit legal responsibility for any environmental problems existing on any property purchased, whether the transaction is in the form of an asset acquisition, share acquisition, or merger. Environmental liabilities represent one of the most significant traps for the unwary buyer. Therefore, buyers typically want full disclosure of any such problems. These will include any failure by the business to comply with environmental laws or any environmental permits for day-to-day operations.

Of equal concern are any hazardous waste materials that may be stored or buried on any real property. The removal of such waste can be very expensive. In many industries, it may be appropriate to have a so-called Phase I environmental audit of the premises and, if problems appear, a Phase II or Phase III audit that includes soil borings and air and water tests, to ascertain the presence and extent of any such

problems. (However, Phase II and III environmental audits may trigger disclosure obligations.) The buyer will want to confirm that any waste materials that have been carried off the premises have been handled and disposed of in accordance with applicable legal requirements. A purchaser may become liable for the improper off-site disposal of waste material by a predecessor or even by an unrelated third party, such as a waste disposal service retained by a previous owner of the business.

Environmental permits or licenses will have to be transferred or new ones obtained in the case of an asset acquisition. It will be necessary to consult with environmental authorities to be certain that the permits will be respected upon the change of ownership in a share acquisition. In certain states, such as New Jersey and Connecticut, the advance approval of state authorities may be required in order to complete the acquisition.

Because environmental liabilities are so extensive in scope, buyer's often seek to make the seller's environmental indemnities unlimited in monetary amount and time.

5.3.2 Other Licenses and Permits

Although the regulation of businesses is relatively limited in the United States, most businesses operate with a variety of governmental licenses and permits. These include general business licenses; building permits and certificates of occupancy relating to structures; boiler permits and other permits to operate certain forms of machinery and equipment; and vehicle licenses and registrations. In addition, specific governmental licenses and franchises may be necessary for certain kinds of businesses. It may be possible to transfer these license and permits to the buyer in an asset acquisition. More often, however, new license and permits should be obtained. Arrangements for the transfer or obtaining of such licenses or permits must be made so that they are in place at the closing if the business is to continue without interruption. Even vehicle registrations may present problems, since their transfer may take some time.

Government licenses and permits are generally not assignable even though material to the business. They may also terminate in the event of a material change in control of the target. The latter is more often imposed by practice on the local level than by statute. In such case, the buyer will want to be certain it can obtain its own licenses and permits prior to the closing. The agreement will generally call for disclosure of the licenses and permits used by the business and have a representation as to assignability.

5.3.3 Compliance with Other Laws

The buyer typically will wish to confirm that the business operates in compliance with zoning laws and other local laws regulating the use of real estate. Zoning law compliance is not always covered by title insurance. The buyer likely will be concerned about compliance with federal occupational safety and health laws. It is unlikely that the seller will be able to give absolute assurance of such compliance, but the buyer typically will want to know that the seller is at least not aware of, and has not received notice of, any violations. The buyer may also want some assurance that the seller is not aware that it has violated any laws relating to equal employment opportunities, hiring, or other laws affecting employment and employment practices.

These compliance matters may be the subject of specific provisions in the indemnification section of the agreement. Even if it is not possible for the seller to give absolute assurance of compliance in certain areas, buyer's often request that the seller retain responsibility for pre-closing noncompliance. This allocation of risk and responsibility is one of the major negotiating points in any US acquisition.

5.4 Employment Issues in Context of Acquisitions

5.4.1 Employment Protection

Unlike many non-US jurisdictions, there are no US statutes requiring that employees be retained or given specific severance pay upon termination of employment in an acquisition, although as described in Section 6.3 (Labor and Employment – Special Problems and Statutes Related to Mass Layoffs and Terminations), federal law (*e.g.*, the "WARN"Act) and some similar state laws require advance notice if an entire plant is to be closed or a certain percentage of employees are to be terminated. Employees have no statutory right to review, approve, or even be consulted about an acquisition of their employer. Employees do not automatically become the employees of the acquiring corporation in an asset purchase, although they will remain employees of the target or successor in a share acquisition or merger.

Nevertheless, a non-US buyer should not assume that it has an entirely free hand in dealing with employees. Most US employers have adopted employment policies that may legally bind successors. These will often provide for some form of termination compensation or severance, unless the employees are offered employment with substantially the same salary and, perhaps, benefits by the acquiring corporation. For this and other reasons, the seller will often insist that the buyer agree to employ

its existing workforce and may want to specify the terms and conditions of that employment. As with other economic issues, these matters will be negotiated between the buyer and seller. Related matters, such as accrued vacation pay, likely will have to be dealt with as well, since the employees will expect to retain these accrued benefits after closing. A non-US buyer especially will not want to appear to be insensitive to employee expectations.

5.4.2 Labor Agreements

In a stock purchase or merger, the buyer is bound by any collective bargaining (*i.e.*, labor) agreement to which the target corporation is a party. A buyer will be bound in an asset acquisition only if it expressly assumes the collective bargaining agreement. A buyer will usually want to take advantage of the comparatively weak bargaining position of the target's workforce to renegotiate the terms of employment. Consequently, it will generally resist assuming any collective bargaining agreements. The buyer will, however, be required to recognize any existing labor union and bargain with it in good faith. Many non-US buyers will find US labor unions easier to deal with than their non-US counterparts. A collective bargaining agreement will bind only one company and its employees, not an entire industry.

5.4.3 Termination Notice

The federal government and some state governments, as well as many collective bargaining agreements, require advance notice when certain employment sites are closed. Depending on the degree of continuity in an acquisition, such statutes or contract provisions may apply to the buyer. Federal law also requires that a terminated employee be allowed to continue any employer-sponsored health program for a period of time but at the cost of the employee. Certain states, such as Massachusetts, may impose this cost on the employer.

5.4.4 Pensions and Other Benefits

If the target has maintained any employee benefit programs, including pension plans, responsibility for continued adequate funding of these obligations may pass to the buyer, even in an asset acquisition. These plans are subject to extensive federal regulation. A buyer of a business may incur significant obligations created prior to the acquisition, including making up any under-funding of the pension plan. In an asset acquisition, the seller would generally want the buyer to continue its existing pension plans, since termination of a plan can be expensive and time consuming.

Termination is avoidable only if the buyer is willing to have a plan that is comparable in scope, although not necessarily identical, to the seller's existing plan. In any acquisition, the target corporation's pension plan should be examined in detail by experts (lawyers and actuaries) hired by the buyer, to avoid having the buyer incur substantial unexpected liabilities.

For a more detailed discussion on these issues, please see Section 6 (Labor and Employment).

5.5 Material Assets

5.5.1 Physical Facilities

The buyer typically wants to obtain clear title to any plants or other real estate owned by the target, since these are material to the operation of the business. Title to real estate is transferred by a deed, which is publicly recorded. (Title certificates are also used in certain locations.) There is no notary of the kind found in many civil law countries. In most US states, title to real property is investigated and assured by title insurance companies. The title company will insure clear title, subject to certain specified exceptions, such as identified mortgages, easements, and servitudes. If significant real estate is owned by the target, title insurance is often obtained even if shares are being acquired and no real property is actually being transferred.

The buyer may also obtain a survey of the property that indicates the location of all buildings, easements, servitudes (such as utility lines), and other matters affecting the physical layout of the property, and that discloses any difficulty with access to the property. As noted above, the buyer may wish to obtain an environmental audit as well. The buyer will want to ensure that the property is being used legally and in compliance with all building codes and zoning ordinances; these will be covered by title insurance only if specifically requested and paid for. In an asset acquisition, the transfer of real estate will require the payment of state and local transfer taxes, but with certain exceptions, these tend to be far lower than in most other countries.

5.5.2 Intellectual Property

In many businesses, intellectual property constitutes a substantial component of value. In that case, the buyer typically conducts a thorough investigation of title to all intellectual property, including trademarks and patents, and ensure that title to such property can be effectively transferred to it in the case of an asset acquisition.

A non-US buyer may be particularly interested in the extent of foreign protection of the acquired intellectual property. The buyer likely will also want assurance that all necessary consents to the assignment of any intellectual property licenses have been obtained. This may be necessary even in the case of certain stock acquisitions if the license is terminable upon a material change in control of the target enterprise.

A major issue often encountered with non-US buyers is the seller's unwillingness to warrant that its patents are valid, since such a warranty goes far beyond a mere representation of good title. A significant number of challenged patents are ruled invalid in the United States, and so a warranty of validity will generally be resisted by US sellers.

5.5.3 Agreements and Licenses

Agreements and licenses that are material to the success of a business may be jeopardized by an acquisition. For example, following the foreign acquisition of Firestone, General Motors announced that it would no longer purchase tires from Firestone as original equipment on its automobiles. An acquisition agreement typically will require disclosure of any contract above a certain size or extending beyond a certain duration, to alert the buyer of the commitments to which the business is subject and advise the buyer of the consents that must be obtained to assume such agreements or leases. The other party to such contracts or leases may be reluctant to consent to assignment without compensation if, for example, the rent or other compensation is below market. Thus, the acquisition agreement may contain additional representations regarding assignability and a lack of knowledge by the seller that any material business will be lost solely as a result of the acquisition.

5.6 Liabilities

5.6.1 Product Liability

A principal concern of any buyer of a US business is strict liability for personal injuries resulting from products manufactured and sold by the business. As in most other countries, the manufacturer or seller of a product in the United States is liable for damages sustained as a result of the manufacturer's or seller's negligence. However, under the US doctrine of strict liability, one who sells a product is liable for any physical harm caused to the ultimate user or consumer or to its property, if the product at the time of sale is in a defective condition (such that it is unreasonably dangerous to the user); the seller is engaged in the business of selling the product;

and the product may be expected to and does reach the user without substantial change. Combined with the propensity of US juries to award substantial damages, the doctrine of strict liability makes product claims a material cost of doing business in the United States. Accordingly, buyers often want some assurance from the seller that such exposure will not be unreasonable in amount. The buyer also may want to investigate the historical experience of the seller to ascertain whether the business itself involves undue risks.

In a stock purchase or a merger (or in an asset acquisition in some states), the buyer is often concerned about assuming responsibility for products sold prior to the closing. Although the seller may represent that it knows of no such liabilities, there is generally no way the seller can give complete assurance in this regard. Therefore, the parties often allocate responsibility as part of the indemnification provisions. Typically, sellers remain responsible for any products sold or shipped (and sometimes manufactured) prior to the closing and buyers are responsible for products sold or shipped after the closing. Indemnification for product liability will often be either unlimited in time or limited to the applicable state's statute of limitations. This latter limitation is not very meaningful since it generally begins to run only at the time the person is injured, which may be long after the product is sold or shipped.

For a more detailed discussion of US product liability law, please see Section 5 (Product Liability Law).

5.6.2 Tax Liabilities

In an asset acquisition, the buyer will almost never become directly liable for income and most other taxes based on the operation of the business prior to the closing. However, certain ad valorem taxes (those based on the value of property) may constitute a lien on the assets purchased. In addition, the failure to conduct thorough due diligence and/or comply with certain procedures could result in the buyer assuming liability for state or local sales or use taxes owed by the seller. In this case, it is normal for the seller to accept complete responsibility for tax liabilities attributable to the operation of the business prior to the closing and indemnify the buyer against any such liabilities. Such indemnification generally runs for the period of the statute of limitations.

5.6.3 Other Liabilities

In the United States, the seller often will represent that there are no undisclosed liabilities of the business, contingent or otherwise. If the target has any undisclosed liabilities, they will usually be the responsibility of the seller pursuant to an indemnification. In an asset acquisition, the buyer often will expressly not assume any liabilities other than those specifically identified in the agreement.

5.7 No Material Change

The seller often will represent that there has been no material adverse change in the operations or financial condition of the business since the date of the most recent financial statements or some other cutoff date. In addition, lack of any material adverse change will often be a condition of closing. A typical provision in an acquisition agreement will limit the seller's right to conduct the business between contract signing and closing other than in accordance with past practice and in the ordinary course of business and will prohibit the seller from making any material change in the business, making any major purchases or investments, incurring any significant obligations or liabilities, or changing compensation or other employee benefits without the consent of the buyer.

6. Other Legal Matters

There are a number of other legal matters that may be of concern in an acquisition, as discussed below.

6.1 Distributors and Agents

Acquisition agreements often require disclosure of all material distribution and sales representative agreements and arrangements. Unlike the practice in many other countries, in most states the buyer is free to terminate distributors and sales representatives without being liable for mandatory termination compensation payments. Few states have statutes requiring such compensation. However, there is a general trend in the United States against arbitrary or abusive terminations. Thus, a buyer may seek to document that any such terminations are made pursuant to a reorganization of the acquired business's distribution arrangements. A buyer may also seek to ensure that such terminations are not motivated by matters constituting antitrust violations. For example, it would be illegal to terminate a price-cutting distributor in an attempt to control pricing.

6.2 Immigration

A non-US acquirer will often contemplate sending executives and skilled technical experts to assist with the operation of the business after the closing. Those individuals who wish to enter the United States to attend meetings or similar activities may use either the B-1 Business Visitor visa status or Visa Waiver status, if available to visit the United States. In the case of a transferring executive, skilled technical expert, or other employee who will provide direct service to the acquired company in the United States, it is necessary to obtain an appropriate visa that authorizes employment in advance of the assignment. Since obtaining visas may be somewhat time consuming, any important personnel transfers should be planned with the help of experts well in advance of the closing.

6.3 Importation of Parts and Components

All matters pertaining to the importation of merchandise into the United States fall within the exclusive jurisdiction of the federal government. Many products imported into the United States are subject to the payment of import duties, generally payable on an *ad valorem* basis and determined by their specific classification. The Bureau of Customs and Border Protection has the right to challenge any claimed valuation, particularly where the transaction is between a non-US parent and a US subsidiary. If a non-US buyer plans to use an acquired corporation, for example, to assemble parts and components imported from abroad, it will want to ascertain early on that it will be able to import the parts and components without being subject to quotas (quotas are quite rare) and obtain some guidance as to the import duty cost of such importations into the United States.

There are a number of special forms of customs entry, such as foreign trade zones, that may be of particular interest to a non-US buyer. Products of non-US origin may be shipped to a foreign trade zone located in the United States without making a formal customs entry or paying any US customs duties. Such products may be stored, sold for export, or assembled while located within the zone and then re-exported, all without incurring any US customs duty.

A non-US buyer may encounter additional costs on imports to the United States, such as antidumping and countervailing duties. These are imposed when products are imported at what the US government considers an unjustifiably low price. In some cases, restrictions such as quotas may be imposed on certain products.

If the acquired business will be dependent on imported materials or components, the non-US buyer should review its plans and anticipated pricing with customs counsel prior to proceeding with an acquisition.

7. Organizing the Acquisition Vehicle

Whatever the form of the acquisition, it is likely that the buyer will want to organize a US limited liability company or corporation to act as the acquisition vehicle. (Some investors may prefer a form of partnership because of the tax or other advantages available in their own country.) The acquisition vehicle will be organized before the closing and probably prior to signing the acquisition agreement. Alternatively, the acquisition agreement may be signed by the buyer and assigned to the acquisition vehicle prior to the closing. Organizing a US limited liability company or corporation involves a number of steps. For further information on organizing a US limited liability company or corporation, please see Section 4 (Business Entities).

8. Closing

The closing of a US acquisition will be organized primarily by legal counsel for the buyer and seller.

8.1 Transfer Documents

The transfer documents to be executed and delivered at the closing will depend on the nature of the transaction. In a purchase of shares, or LLC membership interests represented by certificates, the seller typically will deliver certificates representing all of the shares or membership interests in the target corporation either endorsed to the buyer or accompanied by an executed “stock power” (or power of attorney) authorizing the transfer of the shares or membership interests on the books of the target. Membership interests not represented by certificates will be transferred by a form of assignment.

In a merger, the parties will execute a formal plan of merger (in most states) for filing with the secretaries of state of the jurisdictions in which the respective corporations or limited liability companies are organized. This document may be considerably shorter than the definitive merger agreement and may have to be

notarized. These formalities will be accomplished immediately prior to the closing and the plan of merger may be sent ahead to the appropriate state agencies to be ready for filing on the date of the closing.

An asset acquisition generally is more complicated. Real estate will be transferred by deeds for each parcel. Deeds typically will have to be notarized and recorded in the locality in which the real estate is located. Recording will be completed on the date of the closing or shortly thereafter. At the closing, the title insurance company will execute and deliver a binding commitment insuring title to the real estate. Personal property will be transferred by bill of sale, which requires no formalities. Agreements and other intangibles will be transferred by a form of assignment, which may be combined with the bill of sale. Separate assignment documents may be required for patents and certain other assets, some of which are subject to formal requirements.

8.2 Payment

In an international acquisition, payment is more often effected by wire transfer than cashier's check. The disadvantage of a cashier's check is that it will have to be deposited for collection, and so, funds may not be available to the seller on the day of closing. This can cause the loss of a substantial amount of interest. Wire transfers make funds immediately available once the transfer is acknowledged by the seller's bank, but delays sometimes occur. International wire transfers are more likely to be delayed on a Monday or Friday because of the large volume of other transfers and transactions on those days. Therefore, whenever possible, it is preferable to close in the middle of the week. If the closing must be held at the beginning or end of the week or timing is crucial, payment may be made by a federal funds cashier's check which is somewhat inconvenient for the buyer to obtain but which provides immediately available funds to the seller.

8.3 Other Agreements

A number of ancillary agreements may be executed at the closing. These are likely to include the following.

8.3.1 Non-competition Agreements

There are business and tax reasons why the buyer often wants key seller personnel to agree not to compete with the target business for some period of time after the closing. Such agreements are generally enforceable if they are reasonable in scope and duration and designed to preserve the benefit of the acquisition to the buyer.

8.3.2 Employment Agreements

It is not unusual for the seller of a privately held business, and possibly family members, to have been employed by the corporation prior to the acquisition. A significant consideration in agreeing to sell the business may be some assurance of continuity of employment. In acquisitions of professionally managed entities, the buyer often wants to ensure that certain key individuals will be available to operate the target business after the closing. This is most often true of top executives and important technical personnel. In these cases, either the buyer or seller may require that employment agreements be executed with such key persons at or prior to the closing.

8.3.3 Leases and Licenses

It may not be possible to transfer all of the tangible and intangible property necessary to operate the target business to the buyer. For example, the seller may continue to use key software or technology in its retained businesses. In such cases, tangible property may have to be leased and intangible property licensed to the target business.

8.3.4 Service Agreements

If the buyer is purchasing a portion of an integrated business, the buyer may not receive a fully stand-alone operation. In this case, the seller may have to provide post-closing services to the buyer on a short-term or, occasionally, long-term basis. Computer access is a common example of such a post-closing service provided by the seller.

8.4 Other Documents

A number of other documents may also be delivered at the closing. These include legal opinions from counsel for both parties. It is normal to deliver a certified copy of the certificate or articles of incorporation or association of the target company to the buyer as well as a certificate issued by the appropriate secretary of state indicating that the target company is in “good standing” in its state of incorporation.

It is also customary for the target (and for the buyer) to deliver a certificate affirming that all representations and warranties in the acquisition agreement are true and correct as of the day of closing. Unless they are to continue on in such capacities, the officers and directors of the target in a stock acquisition and the managers of a limited liability company will deliver written resignations. This is not necessary in an asset acquisition, since employees are not automatically transferred with the business.

9. Post-Acquisition Trade (Import/Export) Issues

Once an acquisition is complete, the buyer needs to be aware of a few potential import-and export-control compliance details that can significantly impact the business' operations if they are mishandled.

First, as discussed in Section 2 (Direct Sales), the business needs (among other things) a customs bond if it is importing. If a new entity was created which bought assets in the acquisition, then that new entity will need a customs bond in its name. If the acquisition is one of shares, a new customs bond may not be needed. If the acquired business remains and continues to operate under the same name, its pre-existing customs bond can simply be maintained. However, it is common in a share-purchase acquisition for there to be an official name change of the acquired company, and in such a case the business must officially change its importer-of-record name with the Bureau of Customs and Border Protection and have the name change reflected in its customs bond by either executing a bond rider or obtaining an entirely new bond in the new company name.

Second, if the business exports goods under licenses from the US Departments of State, Commerce, and/or Treasury, these licenses may need to be assigned or transferred in accordance with applicable regulations or altogether new licenses may need to be obtained in the name of the new entity.

Finally, both the US Departments of State and Commerce follow a rule that an export is deemed to have occurred when certain foreign nationals, when present in the United States, are exposed to information related to an item the export of which is controlled. These are so-called "deemed exports." If a license would be needed to export that information to the home country of the foreign national, then a license is needed for the deemed export to legally occur. This can become an issue for a foreign buyer, because it is likely that the buyer will dispatch certain of its employees

to the acquired business in the United States to assist with post-acquisition integration. If the operations of the business concern items which require licenses when exported, it may be necessary to acquire licenses for deemed exports of information related to these controlled items to the foreign-national employees of the buyer.

SECTION 4
BUSINESS ENTITIES

The previous section highlights how a non-US buyer often will establish a US acquisition vehicle in the form of a partnership or corporation to acquire a US target. Establishing a formal presence in the United States, either through acquisition of an existing business or through formation of a branch, joint venture or subsidiary generally involves a greater level of commitment than selling directly in the United States through sales representatives or distributors. This section, therefore, provides an overview of the various types of business entities through which a US presence may be established. In particular, this section focuses upon three limited liability entities: corporations, limited liability companies and limited partnerships. We highlight several factors, including issues of taxation, that typically influence the decision of which form of US business entity is the appropriate vehicle to use to establish a US presence. This section also briefly addresses the formation of a branch, subsidiary and joint venture.

1. Corporations

The sole form of share company in the United States is the corporation. US corporate law has few mandatory provisions and is without restriction on the number of stockholders (except in the case of a close corporation) and with free transferability of shares. This flexibility facilitates structuring a corporation to fit the needs and objectives of a foreign investor.

1.1 Formation of Corporations

1.1.1 Place of Incorporation

The US has no national (federal) company law, and regulation of the formation and operation of corporations is left largely to the individual states. Unlike a widespread European practice that requires a company be formed under the law of the jurisdiction in which its principal place of business is located, a US corporation may be formed under the laws of any state and have its principal place of business elsewhere so long as it “qualifies to do business” in each state in which it operates. This means that investors may choose the state law that best fits their needs.

Delaware law is particularly well suited to operation without in-person meetings (*i.e.*, meetings by teleconference) or even without meetings at all (*i.e.*, by written consent), a factor that can be quite convenient where stockholders and directors outside the United States are involved. In addition, the Delaware annual reporting requirements are simple and Delaware law and practice are well-adapted to corporations whose principal place of business is not located in Delaware. Delaware courts are also well-versed in corporate matters. On the other hand, a Delaware corporation doing business in another state may have to pay two annual franchise fees. This factor may be sufficient reason to incorporate under the law of the state in which the corporation will be doing business. Because of the preeminence of Delaware, any references to legal rules in this chapter are to those of Delaware unless otherwise indicated.

In general, state laws do not restrict the citizenship or residency of officers, directors or stockholders of a corporation, and so the choice of place of incorporation is unlikely to be critical to a foreign investor. With a few exceptions, a corporation may be reorganized under the laws of another state at any time without substantial tax liability, although this can be rather expensive to implement.

1.1.2 Formalities

Generally, a corporation is formed when its certificate of incorporation (or, in certain states, articles of incorporation) is filed with the Secretary of State of the state in which it is to be incorporated. The certificate of incorporation may be executed by anyone acting as incorporator, and thus need not be executed by an employee of the non-US investor. No special formalities, such as notarization, are required. Thus, a US corporation could be formed on a few days, and even a few hours, notice.

1.1.3 Name

In most states, the name of the corporation must provide indicia of corporate status *e.g.*, “Corporation,” “Incorporated,” “Limited,” “Company” or an abbreviation thereof. The name also must be distinguishable from other existing or reserved entity names. For most states, one may determine by telephone or on the Secretary of State’s website if a particular name is available. Since corporate laws operate only at the state level, a name could be available in one state, but blocked in many others. On the other hand, unlike in some non-US jurisdictions, almost any name

can be used (that is, it need not be descriptive of the business or be that of a stockholder). Finally, the name may be reserved for a limited period of time in anticipation of filing the certificate of incorporation.

1.1.4 Purpose

The purpose of the company may be stated very broadly, including "any activity permitted by law." However, in some states there must nonetheless be some indication of the business in which the company will actually engage. This purpose may be expanded in the future by means of an amendment to the certificate of incorporation.

1.1.5 Procedures

The principal steps in organizing a Delaware corporation are the following:

- The certificate of incorporation is executed by an "incorporator" and filed with the Secretary of State of the State of Delaware. The incorporator may be a natural person, partnership, association or corporation and need not be a resident of or domiciled in Delaware. The incorporator may act alone or with others and most US jurisdictions require only one incorporator. In practice, the incorporator is usually an individual – sometimes a lawyer, paralegal or law clerk, or an employee of a corporate services company who, for a fee, will provide incorporating services. (The certificate of incorporation must also list a registered agent and registered office in the state for purposes of accepting service of process in the context of litigation and a corporate service company is often retained for this purpose when the corporation's principle place of business is outside of Delaware.)

- The investor-stockholders subscribe for the number of shares that are to be issued by the corporation and pay in their capital contribution. This may be done before the filing of the certificate of incorporation. There is no minimum capital requirement. See the following subsection (Shares and Capital) for further discussion.

The initial board of directors (the members of which may be named in the certificate of incorporation or appointed by the incorporator) then holds the initial or organizational meeting (or all execute written resolutions) at which (or by which) the board typically:

(i) Approves the certificate of incorporation and the actions of the incorporator.

(ii) Adopts bylaws for the company. The bylaws generally govern the organization and operation of a corporation. The bylaws of a privately held corporation remain a private document (that is, they are not filed with a state Secretary of State). Unless otherwise provided in the certificate of incorporation, the bylaws may be amended only by stockholders entitled to vote. Bylaws for corporations formed in other states would be similar in most respects.

(iii) Appoints the officers of the corporation. See heading 1.3.2 (Corporate Structure and Governance) in this Section for further discussion.

(iv) Authorizes officers to qualify the corporation to do business in whatever other state may be necessary because of the nature of the corporation's activities in that state.

(v) Adopts a fiscal year, corporate seal and form of stock certificate.

(vi) Approves opening a bank account.

(vii) Accepts subscriptions for the corporation's shares.

(viii) Appoints independent auditors, if any. US law does not require non-public companies to appoint auditors, although a corporation's banks and principal creditors will usually require financial statements certified by independent auditors.

(ix) Approves any agreement among the stockholders. Such approval is not mandatory, however.

- A federal employer identification number is obtained from the Internal Revenue Service, or IRS, and a bank account is opened in the name of the corporation. At this point, the corporation is able to engage in any lawful business within its purpose.

If the corporation is organized under the laws of any other state, the steps to be followed would be substantially similar to those outlined above for a Delaware corporation. Although some states impose relatively small minimum capital requirements that must be paid in before the corporation may commence business, in Delaware and many other states, the corporation may commence operation even without capital or stockholder subscriptions. Nevertheless, operating with grossly inadequate capital is one of several factors that courts consider in determining whether to "pierce the corporate veil" and hold the stockholders liable for the obligations of the corporation in certain circumstances. See Section 7 (Preserving Limited Liability, and, in particular, heading 7.2 – Factors to Support Veil Piercing) for further discussion.

1.2 Shares and Capital

1.2.1 Common and Preferred Shares

The ordinary shares issued by US corporations are generally referred to as "common shares" or stock. It is also possible for a corporation to issue preferred shares, that is, shares carrying a priority with respect to dividends, distribution of capital upon liquidation, or both. Preferred shares may be redeemed by the company under specific conditions at a fixed price or at a price determined in accordance with a pre-established formula. As discussed below, although preferred dividends are normally payable only out of profits, and only to the extent there are profits, such dividends may be made cumulative; thus the dividend payable in a year when the company had no profits available would continue as an obligation to be repaid in later, profitable years before any dividends could be paid on common shares. The use of both common and preferred shares in various combinations, often in conjunction with stockholder loans, offers considerable flexibility to investors in financing a US subsidiary.

1.2.2 Authorized Shares

Stockholders need not subscribe for all of the shares that a corporation is authorized by its certificate to issue, and it is often true that a corporation will have substantially

more shares authorized than issued. In general, the board of directors may cause the corporation to issue additional shares up to the maximum authorized by the certificate of incorporation, but an amendment to the certificate of incorporation is required to increase the amount of authorized shares, thus necessitating a vote by both the board of directors and the stockholders.

1.2.3 Treasury Shares

A US corporation may purchase its own shares, subject to certain limitations. Such treasury shares may not be voted and may not receive dividends, but the corporation may dispose of them in the same manner as any of its other property subject to federal and state securities laws.

1.2.4 Par and No-Par Shares; Absence of Bearer Shares

A corporation generally may issue shares with or without par value. No-par shares offer certain flexibility, but if the corporation will be issuing a large number of shares, shares with a nominal par value (*e.g.*, $.01 or $.001) may carry a lower annual franchise tax rate. Many foreign investors opt for shares with par value out of a sense of familiarity. Bearer shares are not permitted in the United States, and so ownership of all shares in an US corporation is registered on the internal books of the corporation. The identity of the stockholders normally need not be disclosed in any public document.

1.2.5 Non-Voting Stock

Delaware and other US corporations may issue one or more classes of shares which may have limited or no voting rights. When shares do have voting rights, voting power need not be in proportion to capital contribution or economic interest.

1.2.6 Capital and Surplus

The concept of capital in US corporate law is both more flexible and less important than under many other legal systems. The emphasis in the United States tends to be on promoting the growth of the corporation rather than preserving its capital, and ultimately, the amount of capital often bears little relationship to a company's actual importance. In the United States, persons dealing with a corporation often rely upon its net worth (as indicated by its balance sheet), its earnings (as indicated on its income statement) or some other representative measure of value, rather

than upon its stated capital. As a result, the directors of a corporation are less likely to be held liable for a failure to preserve the corporation's capital than in, for example, Europe.

If shares are issued in excess of par value (or at an aggregate price in excess of stated capital in the case of no-par shares), that surplus is called paid-in surplus. It is customary that only a portion of the contributions of stockholders to the corporation be allocated to capital and the balance treated as paid-in surplus. In many states, this would permit dividends to be paid out of these contributions, which can add flexibility to the financial operations of the corporation. See heading 1.3.3 (Financial Matters) below in this Section for further discussion.

1.2.7 Cash, Property and Services as Capital Contributions

Shares may be issued for cash, personal or real property, a promissory note or services already performed. Shares with par value may not be issued for less than par value. Shares may not be issued for services to be performed in the future. No public appraisal or court approval of property contributed for shares is required; the valuation of non-cash contributions by the board of directors is conclusive in the absence of actual fraud under most states' laws.

1.2.8 Limitations upon the Transfer of Shares

US corporate law imposes few restrictions on the transfer of shares. In closely held corporations with more than one stockholder, there are practical motivations to restrict the transfer of shares. Agreements among stockholders restricting transferability are enforceable, and can provide for the following type of restrictions:

Transfer Subject to Stockholder (or Board of Directors) Consent

Under the laws of certain states, a requirement that shares may be transferred only with the consent of a specified percentage of stockholders or directors is permissible, subject, however, to a requirement that this power be exercised in good faith. However, the laws of many other states do not expressly provide for such restrictions, and it is possible that the provision would be denied enforcement if it were deemed to be equivalent to an absolute prohibition on transfer, a prohibition considered to be contrary to public policy. Again, good faith is required for enforcement of such a provision.

Prohibitions on Transfer to Particular Persons or Classes

It is possible under Delaware law and the laws of a number of other states to prohibit transfers to designated persons or classes of persons, such as competitors.

Right of First Offer or First Refusal

It is possible (and customary) to provide for a right of "first offer" or "first refusal," that is, a right given to the corporation or the other stockholders to purchase the shares of a stockholder who wishes to dispose of some or all of his shares, either at a price fixed in advance of offering the shares to an outside purchaser or at the price and terms offered by an outside purchaser usually up to an amount to maintain a stockholder's existing percentage ownership. While such restrictions are acceptable generally in the United States, they may have the effect of diminishing the liquidity of the shares, especially if the provision is not drafted with great care.

Preemptive Rights

Existing stockholders have no automatic and initial right to receive a proportionate share of newly issues stock. However, in contrast to certain states wherein a preemptive right is a default provision, a preemptive right may be included in the certificate of incorporation for a new corporation.

Notice of Restriction

The foregoing restrictions on transfer may be accomplished by inclusion of a provision in the certificate of incorporation or bylaws of the corporation. More often, a provision is included in a private agreement among the stockholders. Regardless of where the restriction appears, a notation, or "legend," indicating the existence of a restriction on share transfers must be placed on the reverse side of the stock certificate in order to be sure that the restriction is binding on third parties. The absence of a commercial register in the United States means that there is no other means of effectively notifying third parties of such restrictions.

1.3 Corporate Structure and Governance

1.3.1 Corporate Structure

A corporation consists of three principal constituencies: the stockholders, the board of directors and the officers. The functions of each, which differ from those in many other legal systems, are as follows:

Stockholders

The stockholders are the owners of the corporation. In US corporations, except for a limited number of regulated industries, such as banking and insurance in certain states, there is no restriction as to the nationality or place of residence of stockholders. A corporation may have a single stockholder both upon formation and thereafter without creating any special risk that the stockholder would be liable for the obligations of the corporation. For a more in-depth discussion of issues of limited liability, please see Section 7 (Preserving Limited Liability). The stockholders generally have the following powers:

Election of Directors/Cumulative Voting

In most states, a simple majority of the stockholders may elect the entire board of directors. However, the certificate of incorporation may provide for cumulative voting, whereby stockholders may elect directors in proportion to their shareholding in the company. As a result of cumulative voting, a substantial minority stockholder could elect one or more directors. However, if it is desired that minority stockholders be guaranteed the right to elect a fixed number of directors, this should be accomplished by an agreement among the stockholders.

Merger, Sale of Assets, and Dissolution

In general, a merger, sale of all or substantially all of the assets, or a dissolution of the company must be approved by stockholders entitled to vote and owning a majority of the outstanding shares of the company. The certificate of incorporation or the laws of certain states, however, may require the approval of an extraordinary majority, or supermajority, of stockholders.

Amendment of Certificate of Incorporation and Bylaws

The stockholders may amend the certificate of incorporation by simple majority vote unless otherwise specified in the certificate of incorporation or provided by agreement among the stockholders. In certain states, the amendment must receive the approval of a supermajority of stockholders. In addition, in most states the stockholders may amend the bylaws by a simple majority, although many states allow this power to be given to the board of directors concurrently by inclusion of a provision to that effect in the certificate of incorporation or bylaws. However, Delaware recently amended its corporate law statute to provide that a by-law adopted by shareholders that sets the vote required for director elections may not be further amended or repealed by the board of directors.

Declaration of Dividends

The stockholders do not have the right to declare dividends. As explained below, this power is reserved to the board of directors in a US corporation.

Stockholder Meetings

The stockholders may, to some extent, restrict the powers of the board of directors by requiring stockholder approval for certain decisions.

The stockholders must formally exercise their powers at meetings of the stockholders. The stockholders must meet at least annually on a date and at a time fixed by the bylaws unless they act by written consent as described below. Stockholders may hold special meetings at any time. The following are some of the principal procedural aspects of a stockholder meeting:

> *Notice and Waiver*
>
> Notice of a meeting must be given in accordance with the bylaws but generally under state law must neither be less than 10 nor more than 60 days prior to the date of the meeting. However, these temporal requirements may be altered by the dictates of the federal securities laws. A stockholder may waive notice formally in writing or impliedly by attendance at a meeting (except if attendance is for the purpose of protesting lack of notice).
>
> *Quorum*
>
> In most states, a majority of the shares entitled to vote constitutes a quorum so long as the action to be taken at the meeting does not require a greater percentage vote. In Delaware, the certificate of incorporation or bylaws may specify a quorum of as low as one third of the shares entitled to vote.
>
> *Proxy*
>
> Stockholders may vote through proxies, and the presence of a proxy holder at a meeting will count towards constituting a quorum. Proxies are generally revocable and are automatically revoked if a new proxy is given.

Action by Written Consent of Stockholders

In lieu of a formal meeting, the stockholders may act through a consent in writing executed, in most states, by the stockholders holding the requisite voting power

necessary to authorize the particular action. Consent resolutions are a considerable convenience where a wholly-owned subsidiary is involved since they avoid the charade of holding a "meeting" of the sole stockholder.

Board of Directors

A US corporation is generally managed by its board of directors, which has the power to carry out substantially all corporate acts not specifically reserved to the stockholders. US corporations have only one board of directors, unlike the dual board of directors arrangement in certain European entities, for example, a German Aktiengesellschaft.

Although most states allow a board of directors to be comprised of only one director, typically a board of directors will be have more than one director, with three or five being the number of directors most commonly specified. Only individuals may act as directors. There is no general requirement that directors be citizens or residents of the United States or of the state of incorporation. Certain states do impose residency or citizenship requirements on directors of companies operating in certain sectors of the economy, such as insurance and banking, and federal law limits foreign participation in a few industries that are deemed particularly sensitive (*e.g.*, defense, commercial fishing, communications and the like). Directors do not have to be stockholders and therefore do not require qualifying shares.

As noted, the board of directors exercises all corporate powers not reserved to the stockholders. Those powers include:

Management

The directors as a group manage the corporation. The board of directors sets policy for the corporation and is responsible for its performance. It will specifically authorize significant transactions, but the actual day-to-day operations are usually delegated to the officers, with the board supervising the conduct of the officers.

Dividends

Unlike the European model, for example, the directors of a US corporation have the power to declare dividends without the participation of the stockholders.

Merger, Consolidation, Dissolution

The board of directors will normally recommend the merger, consolidation or dissolution of the corporation to the stockholders.

Board of Directors Meetings

Normally, directors do not represent the corporation in its dealings with third parties – this is typically done by the officers. Rather, the directors, in principle, act as a body through meetings called in accordance with the bylaws. Directors must personally participate in meetings though they may also do so through telephone conference. Resolutions generally are adopted by a simple majority of the directors present and voting at a meeting at which a quorum is present. The following are some of the principal procedural aspects of a meeting of the board of directors are:

> *Notice and Waiver*
>
> Notice requirements for meetings may be very short, perhaps 24 hours, although foreign investors typically require longer periods if directors are located on two continents. Modern US law is extremely flexible in this regard, however, and notice may be formally waived in writing at any time by a director or impliedly waived by his or her presence at a meeting.
>
> *Quorum*
>
> A majority of the directors will constitute a quorum unless a different number is specified in the certificate of incorporation or bylaws. Most states allow a quorum of no less than one third of the directors.
>
> *Proxy*
>
> Directors of a corporation may not vote by proxy, the rationale being that the corporation must benefit from the unique skills and judgment of a particular director when deciding an issue.

Action by Written Consent of Directors

Directors may also act through a written consent in writing signed by every director. Thus, a formal meeting of the directors need never be held, even in connection with the organization of the company. This proves to be a considerable convenience for foreign investors.

Officers

The board of directors normally delegates responsibility for the day-to-day operations of a corporation to the officers. Because there is no commercial register in the

United States, third parties rely upon an officer's apparent authority based on his or her title, that is, they rely upon the officer enjoying the authority normally attendant to such title. Thus, titles should be chosen with care. Officers are not normally given powers of attorney and a person dealing with the corporation ordinarily should not expect one.

The officers generally consist of a chief executive officer, who may also hold the title of "chairman of the board of directors" or, more often, "president," one or more vice presidents, a secretary and a chief financial offer. The board of directors appoints the officers and may remove them at any time. At a minimum, the corporation should have a chief executive officer and a secretary. One person may hold more than one office; however, it is recommended, but not required, that different individuals hold the offices of president and secretary. The authority and functions of each of these officers are set forth in detail in the bylaws. The typical functions of the various corporate officers may be summarized as follows:

Chief Executive Officer

The chief executive officer has the power to act on behalf of the corporation and represent it in the ordinary course of business. Moreover, he or she supervises the administration and operation of the corporation's business. Where the US corporation is a subsidiary of a foreign parent, it may be advisable to have a representative of the foreign parent who is resident in the United States serve as chief executive officer if at all possible. Neither the chief executive officer nor any other officer will be able to act alone on matters other than matters in the ordinary course of the corporation's business without specific authorization from the board of directors, which authorization will have to be certified by the secretary of the corporation in some instances, as described below. Some corporations also provide for a chief operating office who deals with the daily operations of the corporation under the direction of the chief executive officer.

Vice President

The vice president acts in the absence or at the request of the chief executive officer and exercises such other powers as may be delegated by the board of directors. If there is more than one vice president, one among them is often designated the executive vice president, or senior vice president. Very large corporations and banks may have a hierarchy of vice presidents. Where the US corporation is a subsidiary of a foreign parent and where the president or chief

executive officer will not reside in the United States, it may be advisable to appoint the local manager as a vice president. There are many circumstances in which persons having business with the US corporation will expect to deal with an officer of the company and it will prove useful to have someone available for that purpose.

Secretary

The secretary is a position unfamiliar to many practitioners in civil law countries. The secretary is the officer of the corporation responsible for maintaining certain books and records of the company, especially the minutes of the board of directors and the share transfer records.

Furthermore, it is common in the United States to require that the secretary of a company attest to the authority of an officer to execute any important documents, particularly bank documents. This is so because there is no equivalent to the commercial register in which the names of persons having signature powers for the corporation may be listed. Accordingly, because outsiders cannot independently verify an officer's authority to represent and sign for the corporation, they often require the participation of two officers (of which one often is the secretary) in substantial transactions. In this role, the secretary does not truly represent the company, but rather merely attests to the fact that the officer who does act on behalf of the company is authorized to do so, either under the company's bylaws or by a specific resolution of the board of directors. Ultimately, the secretary safeguards against an officer exceeding his or her authority when acting on behalf of the company. An in-house or outside attorney may fill this role for his or her clients, which may be particularly helpful for foreign investors. The board of directors may also elect an assistant secretary to act in the absence of the secretary. Since there is no way to verify who is the secretary, the process can be circular in its logic; thus an outside attorney is sometimes selected as secretary or assistant secretary to add credibility to the attestation.

Chief Financial Officer

The chief financial officer is responsible for supervising the financial affairs of the company and the management of its funds. In a large company, he or she may be aided in his role by the controller. The controller has a function somewhat equivalent to that of an internal auditor, but in the United States the controller's function is not required or defined by law. Thus, the controller does not act independently of the company's management. In general, US company law does

not impose the kind of independent financial control for the protection of stockholders imposed by many European company laws, and there is no position in a corporation equivalent to the auditor or commissar found in many European companies. Nevertheless, the Securities and Exchange Commission, or SEC, in the case of public companies, or the corporation's bank, in the case of private companies, typically requires an annual audit (which is more than a review or compilation under US generally accepted accounting principles) of the corporation's books and records by an independent certified public accountant.

The Sarbanes-Oxley Act also requires that the chief financial officer and chief executive officer of companies with securities that are listed, traded or otherwise registered in the United States to certify as to the corporation's internal control over financial reporting.

1.3.2 Corporate Governance

Liability of Stockholders

Businesses are conducted in corporate form primarily in order to enjoy the benefit of limited liability. The investment that a stockholder makes in a corporation is necessarily at risk but the stockholder typically is not responsible for the liabilities or losses of the corporation beyond that investment. Nonetheless, if the separate existence of the corporation is not respected, there is a risk that creditors will be able to disregard the corporation's separate legal existence and seek to recover from the stockholders under the doctrine of "piercing the corporate veil." For a more in-depth discussion of issues of limited liability, please see Section 7 (Preserving Limited Liability).

Responsibilities of Officers and Directors

Officers and directors owe a fiduciary duty of care to the corporation and its stockholders. In this, they must exercise reasonable business judgment to advance the interests of the corporation. They also owe a fiduciary duty of loyalty to the corporation and its stockholders. Thus, they must always act in the best interest of the corporation; they may not, for example, take personal advantage of a business opportunity that comes to their attention in their capacity as a director or officer. Moreover, they must disclose any personal interest they may have when considering

matters at directors' meetings or in functioning as officers. Further, directors may not vote on issues in which they have a personal interest and, similarly, officers may not act in such circumstances.

Directors and officers who act in accordance with these responsibilities will generally not be liable to the corporation or its stockholders. Moreover, except in cases of insolvency or where the corporation is approaching of insolvency, directors generally do not owe a fiduciary duty to persons other than the corporation and its stockholders in making business decisions. On the other hand, the corporation will almost always be responsible for the acts of its directors, officers or employees acting within the scope of their authority.

Generally, neither directors nor officers will have personal criminal or civil liability for the criminal or civil acts of the corporation in which they do not participate or which they do not explicitly or implicitly authorize, as the corporation is considered itself to be criminally liable. A director or officer is always responsible for his or her own criminal or wrongful civil acts.

The directors and officers are also generally not liable to the creditors of the corporation absent personal wrongdoing, such as self-dealing or embezzlement. While the directors and officers may not defraud creditors or conceal the corporation's weak financial condition from them, they will not incur liability solely on account of the corporation's inability to satisfy its debts. Recently, however, some courts have expanded the fiduciary duties of directors and officers when a corporation becomes insolvent or approaches insolvency to include not only the corporation and its stockholders, but the corporation's creditors as well.

Just as with stockholders, the directors and officers are best protected from liability for corporate debts and acts by respecting all corporate formalities, maintaining complete and accurate financial books and records, obtaining full and frank financial information before approving transactions (particularly if the corporation is approaching insolvency) and maintaining internal accounting controls that enable them to manage the acts and assets of the corporation. For a more complete treatment of issues of limited liability, please see Section 7 (Preserving Limited Liability).

1.3.3 Financial Matters

Corporate law in the United States with respect to non-publicly traded companies has few mandatory rules regarding the financial management of the corporation.

Approval of Balance Sheet

It is not required (or customary) that the stockholders approve the balance sheet and annual profit and loss statement. Moreover, the annual balance sheet is not published except in the case of corporations whose shares are publicly traded. In addition, it is not customary or necessary for the stockholders to release the board of directors from liability for their actions.

Reserves

US law establishes no compulsory reserves of any kind. Generally accepted accounting principles, however, require the setting-up of certain reserves, such as for bad debts or current litigation, on a corporation's balance sheet.

Dividends

In most states, dividends may be paid out of accumulated profits (or "earned surplus") and out of paid-in surplus. In Delaware, it is also permitted to pay dividends out of current profits even if losses in earlier years have impaired the corporation's capital. A "dividend" out of paid-in surplus where there is a current and cumulative loss would not be considered to be a "dividend" for tax purposes, however, since the company would have no earnings and profits; rather, it would be treated as a return of capital.

Tax Matters

There are two kinds of corporations for federal income tax purposes. One kind is governed by Subchapter C of the Internal Revenue Code, or "C corporation," and the other is a "small business corporation," or "S corporation," for which a Subchapter S election under the Internal Revenue Code is in effect. A C corporation must itself pay income tax. Thus, the profits of a C corporation are subject to double taxation, first, on the corporate level and, second, on the level of the recipient stockholder.

An S corporation is not subject to income tax at the corporate level. Rather, its profits are directly allocated to its stockholders, who must then report the income and expenses on their own tax returns. To qualify as an S corporation, a corporation

must have been founded under US law and have no more than 75 stockholders, who must either be a natural person other than a nonresident alien, the estate of a natural person, or a qualified trust. Furthermore, an S corporation may not have more than one class of stock. An S corporation is generally not suitable for non-US investors.

2. Limited Liability Companies

In addition to corporations, the laws of all states in the United States provide for the organization of limited liability companies, or LLCs. LLCs do not have any limitation on the minimum (*i.e.*, one member is acceptable) or maximum number of members or the transferability of shares. They are a hybrid entity, essentially comprised of the more favorable attributes of partnerships and corporations. Like US corporations, LLCs are extremely flexible. Usually, the choice between an LLC and a corporation will often be driven by tax considerations, as discussed below.

2.1 Types of LLCs

The flexibility available with a limited liability company is useful in meeting the particular needs and objectives of either a non-US investor or a US entrepreneur. An LLC can be, and often is, customized for each client. However, there is a cost associated with customization, and ultimately an LLC may prove significantly more expensive to organize than a corporation. In order to address this problem, Baker & McKenzie often provides four “model” LLC formats: a “corporate model,” a “partnership model” and two hybrid models - one with “managers” and one with “officers.” These models are more fully set forth below. Note that the choice among these models relates to their structure and management, not to their tax treatment, which is entirely independent of their structure.

2.1.1 Corporate Model LLC

A corporate model LLC is organized and managed similarly to a US corporation. The owners of an LLC are its members, and are analogous to a corporation’s stockholders. The members are issued membership units, which are analogous to shares. A corporate model LLC will have a board of directors elected by the members. As in a corporation, the board manages the LLC and establishes business policies by acting collectively, that is, making decisions as a group. The board elects officers, who conduct the day-to-day affairs of the LLC, represent it in dealing with

third parties and otherwise act as authorized by the board of directors. The officers thus serve the same functions as officers in a US corporation. Profits are allocated in accordance with unit ownership (although this may be varied) and there will normally be no complicated provisions, or special allocations, allocating profits and losses. Thus the corporate model LLC agreement is a rather compact document. The members will typically only vote for the election of directors or on fundamental matters such as a merger or dissolution of the LLC. The principal choices relate to the number and identity of the directors and officers, amount and nature of capital contributions, and any fundamental items to be resolved by the members.

2.1.2 Partnership Model

In contrast, the partnership model does not attempt to replicate the features of a corporation. It may be used when the owners of the LLC are individuals or entities; it is a particularly appropriate model when all of the members are active in the business of the LLC. The partnership model is managed directly by its members, as in the case of a US general partnership (but without the liability of general partners). Each member may represent the LLC in its dealings with third parties. Although it is possible to limit representation and management to fewer than all members, in many states such a limitation may not be binding on third parties who are unaware of it. Thus, it is typically more efficient to use the "hybrid model with managers," as discussed below, to achieve management by less than all members. Unlike the corporate model, profits and losses may be allocated other than by way of percentage ownership. Thus, a key question in the partnership model is how profits and losses are to be allocated. If special allocations are employed, fairly lengthy tax provisions are often inserted to ensure that the allocations are respected by the IRS. This may add considerably to the length and complexity of the LLC agreement.

2.1.3 Hybrid Models

Since both "hybrid" LLCs are managed by the members and so, similar to the partnership model, neither has a board of directors. In both models, the members establish company policy acting as a group but the members do not directly represent and operate the LLC in its day-to-day business. Rather, they elect other persons to conduct the day-to-day business of the LLC and represent it in dealings with third parties. In one hybrid model, this person is designated as the manager (who may or may not be a member). In the other hybrid model, these persons are designated

as officers, thus mirroring the corporate model, but without an intervening board of directors. A manager will generally exercise greater authority than an officer, as described below.

We generally recommend the use of a manager or officers. Having the LLC represented by the members with respect to third parties often proves cumbersome in practice. Third parties are generally more comfortable dealing with officers or managers, and the members may not wish to have daily management responsibility. Special profit and loss allocations can be utilized, as with the partnership model.

2.1.4 Single Member Limited Liability Companies

Single member LLCs may take any of the foregoing forms. The preferred governance model for a single member LLC may depend in part upon whether the single member is an individual or a corporation or other business entity, and also in part upon whether the owner of the LLC is US or a non-US citizen or entity.

If the sole owner of the LLC is an individual, there is no need to have a board of directors, and the LLC could be managed by the sole member. However, we generally still recommend the use of a manager or officers (even if the sole member is the manager or president) because, unless a manager or officers are present, the LLC must be represented by the member in that capacity with respect to third parties. Without the use of the title of manager or president, it may be difficult for the member to avoid treating the LLC as his or her alter ego and so there is some chance that the LLC could fall afoul of the doctrine of piercing the corporate veil doctrine. For further discussion of issues of limited liability, please see Section 7 (Preserving Limited Liability).

If the owner is a corporation, the owner may prefer the familiar structure of the corporate model LLC. Furthermore, a non-US investor may prefer to have the LLC managed by one or more managers who would act similarly to managing directors of certain non-US companies. In this case, the manager or managers would not act primarily through meetings but would individually represent the LLC in its dealings with third parties.

2.2 Formation of Limited Liability Companies

2.2.1 Place of Formation

There is no national LLC law and so regulation of the formation and operation of LLCs is, as in the context of corporations, left largely to the individual states. Unlike, for example, the European practice of requiring a company to be organized under the law of the jurisdiction in which its principal place of business is located, a US LLC, like a US corporation, may be organized under the laws of one state and yet have its principal place of business elsewhere so long as it "qualifies to do business" in each state in which it operates. This allows investors to choose the optimal state law.

Sometimes there is no great significance to the jurisdiction chosen, but Delaware law is considerably better suited for companies with multiple investors. On the other hand (and as discussed earlier in this chapter with respect to formation of corporations), a Delaware company doing business in just one state (other than Delaware) will have to pay two annual franchise fees. This factor may be sufficient reason to organize under the law of the state in which the company will be doing business. The laws of Illinois and many other states are nearly as convenient and flexible as Delaware law notwithstanding certain disadvantages, particularly as regards the corporate model, especially if the LLC is to have more than one member. Again, because of Delaware's preeminence, any references to legal rules throughout this subsection are to those of Delaware, unless otherwise noted.

2.2.2 Certificate of Formation

A limited liability company is organized by registering its certificate of formation or, in certain states, articles of organization, with the Secretary of State of the state in which it is to be organized. The certificate of formation may be executed by any one person (frequently an attorney) acting on behalf of the future members and so it need not be executed by a non-US investor.

2.2.3 Name

The name of the limited liability company must end with the word "Limited Liability Company" or, in many states, the abbreviation "LLC." The name also must be distinguishable from other existing or reserved entity names.

2.2.4 Purpose

This may be stated in very broad terms under the Delaware statute, usually including "any activity permitted by law" without any indication of the business in which the company will actually engage. In certain other states, the purpose may be stated broadly, but there must be some indication of the specific type of business in which the company will actually engage. This purpose may be expanded in the future by means of an amendment of the certificate of formation.

2.2.5 Procedures

The principal steps in organizing a Delaware limited liability company are the following:

- The certificate of formation is executed (by one or more "authorized persons") and filed with the Secretary of State of the state of organization.
- The members normally enter into a "limited liability company agreement" (or, in other states, an "operating agreement") to govern the operation of the LLC. The LLC agreement is a private document among the members. A typical LLC agreement covers such matters as the formation of the company, its business, the members and their capital contributions, the management of the company, the means by which the members may act, the allocation of profits, and the dissolution of the company and termination of the operating agreement. If the LLC has a single member, the LLC agreement is quite simple. If the LLC has two or more members, it is more like a joint venture and the LLC agreement often includes other provisions typical of a joint venture agreement or stockholders agreement, such as limitations on the ability of the members to transfer their interests and provision for resolution of deadlocks. The investor-members "subscribe" for membership interests in the LLC. Membership interests may also be called membership units, and may be represented by certificates or not at the election of the members.
- The managers or directors, if any, are appointed by the members; and
- The members, and managers or directors, if any, hold an initial meeting, which may also be accomplished by means of a "consent

resolution," (that is, a written resolution signed by all members, managers or directors, as applicable, without a meeting) at which the following action is typically taken:

(i) Approve the actions of the person who signed the certificate of formation.

(ii) Appoint the officers, if any, of the LLC.

(iii) Appoint a registered or resident agent (as with corporations, this may be a corporate service provider).

(iv) Authorize the officers or, in the absence of officers, other appropriate persons, to qualify the LLC to do business in whatever other state may be necessary because of the nature of the limited liability company's activities in that state.

(v) Adopt an accounting method and fiscal year if not covered in the operating agreement.

(vi) Approve opening a bank account.

(vii) Appoint independent auditors, if any. Auditors are not required under any US law for a limited liability company although a limited liability company's banks and other principal creditors will usually require financial statements prepared, reviewed by, certified or audited by independent auditors.

(viii) Approve the operating agreement. This approval is not mandatory, however.

2.3 Membership Interests and Capital

2.3.1 Membership Interests and Contributions

The ownership interests of the members in a LLC, formally known as membership interests or membership units, may be represented by membership certificates or may merely be reflected in the operating agreement or a membership register maintained by the company. Membership certificates may not be in bearer form. Membership interests may be issued for cash, personal or real property, an agreement to contribute cash or property in the future, and past or, in most states, future

services. No appraisal or court approval is required for valuing members' contributions of any kind or for issuing membership interests. The good faith determination of the value of a contribution by the members is sufficient. A member's interest in the company does not have to be in any way proportional to the value of its contribution.

2.3.2 Voting and Other Rights

A member does not have to be given a right to vote or otherwise participate in the management of the company, although the right of a member to obtain certain information about the financial and other affairs of the company cannot be restricted in most states. Members and membership units may be given differing and non-proportional rights to participate in the profits and losses, distributions and equity of the company (but see the discussion of tax allocation of profits and losses under "Tax Matters" at heading 2.5.5 of this Section). The flexibility offered by a limited liability company in this regard is limited only by the imagination of the parties and their counsel, although US tax laws impose certain requirements in order that an allocation of profits and losses be recognized for US tax purposes.

2.3.3 Role of Capital

As stated above in the context of corporations, in general, the concept of capital is both more flexible and less important with respect to US business entities than those of other jurisdictions. The emphasis in the United States tends to be on promoting the growth of the company rather than preserving its capital. For LLCs, capital is an accounting, and not legal, concept. As such it plays an insignificant procedural role in the formation and operation of LLCs.

2.4 Structure and Governance of Limited Liability Companies

2.4.1 LLC Structure

A limited liability company must have at least one member but, as noted above, its management structure generally may be determined in whatever manner the members desire. The member or members may operate the company directly (as in the partnership model) or may themselves appoint officers or managers to operate the daily affairs of the LLC. If there are multiple members with differing equity interests, member management with officers to conduct the day-to-day business may be quite convenient since the members will automatically vote in

accordance with their respective voting percentage interests. Reflecting such interests through board membership in a corporate model can be somewhat clumsy. If the members do not wish to manage the company directly, they may provide for the election of a manager or managers to conduct the ordinary business affairs of the company. This approach may be familiar to non-US investors. In some cases, the members may choose to have a corporation-type management structure, with both a board of directors and officers. This structure has the advantage of appearing familiar to those persons in the United States with whom the company will deal who may be more familiar with corporations than limited liability companies. Each of these management structures is described below.

Members

The members hold the ultimate authority in the company. Thus, under any management structure, they will have to approve any extraordinary action, such as a merger of the limited liability company into another entity, the sale of all or substantially all of the assets of the company, or its dissolution. However, the percentage of members who must approve such extraordinary acts is determined by the operating agreement. In the absence of an appropriate provision, approval would normally be by majority vote in most states.

The members may act in a variety of ways. Under the corporate and hybrid models, the operating agreement provides that members act through an actual meeting at which the members may be present in person, by proxy, or by conference telephone (that is, any telephone arrangement through which members may be heard by all other members). Members may also act in lieu of a meeting through a consent in writing executed by a majority of the members unless state law or the operating agreement requires a larger number. This is a considerable convenience, especially where the company is wholly-owned by a US or non-US investor, since it avoids the charade of holding a “meeting” of the sole member. In a partnership model, the members actively participate in the business and each has the authority to make decisions for the LLC individually, without a meeting. In this case, there may still be provision for meetings of the members for consideration of extraordinary matters where decisions are to be taken by the members as a whole.

Dissociation of a Member

The term "dissociation" is used in conjunction with LLCs and partnerships in the United States. It generally refers to any circumstance under which a member or partner ceases to have that status, which may arise in a variety of situations.

Transfer

If a member transfers his or her entire interest, he or she will no longer be a member. Although this is treated as dissociation in a number of LLC statutes, this is not typically the case because there will be a substitute member and so none of the issues discussed below are likely to arise.

Voluntary Resignation

Because LLC statutes are often derived from partnership predecessors, they used to permit a member to resign at will, although an LLC statute might also provide that this voluntary resignation might be wrongful or in violation of the operating agreement. This situation prevails in a number of states. In Delaware, however, a member only has the right to resign if it is stated in the operating agreement. Absent special circumstances, we generally recommend against permitting members to resign voluntarily in order to insure the stability of the business.

Death or Dissolution

A member will cease to be such upon the member's death (in the case of an individual) or dissolution (in the case of an entity). In a corporation, neither event would have any automatic impact (the heirs or successors would simply succeed as owners of the shares) absent a contrary provision in a stockholders agreement. Under many LLC statutes, death or dissolution still results in dissolution of the LLC although the LLC may be continued, and liquidation of the business avoided, if the remaining members decide to do so. In Delaware and some other states, death or dissolution does not automatically result in dissolution of the LLC. However, even in the case of a corporation, it may not be practical to continue to operate with the heirs or successors as owner. This is particularly true of a business in which the participation of each member is important, in which case it would not be appropriate to have a passive investor as a member. In this case, the only practical alternative to dissolution or liquidation of the LLC may be to have the LLC redeem the interest of the dissociated member.

Bankruptcy or Insolvency

It is customary to provide for the automatic dissociation of a member that becomes bankrupt or otherwise is insolvent. However, such a provision may not be binding on a bankruptcy court. A trustee in bankruptcy may have the right to avoid such a provision if the trustee is not satisfied that the provision for the redemption of the membership interest is fair to creditors of the bankrupt member.

Redemption and Valuation

A threshold question with respect to redemption is whether the LLC is likely to have the liquidity to pay for the dissociated member's interest regardless of its valuation. Under most LLC statutes, one may provide for a payout of the redemption amount over an extended period of time, but even the incurrence of that type of liability may put a significant strain on the business. Liquidity may be enhanced by appropriate planning, such as obtaining life insurance for the benefit of the LLC on the life of each individual member. Assuming liquidity is adequate, there remains the problem of valuing the dissociated member's interest. One may always look to the book value of the interest (or the member's capital account in the context of an LLC) but, in a going concern, this is unlikely to reflect the full fair value of the interest. There are a number of other ways in which a membership interest may be valued, such as:

- An annual valuation of the business or at least of its key assets. The principal risk in this approach is that the members may fail to do this on an annual basis, in which case the valuation may be significantly out of date.

- Valuation by formula. A business is often valued in relation to an indicative financial or operating performance measure or anticipated income stream. If the members are confident that past history is predictive of the future, one may value the company, and therefore the interest, as a multiple of the LLC's recent earnings (a three-year period is a frequent reference). A host of relevant financial or operating measures (*e.g.*, earnings multiple, sales multiple, number of customers, number of stores) may be appropriate for valuation purposes.

- Third-party valuation. It is possible to have the business valued by an individual knowledgeable about such businesses (who should be identified at least by title in the operating agreement) or by a professional organization, such as an accounting firm, a business valuation professional, or an investment banker.

Directors, Officers and Managers

As mentioned above, a limited liability company may, but is not required to, act through directors, officers and/or managers. Directors, officers and managers are normally individuals but there is no general requirement that they be citizens or residents of the United States or a particular state (although visa requirements do apply to non-citizens and non-residents). None need be members.

Board of Directors

A corporate model LLC has a board of directors elected by the members which often operates in a manner similar to that of a board of directors of a corporation. Thus, the directors usually make decisions and set policy acting as a group, meeting in person or through the use of a conference telephone. They may also act through consent resolutions with whatever majority is specified in the operating agreement. In addition, unlike a corporation, there is no requirement that directors participate personally in meetings. Therefore, an operating agreement may provide that directors can act through proxies or may provide for alternate directors or substitute directors, however unusual in the United States.

Officers

Limited liability companies organized on a corporate or hybrid model may provide for officers to actually conduct the company's business. As noted above, this may be advantageous in dealing with parties who are used to dealing with the "president" of an entity. The officers will be appointed by the members or board of directors (depending on the model chosen) and will typically be removable by them at any time. Officers generally consist of a president and secretary, and possibly one or more vice-presidents, and a treasurer. The president typically acts as chief executive officer of the LLC although one may opt for a chairman of the board of directors to hold this position. As chief executive, the president has broad powers to represent the LLC in the ordinary course of its business. However, any significant corporate

action, including most dealings with real estate and with financial institutions, require express approval by the board of directors, unless otherwise provided in the operating agreement.

Managers

In a hybrid model LLC in which the members elect a manager or managers to operate the business, the managers generally exercise broader authority than would persons designated as officers. In most states, managers may exercise all company powers not reserved to the members in the operating agreement. Moreover, in many states, third parties are entitled to rely on the broad authority of a manager unless the third party has actual knowledge of limitations imposed on the manager's authority in the operating agreement. Thus, it is more difficult to restrict the actual or apparent authority of one designated as a "manager" than would be the case of one designated as "president." Managers may themselves represent the company or may delegate authority for the day-to-day conduct of the company's business to other employees.

2.4.2 Governance of the Limited Liability Company

Liability of Members

Businesses are conducted as limited liability companies primarily in order to secure the benefits of limited liability. Accordingly, the investment that a member makes in a company is necessarily at risk but the member ought not to be responsible for the liabilities or losses of the company beyond that investment. However, even in the case of a corporation, creditors may "pierce the corporate veil" and hold the stockholders liable for corporate debts under some circumstances. The limited liability company is a relatively new form of entity in the United States, but it seems likely that the same principles will be applied to them as apply to corporations. Thus, if the separate existence of the limited liability company is not respected, there is a risk that creditors are able to disregard the company and recover from the members any damages. For further analysis of piercing the corporate veil, please see Section 7 (Preserving Limited Liability).

Responsibilities of Officers and Directors

The subject of fiduciary duties owed by managers in a manager-managed LLC, or members in a member-managed LLC, is an emerging and complex topic, the details of which are beyond the scope of this handbook. However, the Delaware limited liability company statute was recently amended to clarify that the parties

may define by contract their responsibilities and duties, including fiduciary duties. In particular, the Delaware LLC statute provides that a "member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing." Furthermore, the statute provides that, unless otherwise specified in the LLC agreement, a person (*e.g.*, a member or manager) is not liable to the LLC or another person (*e.g.*, another member or manager) for breach of fiduciary duty for the person's good faith reliance on the provisions of the LLC agreement. This suggests that disgruntled members would need to bring claims for breach of contract, rather than breach of fiduciary (or other) duties owed if those duties are not specified in the LLC agreement.

2.5 Financial Matters

In the United States, the law governing limited liability companies has few mandatory rules with respect to the financial management of the LLC.

2.5.1 Approval of Balance Sheet and Management

It is not required (or customary) that the members approve the balance sheet and annual profit and loss statement. Moreover, the annual balance sheet is not published except in the case of companies whose shares are publicly traded (which are almost always corporations, not limited liability companies). In addition, it is not customary or necessary for the members annually to approve the actions of the managers or officers or to release the managers or officers from liability for their actions.

2.5.2 Reserves

US law establishes no compulsory reserves of any kind. Generally accepted accounting principles may require the setting-up of certain reserves, such as for bad debts, on a company's balance sheet, however.

2.5.3 Distributions

Limited liability company law in the United States has few mandatory rules with respect to the financial management of the company but distributions may only be made if they would not impair the Company's financial condition.

2.5.4 Profit and Loss Allocations

In a limited liability company, profits and losses can be allocated among the members without regard to the members' equity interests or voting power (a so-called "special allocation"). However, if an allocation of profits and/or losses not in accordance with equity interests is to be respected for US income tax purposes, the tax allocation must reflect the actual economic relationship between the members. This rule only rarely presents problems in practice but may require the inclusion of lengthy tax provisions in the operating agreement.

2.5.5 Tax Matters

There is no special tax regime for limited liability companies as such. A limited liability company in the United States may be taxed as a corporation or a partnership (or a disregarded entity, in the case of a single member LLC) at its option. If taxed as a corporation, the company must itself pay taxes (at corporate rates) on its income. If taxed as a partnership, the company is not itself subject to US income taxation but only acts as a conduit. This tax treatment is determined simply by checking the appropriate box on the LLC's tax return. It is not affected in any way by the model chosen. In other words, a corporate model may be taxed as a partnership and a partnership model may be taxed as a corporation.

From the point of view of a non-US investor, structuring a limited liability company as a partnership will cause the investor/member to be taxed as if it were operating in the United States through a branch, but at the same time enjoy limited liability. Such an arrangement will likely subject the investor to the US branch profits tax, which can subject a non-US investor to higher current US taxes and a loss of flexibility in timing the payment of dividends. A detailed discussion of whether operating as a branch is advantageous is beyond the scope of this Handbook and should be addressed in the context of each particular investor, its country of origin, and the nature of its proposed investment or operations in the United States. Some of the basic issues in this tax analysis, however are discussed in Section 8 (Income Tax Issues).

3. Limited Partnerships and Limited Liability Partnerships

Generally, a partnership is an association of two or more persons to carry on a business for profit. A partnership is typically a pass-through vehicle, that is, it is not itself subject to taxation. Rather, its income is taxed directly to the partners. However, if desired, a partnership may elect to be subject to tax as if it were a corporation.

Partnerships may be either a general partnership or a limited partnership. All of the partners in a general partnership, the general partners, are entirely liable for the debts of the partnership. Because of the focus upon limited liability in US business entities, the general partnership will not be discussed herein.

Limited partnerships consist of two species of partners: general partners, who are subject to unlimited liability, and limited partners, whose liability is limited to their contribution to the limited partnership. General partners have the same rights, liabilities, and powers as partners in general partnerships. Thus, the ordinary principles of partnership apply: general partners manage the partnership, share in the partnership's profits and losses and have unlimited personal liability. In contrast, the limited partners' liability is limited to their investment in the business. The desirable limited liability status of limited partners, however, comes at a price: limited partners generally have to abstain from participating in managing the business. Therefore, limited partnerships provide individuals the opportunity to invest in a business in return for the share of the profits and still avoid personal liability for the business's debts.

It is common to structure limited partnerships with a corporate general partner. Although limited partners normally may not directly manage the limited partnership without jeopardizing their limited liability, they may engage in management indirectly through a corporate general partner. Delaware and a number of other states specifically provide that a limited partner's acting as a director or officer of a corporate general partner will not constitute participation in management for liability purposes. The investor or investors may be the shareholder or shareholders of the corporate general partner and also be the limited partner or limited partners in the limited partnership. In this structure, the investors would control the corporate general

partner by appointing its directors and officers. While the corporate general partner's assets would be at risk, this structure means that the investors would have limited their liability to their respective investments in the enterprise.

Unlike an ordinary general partnership, a limited partnership may not be formed by anything less than deliberate action. In every state, there are statutory requirements which have to be complied with to form a limited partnership. Instead of individually drafting their respective limited partnership acts in isolation, almost all states have enacted the Revised Uniform Limited Partnership Act. Thus, the differences from state to state are minute. Most state statutes require a limited partnership to file a certificate with the information specified by its state of organization, to appoint and maintain an agent for service of process in the state, and to make filings if it amends or cancels its certificate. Out-of-state limited partnerships generally will be permitted to be licensed to do business upon filing the appropriate application with the state where it wishes to expand its business.

Recently, almost all states have enacted legislation allowing general partnerships to register and thereby shield their partners from some or all liabilities. In Delaware, Illinois and certain other states, the partners will not have any personal liability for any partnership obligation incurred after the partnership is registered as a "limited liability partnership." (The liability shield is more limited in other states, and limited liability partnerships are not available for commercial investments in, for example, New York.) If an investment is contemplated in a state providing a full liability shield for registered limited liability partnerships, this alternative should be considered as an investment vehicle, particularly where investment through a partnership is otherwise advantageous.

General and limited partnerships have long been used for joint ventures but, with the advent of limited liability companies, their use has declined considerably. Nonetheless, limited partnerships are still used for ventures operating in certain states where that form may significantly reduce state taxes on the parties and by non-US investors for whom there may be a non-US tax benefit to operating in the United States in partnership form, see Section 8 (Income Tax Issues).

4. Choice of Entity

Parties seeking to access the US market will often debate whether to utilize a corporation or an LLC. While an LLC is similar to a corporation from a limited liability perspective, and both entities are well respected business organizations, an LLC may be preferable to the corporate form because of its flexibility and its tax attributes. It is generally easier to provide for different financial and membership interests in an LLC than in a corporation as, for example, ownership interests in an LLC may be expressed as units (essentially equivalent to shares) or as a percentage interest in the entity. Currently, however, an LLC's membership interests cannot be traded publicly. Thus, with the exception of a publicly traded entity, an LLC may almost always be substituted for a corporation.

An LLC also enjoys advantages over a corporation with respect to its tax attributes. While the operation of a venture through a corporation typically will involve two levels of taxation (to the corporation itself and then to its stockholders), an LLC may elect to be taxed as if it were a corporation or as if it were a pass-through entity like a partnership. The tax considerations are likely to drive the determination of whether an LLC rather than a corporation is the preferred vehicle for the US subsidiary. However, since both an LLC and a corporation generally provide for limited liability of its owners, an LLC may be preferable to a corporation for the US subsidiary from a flexibility perspective. Moreover, as mentioned above, an LLC can assume the structure of a corporation, and thus can have officers and directors.

However, for certain non-US investors, utilization of a partnership may provide significant tax advantages. The details of this tax-savings possibility are described briefly in Section 8 (Income Tax Issues). In addition to those potential tax benefits, a limited partnership or a limited liability partnership provides the benefits of limited liability of a corporation or LLC. Moreover, a limited partnership is an equally-respected business entity in the US business community and market. This structure is commercially feasible, increasingly used by purely US-owned business and provides limited liability. The limited partnership form generally poses no significant problem with respect to supplier, customer or bank acceptance.

Further, by operating through a Delaware limited partnership with a corporate general partner, the investor or investors would be shielded from direct liability

(which would be limited to their capital contributions to the entity). Use of a corporation as a general partner in a limited partnership should likewise result in limited liability for the corporation's stockholders even though the corporation itself has unlimited liability for the obligations of the limited partnership. Therefore, except in extraordinary circumstances which justify piercing the corporate veil, discussed further in Section 7 (Preserving Limited Liability), the exposure of the corporation's stockholders should be limited to their equity investment in the corporation.

5. Branches

It is possible for a non-US corporation to operate a branch office in the United States, but there are significant disadvantages to a branch, particularly with respect to its tax treatment and liability. For a brief overview of the tax disadvantages please see Section 8 (Income Tax Issues). For a discussion of liability concerns please see Section 7 (Preserving Limited Liability).

Branches of non-US corporations are not subject to federal regulation or registration requirements. However, each state will require a "foreign" corporation to qualify before "doing business" in that state. A corporation will be considered "foreign" if it is organized under the laws of another country or another US state, and so this is not a requirement imposed solely upon non-US investors. "Doing business" is a technical term that implies a substantial presence in the state. Thus, examples of "doing business" include the ownership or leasing of real property, the maintenance of a stock of goods for local sale, employees, etc. Selling products to local customers, either directly or through an independent sales representative or distributor, would not in itself constitute "doing business."

States actually exercise little control over the qualification process other than to ensure that the qualifying entity's name is not confusingly similar to an already registered entity and that all registration fees and taxes are paid (qualification is basically a form of taxation). In most states, qualification for a non-US corporation consists of a relatively easy application, a registration fee, and a notarized or legalized copy of the corporation's articles of incorporation (in English or accompanied by a certified translation). The burdens deriving from being considered as "doing business" in a state are not particularly onerous, although it likely also results in an obligation to file state income tax returns and pay related taxes.

6. Subsidiaries

Most often, investment in the United States is done via a subsidiary (whether as the vehicle to implement an acquisition, or to conduct day-to-day operations in connection with a direct investment by means other than an acquisition). Recall that the formation of business entities is not subject to extensive federal regulation or registration procedures. Corporations, LLCs and other entities are organized under state law. As discussed previously, it is fairly easy to organize a corporation, partnership or an LLC. No administrative or court approval or appraisal of non-cash contributions is required, and so either form of entity may be organized in 48 hours or less.

A US subsidiary will provide significant flexibility for US operations and protection for the investor. A subsidiary provides great financial flexibility and the existence of a US subsidiary will generally not subject the foreign parent to jurisdiction in US courts. However, exposure may arise if the plaintiff successfully pierces the corporate veil. For a more detailed discussion regarding issues of limited liability, please see Section 7 (Preserving Limited Liability). A corporation or LLC may also be used for a joint venture. In many cases, however, the US participant will prefer an LLC or a limited partnership for tax reasons.

7. US Joint Ventures and Strategic Alliances

The term joint venture or strategic alliance encompasses any ongoing cooperative relationship between businesses. As such, a joint venture may assume any one of many forms from that of a purely contractual relationship to that of organizing a new entity, and may be referred to as a joint venture or strategic alliance. While a range of forms constitute a joint venture, joint ventures typically involve some sharing of profits and an ongoing relationship.

Where the parties to the arrangement determine that it will be in their best interest to form a separate legal entity for purposes of conducting the venture, it will be important to consider the features and attributes (in particular, tax attributes) of the available types of entities described earlier in this section in more detail. Limited liability companies are frequently utilized given their flexibility with respect to addressing financial, tax and management issues. Please see Baker & McKenzie's

International Joint Ventures Handbook, which contains practical guidance to assist the business and legal teams when assessing, structuring and implementing joint ventures, for further information.

SECTION 5
PRODUCT LIABILITY LAW

As distribution systems become more efficient and legal systems more sophisticated, the number and cost of such claims rise dramatically. The development of effective company systems to deal with claims – to make products safer – and, thus, to lower costs, is imperative.

More than any other jurisdiction, the United States has developed legal concepts and substantive rules of law to provide compensation for injuries or damages sustained by consumers and other product users. As a result, the expense of insuring against such claims has risen considerably.

The United States has a federal system of government. Under this federal system, the laws of the fifty separate states (along with that of US territories and the District of Columbia) co-exist with the national or federal law. While certain conduct is regulated by both federal and state law, the states are traditionally left to regulate certain areas exclusively. Generally, such areas include the right to promulgate jurisdictional rules and standards of conduct which apply to manufacturers whose products have certain "contacts" with a state's geographical boundaries. While the laws of each of the fifty states are essentially similar in the obligations they impose upon product manufacturers and other sellers, there are often subtle differences.

The discussion in this chapter gives a broad overview of jurisdictional and liability issues that a foreign manufacturer is likely to face if forced to defend a products liability suit in the United States.

1. Comparison with Foreign Jurisdictions

Practically every jurisdiction in the world provides a potential remedy for a person injured as a result of a defective product. Foreign manufacturers selling or distributing their products in the United States should exercise particular care because United States product liability law is, in numerous respects, strikingly different from the law in most foreign jurisdictions. In virtually every respect, these differences are favorable to the plaintiff and enhance the plaintiff's likelihood of a recovery. The principal substantive distinctions are discussed below.

1.1 Theories and Defenses

As discussed in detail below, the vast majority of states have adopted the doctrine of strict liability in tort. Certain characteristics of the doctrine of strict liability may differ from the rules prevailing in many foreign jurisdictions. In particular, foreign manufacturers selling or distributing their products in the United States should not expect to defend product liability actions on the basis that: (a) the plaintiff may be unable to prove negligence on the part of the manufacturer; (b) the plaintiff may have been contributorily or comparatively negligent with regard to the use of the product; or (c) the plaintiff has not had any contractual or other direct relationship with the manufacturer.

1.2 Damages

There also are certain significant distinctions in the nature of damages available to a US product liability plaintiff:

1.2.1 Compensatory Damages

Product liability plaintiffs in the US, like product liability plaintiffs in most of the rest of the world, can recover compensatory damages for economic damages such as medical costs, lost wages and property damage and for non-economic damages such as pain and suffering and emotional distress.

The principle difference in regard to compensatory damages is quantitative rather than qualitative. In general, a US plaintiff has the potential of recovering a much larger amount of compensatory damages. In cases involving serious physical injury, recoveries of compensatory damages ranging from hundreds of thousands of dollars to millions of dollars are not at all uncommon. The rationale for such relatively large recoveries often is attributed to the jury system and to the absence in the United States of a highly-developed social network providing universal protection for certain of the risks for which compensatory damages otherwise provide compensation.

1.2.2 Punitive Damages

Punitive damages are damages intended not to compensate the injured party but to punish the wrongdoer. They generally are awarded only when the wrongdoer intends to cause harm or engages in acts that the wrongdoer knows or should know are very likely to cause harm.

Punitive damages are completely unavailable in almost all jurisdictions outside the United States. Although the risk of punitive damages may not be great, the possibility that they may be awarded in US product liability litigation is a material distinction for foreign manufacturers entering the US market.

2. Overview of US Product Liability Law

Plaintiffs in a US products liability case generally may pursue a claim under three theories: negligence, breach of warranty, and strict products liability. In most products liability cases, the plaintiff is free to assert any one or all of these theories of liability against a defendant.

2.1 Negligence

It is axiomatic that a person is responsible for his own carelessness. Generally, as a matter of law, one is deemed to be negligent if he fails to use the same care, skill, and diligence in and about the process of manufacturing that a reasonable, skillful, and prudent person would use under similar circumstances. The circumstances which may constitute negligent manufacture are infinite. Whether negligence occurred is usually a question of fact to be decided by the trier of fact. In US jurisprudence, this means either a single judge or, at the option of one of the parties, a jury of 6 to 12 individuals drawn from the community.

2.2 Warranty

In the area of sales of goods, two types of warranties exist – express warranties and implied warranties. An express warranty is generally defined as any written or oral statement or representation made by the seller about the product. An express warranty may be created by a salesperson's statement that a product, for example, is "safe if used in accordance with the manufacturer's instructions." An express warranty may be created if literature distributed with the product, or contained in advertising materials, makes certain representations, such as a gas engine manufacturer's promotional materials describing the product as "safe," "simple," "reliable," and involving "no danger."

If, for example, the consumer is shown a model or sample, and the product does not conform to that model or sample, the seller has breached an express warranty.

There are two types of implied warranties – the implied warranty of merchantability and the implied warranty of fitness for a particular purpose. By the terms of the UCC, these warranties, unless modified or excluded, apply to all sales when made by a merchant in the business of selling goods of that kind. To be merchantable, goods, among other things, must be fit for the ordinary purpose for which such goods are used, must be adequately packaged and labeled, must, if fungible, be of fair average quality, and must conform to any factual promises made on the container or label. A seller breaches a warranty of fitness for a particular purpose if he knows of the particular purpose for which the goods are required and the goods are not fit for that purpose. It should be emphasized that the implied warranties of merchantability and fitness can be excluded or modified but, generally, only if done in writing and in strict conformity with the UCC's requirements.

2.3 Misrepresentation

In view of the availability of other grounds for recovery – and especially those discussed under strict liability below – a recovery under a theory of misrepresentation, although permissible, is relatively rare. It is far more difficult to prove that a seller negligently or deliberately lied concerning his product than to demonstrate mere negligence in design or strict liability. Nevertheless, it is obvious that a manufacturer or other seller is not entitled to lie about the goods or to make willful, or even negligent, misrepresentations about them. A seller, for example, who described a used soda fountain as "dead" and "harmless" was held liable for negligent misrepresentation when the unit exploded.

2.4 Strict Liability in Tort

One of the leading authorities of US tort law defines strict liability as follows:

> "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 was sold."

Under this generally accepted definition, a product is in a defective condition if, at the time it leaves the manufacturer's hands, it is in a condition not contemplated by

the ultimate consumer which makes it unreasonably dangerous. A product is deemed to be unreasonably dangerous if it is dangerous to the extent beyond which would be contemplated by the ordinary consumer who purchases or uses it.

The precise definition will depend on the particular facts of each case and the law of the state. For example, California has refused to follow the "unreasonably dangerous" requirement and instead, allows a plaintiff to recover in strict products liability upon establishing that the product was merely "defective." Under this approach, a product is defectively designed if the plaintiff proves that (1) a product is not safe as an ordinary consumer might expect when the product is used in an intended or reasonably foreseeable matter, or (2) the product's design was the proximate cause of the injury and the defendant fails to prove that the benefits of the product as designed outweigh the inherent risks in such a design. In essence, under California law, a product must meet at least ordinary consumer expectations as to safety to avoid being found defective. This approach has influenced many other states; although few, if any, completely adopted it.

The popularity of the strict liability theory is readily explained in terms of the plaintiff's burden of proof. The plaintiff is required to demonstrate only that his injury was caused by a product sold in a defective condition which renders the product unreasonably dangerous. If this is proved, the facts that the manufacturer exercised prudent care in the manufacture of the product, or that the plaintiff was contributorily negligent, are not defenses. The focus of a suit brought under a theory of strict tort liability is on the condition or character of the product rather than on the nature of the defendant's conduct. Likewise, the injured party need not be in contractual privity with the seller to recover. For example, the manufacturer of a component part used in the assembly of a product may be liable even though that manufacturer of the component part never dealt with the ultimate user.

It is also important to note that strict liability is not to be equated with absolute liability. Indeed, the manufacturer is not an insurer for all injuries caused by its products. Nevertheless, the imposition of strict liability is justified on the grounds that the manufacturer is almost always better equipped than the consumer to endure the economic consequences of accidents caused by defective products. In the United States, economic responsibility for the debilitating consequences of injuries caused by defective products is considered one of the many costs associated with doing business and earning profits. Indeed, courts are not likely to find unfairness in holding manufacturers economically responsible for injuries

caused by products they place in the stream of commerce. Most courts have determined that the policy concerns underlying strict liability in tort justify holding a manufacturer liable without regard to the reasonableness of the manufacturer's conduct.

There are three generally accepted ways to establish a claim for strict liability in tort: (1) proof that the product was the result of an aberration in the defendant's normal manufacturing process or a manufacturing defect; (2) proof that the product was designed defectively so as to create an unreasonably dangerous product; and (3) proof that the manufacturer failed to give adequate warning about the dangerous propensities of the product.

2.5 Manufacturing Defect

Manufacturing defects arise when a condition of the product unintended by the manufacturer causes harm. A recent publication on US product liability law discussed manufacturing defects as follows:

> "By their very nature, these types of defects consist of qualitative deficiencies in the product involved compared with other kindred products produced by the same manufacturer. A product is defective if it fails to match the average quality of like products. These defects are of a type that are unintended by the manufacturer. Such unintended defects include missing parts, inferior parts, and impure ingredients."

The plaintiff, in order to meet his burden of proof that a construction or manufacturing defect existed, can satisfy that burden by the utilization of direct evidence or circumstantial evidence. Direct evidence is evidence of a particularly injuring causing defect such as a metallurgical defect in a coupling whereas circumstantial evidence, as one commentator explained, "is the proof of facts and circumstances from which the trier of fact may infer other connected facts which usually and reasonably follow according to the common experience of mankind. This type of evidence is normally employed when the plaintiff is unable to identify a particular flaw in an injury producing product, but is able to establish that the product failed to perform in the manner reasonably expected in light of its nature and intended function."

2.6 Design Defect

The primary inquiry in a design defect case is whether the product – because of the way it is designed – creates an unreasonable risk of danger to the consumer or user when put to normal use. To establish liability in a design defect case, the plaintiff bears the burden of showing that the product, as designed, is unreasonably dangerous and therefore "defective," and that the demonstrated defect caused his injuries. The courts have had much difficulty in establishing a uniform test for a design defect. One commentator has even suggested that the determination of when a product is actionable because of the nature of its design appears to be the most agitated and controversial question before the courts in the field of products liability. Several states, however, have each attempted to formulate practicable tests to apply to the often complex factual scenarios of a design defect case.

Some states have adopted the test that a product's design is defective for the purposes of imposing strict liability when it is shown by a preponderance of the evidence that the design renders the product unreasonably dangerous. Other states take the approach that a product's design is defective if, after balancing the product's risks against its utility and cost, the former outweigh the latter. Still other states hold that a product is defectively designed if the extent of a product's danger exceeds the expectations of an ordinary consumer. In some jurisdictions, a plaintiff may establish that a design is defective by showing an alternative design that was safer, available, and practicable in terms of the products' cost and its overall design and operation.

2.7 Duty to Warn

Failure to warn a consumer of a product's potential hazard is another theory of strict liability important enough to merit its own discussion. It may be that the duty to warn is the most widely used claim in modern products liability litigation. Despite a product being unerringly designed, manufactured, and assembled, a failure to warn of a product's potential risks or to provide appropriate instructions as to its safe use can lead to liability for injuries caused by the product's intended or reasonably foreseeable use.

In general, a seller or manufacturer has a duty to warn users and consumers, in its labeling and instructional material, of any conditions in the product which could cause injury or damage. A manufacturer also has a duty to inspect his product, and

this duty extends to products manufactured by others, which are component parts of the product produced by the manufacturer. These same principles impose upon the manufacturer a duty to test its product when such testing is reasonably necessary to assure product safety. The extent of a manufacturer's duty to inspect and to test depends on the facts and circumstances and will vary with each individual case.

Similarly, the extent of the duty to warn of any product dangers will vary depending upon the facts of each case and the particular product manufactured. Generally, a manufacturer or seller is obligated to warn of product-connected dangers of which he has actual or constructive knowledge and will be liable for a failure to warn if he knows or has reason to know that the product is likely to be dangerous for the use for which it was supplied and if those who use the product will not realize its dangerous condition. The question of how dangerous a product must be before a duty to warn arises has been the source of much litigation. Generally, the duty will be unaffected by the fact that few injuries result from use of the product. Failure by the manufacturer to warn of such dangers might also give rise to a claim for punitive damages, if corporate complicity in not communicating a warning can be proven.

In a strict liability failure to warn case, the first issue is whether the defendant owed the plaintiff a duty to warn. If it did, the next issue is whether the information accompanying the product effectively communicates the dangers of the product that are present during normal use. In order for a necessary warning to be adequate, the warning must be calculated to impress upon a reasonably prudent user of the product the nature and extent of the hazard involved.

The manufacturer's legal duties do not cease once the product is sold. A manufacturer has a duty to warn users after sale of the product even if the defect was discovered after the initial sale if the manufacturer has actual or imputed knowledge of the defect. Thus, a manufacturer may be liable if it ought to have recognized a danger due to accident reports or complaints received after sale and failed to issue an adequate warning. This continuing duty makes record keeping essential. A manufacturer must not only monitor all complaints about its product but also, after consultation with legal counsel, should issue a warning to users if such a warning is necessary. The form of the warning and the means of communicating it to buyers or users will vary depending upon the type of product and the type of defect. Each case must be

examined on its own peculiar facts. If, for example, the warning concerns the method of operation of a machine, amendments to the standard instruction manual might be necessary.

3. Defenses Under Strict Liability

Although the plaintiff has certain advantages when prosecuting a claim under the theory of strict liability, there are still some defenses which a manufacturer may assert. These defenses include lack of proximate cause, state-of-the-art, statutes of limitation, and statutes of repose.

3.1 Proximate Cause

Although proximate cause is technically not a defense, it merits discussion given the success defendants have in defending cases on this basis. The plaintiff in a strict liability case must establish that the defective condition proximately caused the plaintiff's injury or damage. Generally, this requires proof that the injury or damage flowed from an unbroken sequence of events commencing with the failure of the defective product and ending with the injury. In most states, however, the plaintiff need not demonstrate that the defect was the sole cause. The plaintiff must prove only that the defect existed, and that it, perhaps combined with other causes, caused the damage or injury. Issues of proximate cause are usually considered questions of fact to be decided by the jury. Proximate cause cannot be based upon surmise or conjecture, and a plaintiff's failure to present enough evidence at trial on this issue can be fatal to a plaintiff's case.

3.2 State-of-the-Art

Some states allow defendants to escape liability if they conduct state-of-the-art testing procedures before releasing a product. Generally, the term state-of-the-art refers to technical and scientific knowledge existing as of a specific point in time. This defense is invoked particularly in cases involving mechanical defects.

In other states, evidence that the product's technology is state-of-the-art, while not an affirmative defense, is admissible in proving the absence of a defect. Some states, like Illinois, for example, reject the state-of-the-art defense entirely.

3.3 Statues of Limitation

The statute of limitations defense is particularly important because it is a complete defense which, if raised successfully at an early stage in the proceedings, can result in resolution of the dispute without the substantial expense and inconvenience of discovery and trial. Essentially, a statute of limitation sets a legal time limit for bringing a lawsuit. The applicable limitation period varies from state to state and also varies depending on the type of claim asserted.

Difficult questions often arise concerning when the limitation period begins to run, and which statute of limitation is applicable in a given case. Generally, a cause of action in tort does not accrue, and thus the statute of limitation does not begin running, until the date on which the plaintiff discovers his injuries were caused by a defect in the product. This tolling of the limitation period is referred to as the discovery rule, which many states follow. While a cause of action may be barred by the statute of limitation applicable to strict liability actions, this might not bar a plaintiff from bringing a cause of action based on either a negligence or breach of warranty theory. Furthermore, if the plaintiff is incompetent or under the age of majority at the time a cause of action accrues, or if a defendant fraudulently prevents a plaintiff from discovering the existence of a viable cause of action, this will prevent the statute from running.

3.4 Statutes of Repose

In view of the increasing cost of obtaining products liability insurance that manufacturers must procure, statutes of absolute repose have been enacted in a number of states. Statutes of repose establish a fixed time period within which a strict products liability suit must be brought or be forever barred. Repose statutes provide a definite time period after which manufacturers are not strictly liable in tort for injuries caused by the products they manufacture. The policy underlying statutes of repose is to reduce the risk and uncertainty regarding liability for acts committed long ago. Statutes of repose generally start running from the date of manufacture, delivery or sale of the product. The time periods vary from state to state, as do the dates on which the time periods begin to run. Many states provide, however, that even if the statute of repose bars a strict liability claim, the plaintiff can still initiate a negligence cause of action.

3.5 Assumption of the Risk

Assumption of the risk in most jurisdictions is an affirmative defense which must be specially pleaded and supported by the defendant. State laws differ on the effect of this defense as in some states it might bar the user completely from recovering if it is found that he "assumed the risk," whereas in other states using modified comparative fault or pure comparative fault, it will reduce the plaintiff's recovery by the amount of fault ascribed to the plaintiff's conduct by the jury.

Pure comparative fault is a doctrine wherein even if a plaintiff is 99% at fault in producing his own injury he could still recover 1% of his damages from a defendant. In modified comparative fault jurisdictions, by contrast, if the trier of fact finds that the contributory fault (*i.e.*, assumption of the risk) of the plaintiff is more than 50% of the proximate cause of the injury or damages for which recovery is sought, the plaintiff will be barred from recovering damages.

Under the doctrine of assumption of the risk, the plaintiff must not only be consciously aware of the specific defect which would cause the injury, but the plaintiff must also be aware of the potential danger and harm which he would encounter by using the product and, with that knowledge of the defect and the harm, it must be shown that he voluntarily and unreasonably proceeded to expose himself to the risk. The defendant by virtue of the affirmative defense has the burden of proving all of those elements in order to prevail on that defense. Since the defense embodies the concept that the plaintiff voluntarily proceeded at his own peril, it is difficult to imagine a fact pattern which would admit an application of the doctrine when the injured plaintiff was a non user such as a bystander.

In determining whether the plaintiff appreciated the risk of the defect, knew of the defect, and voluntarily encountered it, the judge in a bench trial or the jury in a jury trial is entitled to take into account the plaintiff's experience, knowledge, age, understanding of the obviousness of the defect, and the danger it poses.

Often through pretrial discovery, defense counsel will discover a memorandum or an operating procedure bulletin or similar document which evidences the user's knowledge of the claimed defect. From the manufacturer's or distributor's point of view, this makes it essential that users promptly be notified of any defects discovered in the product. A user's continued utilization of the product after such a warning is clearly communicated may well give rise to a valid defense to a strict liability claim.

3.6 Misuse

Misuse of the product is defined as conduct by the user of the product in a manner which was neither intended nor foreseeable by the manufacturer of the product. In some states, the defense of misuse of the product is an affirmative defense whereas in other states the plaintiff must prove that he did not misuse the product. The theory behind the doctrine of misuse is that an unforeseeable and unintended misuse of the product disrupts the causal connection between the product and the plaintiff's injury. This in turn "places proximate cause in issue; without proximate cause there can be no liability."

3.7 Seller and Distributor Exception

In some states, a seller, distributor or other non-manufacturing defendant once he identifies the manufacturer of the alleged product, can have the strict liability in tort action dismissed against him. Again, like some statutes of repose mentioned above, the dismissal of the non-manufacturing defendant solely relates to the strict liability count, which would still allow the plaintiff to proceed with counts based on warranty or negligence. Additionally, if the plaintiff is able to show at any time subsequent to dismissal that the applicable statute of limitations or statute of repose bars an action against the manufacturer, that the identity of the manufacturer was incorrect, that the manufacturer no longer exists or could not be subject to the jurisdiction of the court, or that the manufacturer is either unable to satisfy a judgment as determined by the court or would be unable to satisfy a reasonable settlement or other agreement, then the court can reinstate the action against the non-manufacturing defendants. Additionally, the non-manufacturing defendant cannot be dismissed if the plaintiff is able to show that the defendant (i) exercised significant control over the design or manufacture of the product, (ii) had provided instructions or warnings to the manufacturer relative to the alleged defect which caused the injury, death or damages, (iii) had actual knowledge of the defect in the product which caused the injury, death or damages, or (iv) created the defect in the product which caused the injury, death or damages.

The laws of the individual states should be consulted to determine the rules regarding dismissal of the non-manufacturing defendant in a strict liability cause of action.

3.8 Specification Compliance

Some states allow the manufacturer to defend a strict liability action by proving that he complied with specifications provided by a third party such as the federal government, a state or governmental entity, or that he manufactured the product in strict conformance of the specifications supplied by another. The exception to this defense is if the plaintiff is able to show that the specifications were so obviously dangerous that the manufacturer should not have followed them.

4. Preventing Product Liability Lawsuits

The prevention of potential product liability claims should be foremost in the mind of the manufacturer and can best be achieved by careful quality control and scrutiny of procedures during manufacturing, distribution, and sales. The manufacturer should have knowledge of all appropriate governmental and industry standards pertaining to its product. The US National Standards Institute publishes standards for various articles of commerce and many of those standards are embodied in federal legislation called the Occupational Safety & Health Act, or OSHA. Additionally, the Consumer Products Safety Act, or CPSA, contains various standards and regulations regarding consumer products.

4.1 Quality Control and Scrutiny of Procedures for Manufacturing, Distribution, and Sales

There should be careful maintenance of documentation and specifications submitted to the manufacturer by component part manufacturers and, of course, by the purchaser, regarding the quality, placement, nature, and design of the component parts in the finished products. If at all possible, a quality control manual should be afforded to certain of the manufacturer's personnel so that even if the detailed records regarding quality control are misplaced or lost, someone will be able at least to refer to the manual and testify that the customary practice was to follow the procedures set forth in the manual. The manual should be periodically updated and revised, and all original documents and revisions should be maintained to demonstrate that the company strives to keep up-to-date with technological improvements and changing standards. Quality control sampling on all items used in the product, including incoming raw materials, component parts, finished products, packaging, storing, and shipping should be encouraged. This would fall within the jurisdiction of the manufacturer's quality control department and is an essential item in limiting the risks involved with the product.

4.2 Warnings, Warranties, Instructions, and Other Literature Distributed with the Product

Proposed warranties and guarantees must be reviewed by technical personnel and by legal counsel in light of governmental regulations regarding the legal effect of such warranties and guarantees and the duties of those giving such assurances. The warranties and guarantees should be in compliance with the appropriate legislation, and, if they contain disclaimers of consequential damages, those disclaimers should be conspicuous and in accordance with the provisions of appropriate statutes. Sales personnel should be instructed to refrain from making warranties or guarantees as to the performance capabilities of the product as certain legislation, such as the UCC, might transform what the salesman believes to be bragging or puffing into an express warranty.

There should be coordination among the various departments of the manufacturer regarding what warnings, labels, and instructions are either applied to the product or sent to the consumer. The customer should be advised as to all improved safety procedures, warnings, and technological advances. Instructional brochures not only should discuss safe operating procedures and depict the same but also should point out unsafe practices and their consequences. Warnings should be unambiguous, explicit, and included in a chapter or section devoted to safe and unsafe operation and maintenance of the equipment. Instructional materials should urge that warnings regarding safe and unsafe operation of the product be communicated by the purchaser to every operator of the device in question. On many occasions, in product liability cases, the warnings were communicated to the consumer's management personnel, and no one communicated the warnings to the actual operators or users of the product. If at all possible, materials should contain an operator's brochure regarding safe and unsafe practices in the operation and maintenance of the machinery along with cautionary instructions as to the steps to take if the product malfunctions. Obviously, literature made available to customers should stress periodic inspections and maintenance and should prompt the user to contact the manufacturer if any failures or malfunctions are noted. The same information should be communicated to maintenance or field personnel and salesmen of the manufacturer or distributor who would be required to discuss those particular problems with the user.

4.3 Monitoring and Follow-Up Communications to Purchasers

There must be a careful and detailed procedure by which the manufacturer informs its identifiable customers of new standards and technological advances regarding safety of the product. Some manufacturing companies send such literature by registered or certified mail with return receipt requested, or they have their field salesmen physically deliver and obtain receipts for safety bulletins delivered to the customer.

Procedures should be established regarding the notification of product users and consumers of any hazards which have been found to exist in the product, but the manufacturer before initiating any recall program should analyze the possible consequences of the recall program.

4.4 Preservation of Records

Due to liberal discovery techniques which are available to adversaries in litigation, competent plaintiffs' counsel ordinarily initiate production requests for detailed correspondence and records involving the subject product. The quality control supervisor or the safety supervisor for the manufacturer must keep an index of all test results, complaints, accident reports, quality control reports, and industry and governmental standards. Particularly, if a complaint is received from a user or customer in the field, this information should be disseminated by the head of quality control to those in the technical and production departments so that the problem can be investigated prior to any ensuing litigation. Immediately upon receipt of any complaint, accident, or incident report, appropriate personnel should segregate and safeguard all quality control reports, test reports, invoices, brochures, technical bulletins, warnings, and supplemental safety or technological bulletins.

Various departments should coordinate regarding the warnings, labels, and instructions which were sent to the consumer with the product, and a program should be initiated by which the consumer is kept up-to-date regarding safety and technological improvements which may be offered either by the manufacturer or by others who provide updated safety devices. Some manufacturers, who in the past have found themselves faced with failure to warn allegations in litigation, now indicate on their invoices which accompany the product that warning tags, safety placards, and instructional materials have also accompanied the machinery. At least one major machinery manufacturer in the United States has photographs taken of

every punch press as it is prepared for final shipment to the consumer with the photographs depicting all technical manuals, brochures, warning plaques, and other materials so supplied. Another method which could be used is to have the consumer, when he acknowledges receipt of the product, also acknowledge receipt of the instructional, warnings and safety materials. Warnings, labeling, advertisement, and instructions should be periodically reviewed and either supplemented or updated if the situation so warrants.

One individual should have overall responsibility for maintaining the records for the useful life of the product in question as many lawsuits have been won or lost depending upon the availability of documents regarding the product's maintenance, operation, and safety.

4.5 Summary: Reducing The Risk – What Can Be Done to Minimize Exposure

- Strict compliance with federal and state regulations;
- Provide clear, concise warnings and labels when applicable;
- Implement meaningful, rigorous quality assurance programs to ensure product safety and document them well;
- Careful documentation can greatly bolster defense prospects;
- But don't forget the converse – careless comments can be fatal to litigation defense; and
- The importance of controlling and educating sales, marketing and research staff.

5. Conclusion

The verdict exposures in product liability actions can be quite substantial. Jury verdict awards are often in the millions of dollars, which used to be aberrations 30 years ago, are now common-place. Additionally, awards have also been returned in states such as Illinois, California and Texas in the range of $50,000,000 to over $100,000,000. Nevertheless, the product manufacturer should be heartened by the fact that there are defenses to product liability claims and of course the best

defense is manufacturing a product that is reasonably safe for its intended and foreseeable purposes. The safety conscious manufacturer should continue to advise its retailers, distributors and users of advanced technological and safety improvements in the product.

Recently there has developed a judicial and legislative trend to compensate injured claimants regardless of a particular defendant's fault or causation. This trend is premised upon the assumption that defendants, often corporations, business or other insured groups, are best able to absorb the cost of traumatic injury. Moreover, the liberalization and broadening of the concepts that serve as a foundation of tort and product liability law have made it increasingly difficult to predict the legal result of certain conduct. This lack of predictability is diametrically opposed to the type of informed and rational decision-making that serves as a foundation for successful business growth. Thus, the development of a judicial and legislative philosophy which favors injured persons has impeded attempts by business groups and manufacturers to assess the extent of their legal exposure and to prepare for potential liabilities.

As discussed previously, partial solution to this increasing unpredictability of legal exposure has been the recent trend toward tort reform in several jurisdictions which has resulted in the adoption of statutes of repose, statutes of limitations, and the other defenses delineated above such as assumption of the risk, misuse of the product, non-manufacturer's exemption, and modified comparative fault. Simply stated, tort reform is an effort to improve the mechanism by which civil wrongs are addressed by our system of justice which has been viewed by many commentators as being both out of control and in need of change.

Unfortunately, in spite of tort reform, the dramatic increase in injury awards for both compensatory and punitive damages create an even greater threat to business planning because so often these damage awards are not quantifiable and are therefore extremely difficult to predict.

Finally, and as a caveat, it should be mentioned that the system of law in the United States is based on both statutory enactments and case law precedent. It is an ever changing body of law and therefore the reader is cautioned to seek counsel as to the laws of any particular jurisdiction.

SECTION 6
LABOR AND EMPLOYMENT

US employment laws treat foreign-based employers in the same manner as US companies. There are only selected exceptions to anti-discrimination laws for foreign-based employers. For this reason, a foreign company undoubtedly will need to adapt its personnel policies and workforce management techniques to US law.

1. Potential Liabilities for Terminating Workers in the United States

The greatest number of employment-related claims arise out of the terminations of workers. To avoid these claims, foreign employers and their executives must have an appreciation for the legal risks inherent in the termination process. The following is a brief discussion of the legal rules and statutes implicated by this process.

1.1 The "At-Will" Employment Rule

Although the United States has certain worker protection laws, employees in general have relatively limited rights in the context of terminations when compared to many other nations. The primary reason for this is a legal concept known as the "at-will" employment rule. This rule of law provides that an employer in the United States is free to fire an employee for any reason, without notice, and at any time. The termination can be made without any financial obligation whatsoever to the discharged worker. In essence, an employee works at the will of the employer. As one might expect, the "at-will" employment rule can be quite harsh in its day-to-day application. However, exceptions to the "at-will" employment rule have steadily eroded the doctrine to the point that employers face significant legal restrictions on the ability to fire employees.

1.2 Employment Contracts and Contract-Based Theories

The first and most important exception to the "at-will" employment doctrine is a contract limiting the company's absolute right to terminate a worker. Although written employment contracts are relatively rare in the United States for middle

management and lower level employees, such contracts are fairly common for high level executives or key employees. When contracts are for a specific duration (for example, providing employment for two years), workers generally can be terminated only for "good cause" or "just cause," unless the contract itself otherwise authorizes the circumstances of a termination. Collective bargaining agreements for union employees are similar in principle, at least with respect to termination, although they are quite different in detail.

It is also possible for an employment contract to be created by an "oral handshake." For example, a manager who assures a worker that "you will have a job here as long as your work is acceptable" may well have created a contract of employment with the employee in some states; such an oral contract would prohibit a termination except for just cause. Either type of contract - written or oral - removes a worker from application of the "at-will" employment rule.

1.3 Federal and State Anti-Discrimination Laws

The most important exceptions to the at-will employment rule are set forth in key federal and state statutes. Federal law prohibits discrimination against workers based upon age, sex, national origin, race, color, religion, disability, and pregnancy.

Federal employment discrimination laws are exceedingly broad in scope and protect all types of workers - those who have contracts, those who are employed "at-will," and even those covered by collective bargaining agreements. These laws also protect those seeking employment from discrimination in the hiring process. Employers are not required to hire or promote individuals protected by these laws, or to lower performance standards for such workers. Rather, federal employment discrimination laws prohibit employers from taking an individual's membership in a protected category into consideration in almost every employment-related situation.

All but three of the fifty states have employment discrimination prohibitions that mirror or exceed federal law. In addition, many local governmental entities have ordinances prohibiting discrimination. Therefore, in major metropolitan areas in the United States, it is not uncommon for three sets of laws - federal, state, and local law - to prohibit employment discrimination.

1.4 State "Common Law" Doctrines Bearing Upon Terminations

Quite apart from federal and state anti-discrimination laws, many states have recognized additional exceptions to the "at-will" employment rule through judicial decisions. In the US legal system, judicial decisions create what is called "common law," a body of law that is based on legal precedents. In most states, the common law provides that an employee who has been terminated in violation of a well-established public policy can recover in tort for compensatory and punitive damages. For example, since all states have workers' compensation laws which require employers to pay for all the medical bills and a portion of the lost wages of employees who suffer on-the-job injuries, the common law of most states has public policies which are violated if employers fire workers in retaliation for having asserted workers' compensation claims. This is known as the tort of retaliatory discharge.

The tort claim of invasion of privacy is also often asserted by workers. These types of claims are usually brought in the context of drug testing programs, searches of employee lockers or desks, or eavesdropping upon employee phone calls, conversations, or e-mails. Broadly speaking, employers enjoy the right in most states to review employee e-mails composed on equipment supplied by the employer. Monitoring phone calls is another matter. Employers must proceed with caution before monitoring or recording employee phone calls. Many state laws prohibit such monitoring without the consent of both parties to the conversations.

1.5 Personal Liability of Executives

Executives should realize that violation of these federal and state laws may result in their own personal liability, quite apart from the potential liability of the company. While employers might indemnify supervisors for their attorney's fees, an adverse court judgment, or a settlement involving compensatory damages, many companies will not indemnify supervisors from punitive damages or are prohibited from doing so on account of state corporation laws. Thus, a manager's compliance with these laws is more than a matter of professionalism. It is also a matter of personal and financial interest.

2. Sexual Harassment

2.1 What is Sexual Harassment?

Sexual harassment is broadly defined to be any unwelcome verbal statements or physical conduct of a sexual nature which unreasonably interferes with another employee's job or work environment. There are two types of sexual harassment: "quid pro quo" sexual harassment and "hostile environment" sexual harassment. The lines between these two types of harassment are not always clear and the two forms of conduct often occur simultaneously. What is clear is that the law is evolving, notions of appropriate workplace behavior are changing, and a record number of claims are being brought against employers and supervisors each year.

2.1.1 "Quid Pro Quo" Sexual Harassment

This occurs in a legal sense when employment decisions on hiring, promotion, transfer, discipline, or termination are made on the basis of submission to or rejection of unwelcome sexual conduct. For example, if a supervisor requests sexual favors from an employee, the employee refuses, and the supervisor then terminates or demotes the employee on account of the refusal, the courts will conclude that the employee is a victim of "quid pro quo" sexual harassment.

2.1.2 "Hostile Environment" Sexual Harassment

This type of illegal sexual harassment occurs where conduct of a sexual nature creates an intimidating, hostile, or offensive working environment. It can take many forms, including verbal abuse; discussing sexual activities; commenting on an employee's physical attributes or appearance; uttering demeaning sexual terms; using crude, vulgar, or offensive language; making unseemly or sexual gestures or motions; engaging in unnecessary touching; or any of these types of activities in combination or if repeated over time.

Courts focus on multiple factors in determining whether a supervisor's conduct has made an employee's work environment "hostile" in a legal sense. These factors include:

- How frequently the conduct was repeated;
- Whether the conduct was blatantly offensive or severe;

- Whether the conduct was physically threatening or humiliating, or merely an isolated verbal utterance; and
- Whether the conduct unreasonably interfered with an employee's work performance; and
- A single isolated utterance of a sexual remark is usually insufficient to rise to the level of sexual harassment.

Courts examine sexual harassment lawsuits with a recognition that men and women have different levels of sensitivity. Thus, conduct is viewed generally from the objective standard of a "reasonable person" – how a reasonable person in the victim's place would have viewed or reacted to the conduct or verbal statements. It is for this reason that employers can never assume that sexual conduct or talk in the workplace is acceptable merely because it appears harmless or in good fun from their perspective. Conduct which is acceptable in the culture of a foreign country may well be deemed offensive by an employee in the United States.

2.2 Proactive Steps to Avoid Sexual Harassment Claims

Recent decisions from the United States Supreme Court make clear that the best possible defense to a sexual harassment claim is a clearly stated and consistently enforced personnel policy which prohibits sexual harassment and provides victims with a mechanism to complain to company officials about any violations of the policy. Employers must also ensure that employees have received adequate training regarding the sexual harassment policy. Courts generally have ruled that employers can avoid liability for sexual harassment by immediately investigating any complaints, and when warranted, instituting prompt remedial measures designed to prevent any reoccurrence of the harassment.

At the same time, prevention of sexual harassment problems through supervisor sensitivity training and education is a necessary component of any loss control program to reduce employment-related exposures. Companies can lessen the risk of legal claims by counseling managers on how to avoid particular types of behaviors and situations which often lead to allegations of sexual harassment.

3. Special Problems and Statutes Relating to Mass Layoffs and Terminations

On many occasions, a foreign executive is sent to the United States for a sad but important task–to close down a facility, transfer the operations to a different location, or terminate most or all of the employees. This process implicates various US laws. The previous discussion concerning the at-will employment rule and its exceptions also apply in connection with mass layoffs. In general, though, four basic problems are of even greater concern in the context of mass layoffs: (1) violations of age discrimination laws in connection with voluntary severance or early retirement programs; (2) violations of a federal statute called the Worker Adjustment and Retraining Notification Act, more commonly known as the "WARN" act; (3) violations of severance obligations; and (4) violations of discrimination laws due to favoritism toward foreign executives.

3.1 Age Discrimination Problems

Because age discrimination is illegal in the United States, foreign executives do not have the option of simply singling out older workers for involuntarily retirement or termination as part of a reduction-in-force. This is often a significant issue, because foreign executives may be accustomed in their home countries to forcing older workers to retire in order to cut costs or maintain a younger workforce. Apart from this cultural difference, many foreign executives are not aware that the age discrimination laws in the United States apply to workers as "young" as 40 years of age and prohibit any attempts to require a worker to retire at any age–at age 60, 65, or even older (with one narrow exception).

As one might expect, it is clearly forbidden to directly state to an employee over age 40, in words or substance, that "you are too old and must retire or quit." Indirect efforts to force older workers to quit or retire are also forbidden. For example, an employer cannot demote older workers or cut their benefits as a way of prodding them to take early retirement. At the same time, a truly "voluntary" retirement is not illegal. Many companies utilize voluntary early retirement programs to trim their payrolls from time-to-time. The key factor in this context is that an employee must be offered a genuine choice between the status quo and a voluntary severance arrangement or early retirement plan under which the employee would be better off in a monetary sense.

3.1.1 Voluntary Severance and Early Retirement Plans

The structuring of a voluntary retirement or severance plan is complex. Typically, all employees (as opposed to just older employees) within certain divisions or operations might be offered incentives to resign or retire. Such incentives usually take the form of severance pay, extended health insurance coverage, or other monetary benefits. The proper criteria that can be considered are subtle and must be developed and implemented with care and considerable record keeping. Ill-planned early retirement programs can lead to years of costly litigation. Older employees many times sue for age discrimination if the offer of early retirement is at all coercive, or if managers seek to maximize cost cutting by threatening older workers with possible lay-offs or demotions if they do not retire.

3.1.2 Problems Associated with Releases Offered to Older Workers

It is common practice for companies to obtain a release of liability from older workers who are terminated or included in a reduction-in-force. The goal is to avoid liability disputes and prevent the filing of lawsuits. The release is a contract in which the employee agrees to waive any legal rights in exchange for a payment of money by the employer. Unfortunately, this process is somewhat complicated with employees over the age of 40 due to federal law known as the Older Workers Benefit Protection Act of 1990. This statute requires that releases offered to employees over the age of 40 meet various conditions.

Failure to comply with this law will render the release unenforceable; however, the employee may be allowed to keep the severance paid under the void release and still sue the employer.

3.2 The WARN Act

The Worker Adjustment and Retraining Notification Act, or WARN Act, is a federal law that, in general, requires employers with more than 100 employees in the United States to give 60-days written notice to employees of large scale lay-offs or plant closings. The law's goal is to provide employees with an opportunity to look for other jobs or to seek retraining. The WARN Act compels employers to provide notice to unions and various governmental entities. The WARN Act has nothing to do with the right to continued employment. It concerns only advance notice of a job loss. Regardless of whether notice is given, an employer is free to terminate or lay off its workers. However, failure to provide the requisite notice under the

WARN Act may expose the employer to claims for back pay and benefits for the period of violation (up to 60 days), as well as a civil penalty of $500 for each day of violation.

3.3 Severance Obligations

Generally, employers in the United States give severance pay to workers when they leave a company through no fault of their own. However, unlike most other industrialized countries, the United States has no laws which require employers to give severance pay to departing employees. Companies usually make severance payments in exchange for the employee signing a release of claims against the employer, although sometimes it is required by the terms of an employment contract or a collective bargaining agreement. One week of pay for every year of service is customary.

3.4 The Practice of Favoring Foreign-Born Managers over Workers of US National Origin

Courts have interpreted US employment discrimination laws to have a narrow exception to the rule against discrimination on the basis of national origin. Courts have determined that in limited circumstances, foreign employers operating within the United States may discriminate in favor of their own foreign nationals in certain management and technical positions. This issue often arises in mass lay-off situations when foreign-based employers favor employees of foreign national origin on assignment to the United States and discriminate against employees of US national origin. The issue also arises when foreign executives are rotated through the facilities of US subsidiary corporations on E-1 immigration visas or are compensated off a different payroll than workers of US national origin. Not surprisingly, unemployment and US trade imbalances have made this subject an emotional issue for employees. These types of personnel practices have led to an increasing number of lawsuits which claim that foreign employers should not be granted such favoritism.

4. The Effect of United States Labor Laws on Non-Union Workplaces

The National Labor Relations Act of 1935, or NLRA, is the federal law which establishes the right of workers to form, join, and assist unions, and the duties of employers to bargain with unions. Employers violating the NLRA are subject to

what are known as "unfair labor practice" charges. Allegations of such charges go before the National Labor Relations Board, or NLRB, the federal agency charged with enforcement responsibility for the NLRA. The NLRB acts as a quasi-judicial body, and it has substantial latitude and discretion in its interpretations of federal labor laws. The NLRB also investigates potential complaints, holds hearings, and enters remedies for violations of the law. The legal exposure to employers from unfair labor practice charges can be quite severe.

The subjects of unions, strikes, picketing, and boycotts are usually associated with workplaces covered by collective bargaining agreements. However, federal labor laws pertaining to unions and collective bargaining agreements in the United States are not limited to workplaces where unions exist. In certain circumstances, the protections and rights afforded to union-represented employees extend to unrepresented employees in non-union workplaces as well.

Foreign-based companies and their executives should be aware of these circumstances in order to avoid unanticipated legal problems. The three most common situations where US labor laws impact upon non-union workplaces involve the hiring and firing of union organizers, restrictions on the right to fire employees engaged in concerted activities, and the legal status of employer-employee committees.

4.1 Avoiding Unfair Labor Practice Charges from Union Organizers

Federal labor law issues may arise in a non-union workplace by virtue of the NLRA's application to the hiring process. This occurs if a person employed by a union as a business agent or organizer applies for a job at a non-union workplace.

Although an employer is free to reject the application of an applicant-organizer for any reasons unrelated to union affiliation, discrimination on the basis of affiliation with a union is unlawful under the NLRA. Unfair labor practices alleging a discriminatory refusal-to-hire are filled with fact-sensitive issues: was the motive for the hiring decision based on discrimination against the union's members or did the employer decline to hire them for a perfectly logical, acceptable, and legitimate reason? In these circumstances, the NLRB has often sided with unions and concluded that employers have violated the NLRA in refusing to hire organizer-applicants. To combat this problem, it is recommended that employers

adopt hiring policies which specify that individuals are disqualified from consideration for employment if they seek only temporary employment or to work simultaneously for more than one employer.

4.2 Restrictions on an Employer's Right to Fire Employees Engaged in Concerted Activities

The NLRA prohibits employers from taking adverse action in response to employees who engage in protected concerted activities. The National Labor Relations Board and the reviewing courts will deem unlawful a termination (or discipline) in response to such activity if:

- the activity was protected (*i.e.*, not unlawful, violent, in breach of an applicable bargaining contract, or indefensibly injurious to employer interests);
- the activity was concerted (*i.e.*, a group of employees or an individual employee with the authority of or on behalf of other employees to be determined by the purpose and effect of the employee's actions);
- the employer had knowledge of the activity; and
- the protected concerted activity was the motivating factor/reason for the employer's decision to discharge or discipline the employee.

Employees who circulate union organizing petitions, file complaints with state or federal agencies complaining about working conditions, participate in government investigations, testify at hearings, or protest terms or conditions of work may be protected for engaging in such actions. Accordingly, employers, managers, and first-line supervisors must carefully consider the facts and surrounding circumstances of group or group-related protests, grievances, or actions before taking disciplinary action against the employees involved in such activities.

4.3 The Legal Status of Employer-Employee Committees

Management through the device of employee participation in workplace decisions is increasing in popularity at US companies. This concept generally involves committees comprised of supervisors and workers, which are charged with the task of addressing certain workplace issues. These have many forms or labels such as "quality control circles," "employer-employee teams," or "employee involvement

committees." A common characteristic of these committees is the goal of enhancing employee productivity and loyalty, both by increasing employee involvement in workplace decisions and in allowing employees to gain a sense of empowerment.

The status of employer-employee committees is unclear under US labor laws. Accordingly, employers should evaluate carefully the propriety of establishing any employee committees so as to avoid a violation of the NLRA. The subjects that these committees can discuss should focus on workplace morale, productivity, training, and customer service. Grievances, wages, hours of work, and conditions of employment are topics which may run afoul of the NLRA.

4.4 The Role of Personnel Policies and the Essentials of Any Employee Handbook

Most employers in the United States adopt and utilize personnel policies to govern their employment relationships with workers. Most often, these policies are set forth in an employee handbook. The employee handbook tells workers how the company's operations are run and provides information about the employer's workplace rules.

Personnel policies play an important role in preventing and minimizing employment law liabilities. Such policies put employees on notice as to what is expected of them. Employers have more discretion and ability to terminate employees who do not follow the company's rules and expectations. In addition, an employer that follows its personnel policies tends to treat employees in a fashion which workers regard as more fair and just, rather than arbitrary and capricious when personnel policies are unwritten and the rules seem to be "made up as you go along."

4.5 The Hiring Process

Employers can control employment-related liabilities during the hiring process by instituting various procedures and policies. Loss prevention efforts should focus on the form of employment applications and offer letters, as well as ensuring that personnel involved in hiring are aware of proper interviewing techniques and sensitive to discrimination issues.

4.5.1 Employment Applications

Most if not all employers in the United States utilize written job application forms. These documents are the first in a series of forms by which a company can avoid employment-related exposures.

An employer can ensure the maintenance of an “at-will” employment relationship with its workers by use of particular language on the job application form. The employer should require any applicant to sign a form by which they acknowledge that if the company hires them, their hiring is “at-will” and they agree and recognize that the company has the absolute right to terminate them at any time in the future, and for any reason, and with or without cause.

Several additional loss prevention devices should be included on the job application form utilized by an employer.

First, the application form should include an authorization whereby the applicant agrees to allow the employer to check background references. This statement would include language releasing the employer from any liability resulting from obtaining, using, or later disclosing the background information. Without this authorization, employers are precluded from conducting extensive background checks on job applicants.

Second, the application form should contain a verification statement by which the applicant certifies that all the information provided on the application is true and complete. This is commonly known as a “truth clause.” The verification statement should provide that the applicant agrees that the employer has the right to terminate them at any time in the future should false or incomplete information be discovered with respect to the applicant’s background, education, or work experience. The issue of “resume fraud” is a significant one for purposes of employment discrimination laws, and utilization of the verification statement will provide an employer with additional defenses in this regard.

Additionally, the application form should include a statement to the effect that the company is an equal opportunity employer. This statement can be utilized to rebut an applicant’s claim that an employer acted with discriminatory animus in rejecting the applicant for employment.

Finally, foreign-based employers must recognize that employment applications should not contain any questions which would cause the company to violate discrimination laws. Unlike the situation in most other countries, it is generally unlawful in the US for an employer to inquire about characteristics which provide protected status to individuals (*e.g.*, the existence of a disability, the applicant's age or marital status, the applicant's national origin). These same concerns apply to job interviews.

4.5.2 Offer Letters

Companies should take special care in drafting "offer letters" to individuals to whom they offer employment. If properly prepared, offer letters can protect employers by preventing later misunderstandings regarding duties, compensation, and the duration of a job. Carelessly worded offer letters are sometimes alleged by plaintiff's lawyers to constitute an employment contract.

Employers also risk defeating the "at-will" employment status of workers if an offer letter creates some sort of contractual arrangement. To avoid such a result, the letter advising an applicant that the company has decided to offer them a job should not state the duration of employment. It should never rise to the level of a "guarantee." Instead, the offer letter should confirm the "at-will" employment status of the job applicant in clear and unambiguous terms.

4.6 The Orientation Process

During the orientation process, employers should clearly communicate their expectations and workplace rules to their new employees. This process also enables employers to secure written commitments from employees that will assist companies in reducing personnel problems and employment-related liabilities. These documents are critical. Loss prevention efforts should focus on the content of employee handbooks, as well as proper recordation of the receipt of personnel policies by all employees.

The orientation process is the time when most employers furnish an employee handbook or set of workplace rules to every new employee. Prudent employers follow a checklist of orientation items when integrating a new employee into the workforce. One of the chief items on the checklist should be dissemination of the employer's personnel policies or employee handbook.

4.7 The Evaluation and Disciplinary Process

Aside from terminating an employee, the second most frequent area giving rise to employment-related claims is the evaluation and disciplinary process. Employers can reduce their exposure to termination claims significantly if evaluations are done correctly and promptly, and discipline is imposed in an appropriate fashion. In this respect, loss control mechanisms should focus on sensitivity training of supervisory personnel, as well as proper documentation of performance appraisals.

Employers should take special care in requiring supervisors to thoroughly and honestly evaluate the job performance of an employee. Performance evaluations are critical to employee morale and documentation of performance. Equally significant is the importance of performance evaluations in the defense of employment-related litigation. Performance evaluations done incorrectly also can scuttle an employer's defenses to any potential employee-initiated claim. The typical scenario involves an employee discharged for poor job performance. The employee files a lawsuit and claims that discrimination rather than poor work performance motivated the employer to terminate the worker. The job evaluation done by the employer therefore becomes critical to the issues in the case. If the evaluations do not substantiate the employer's claim that the worker's job performance was unacceptable, the lawyer for the employee can easily argue that discrimination rather than performance reasons motivated the discharge.

The goal of any performance evaluation system is to ensure that a supervisor is objective and honest with an employee with respect to their strengths and weaknesses, and that the supervisor documents the performance evaluation in a contemporaneous written record. The documentation underlying the performance evaluation should be dated and signed by the supervisor performing the evaluation. In turn, the employee should be required to sign the performance evaluation form. This creates a mechanism to show that the worker received the performance appraisal, acknowledged the company's expectations as to future performance, and understood the consequences of a failure to improve their performance (*i.e.*, possible termination). If performance evaluations are done correctly, terminations on account of poor performance should never surprise the worker.

4.8 The Termination Process

In the United States, most lawsuits arise between workers and their employers when an employee is fired. Indeed, over 80 percent of employment-related lawsuits stem from the firing of workers. For this reason, loss control procedures take on added importance in the termination process.

To lessen the risk of lawsuits over terminations, employers should strive to address fundamental notice and fairness concepts – in other words, did the employer warn the employee in writing of the problems (*i.e.*, put them on "notice") and did the worker have a sufficient opportunity to improve performance (*i.e.*, was the worker treated with "fairness"). Unless these elements are satisfied, the termination decision is probably premature, and especially risky in the case of a worker exhibiting poor job performance.

The concepts of notice and fairness have various consequences with respect to procedures and mechanisms for implementing terminations. To ensure that this process works correctly, employers should avoid summary or "on-the-spot" firings. Termination decisions made hastily and in heated circumstances are very risky. An employee should be summarily terminated in only the rarest of circumstances. It is more prudent for employers to ensure that the ultimate decision with respect to firings should rest with upper-level managers. Although front-line supervisors play a vital role in the disciplinary process, final decision making authority for a termination should be reserved to upper-level managers.

Terminations of employees protected by a federal or state employment law (*e.g.*, a woman, an African-American, a disabled worker) also warrant special consideration. When dealing with such an employee, it is critical that the termination decision be reviewed by an upper-level manager to ensure that the decision is appropriate and fair. The facts should be reviewed independently by someone who has no supervisory responsibility for the employee or emotional involvement in the termination decision. Moreover, information pertinent to the employee and their situation should be gathered from all relevant sources; the decision maker should do more than simply listen to the line supervisor's account of the reason for the termination. Accordingly, the final decision to terminate should not be exercised until all of the facts regarding the employee have been carefully investigated.

While it is true that federal and state employment laws do not require employers "to be fair" (*i.e.*, the laws simply obligate companies to refrain from discrimination),

employers who endeavor to be fair are sued less often; those who are sued lose these claims less often too. This is because juries often equate unfair treatment by employers with discrimination against employees. Thus, an employer risks potential liabilities in following through with a firing unless the termination decision can pass a "fairness" test. This is especially true when the worker in question is protected by federal or state discrimination laws.

It is also important for employers to carry out a firing without delay once the termination decision is made. Companies do harm to the integrity of their disciplinary systems if they do not follow through on a final warning with respect to a firing. Employers who wait too long only weaken the case for the termination; it also sends the wrong signal to the employee who rightly assumes that his or her performance is acceptable.

Employers always should notify the employee of the termination decision in person. This is usually done in what is known as an "exit interview." When the decision is conveyed to the worker, all appropriate information should be at hand with respect to severance, benefits, reference, and outplacement. This provides an opportunity for a final accounting of all employer and employee responsibilities, including the worker's return of keys, computer disks, and other miscellaneous items of company property. In addition, two representatives of management should be present–one to convey the decision and one to witness the discussion. The management witness can substantiate the discussions if the worker subsequently sues. To that end, it also is important to ensure proper documentation of any discussions about the firing with the employee being terminated. Without appropriate documentation, it is difficult to defend employment-related lawsuits stemming from the discharge of the worker.

5. Additional Laws Which Employers Should Know About

Other US employment laws impact upon employment relationships as well. In particular, management officials should be aware of the laws regulating wages and hours, unions and collective bargaining, immigration, family and medical leave of absence rights, health and safety in the workplace, employee benefits, and affirmative action.

5.1 Wage and Hour Laws

The Fair Labor Standards Act of 1938, or FLSA, and the Equal Pay Act of 1963, or EPA, are the two principal federal laws which impose substantive wage-related obligations upon employers. The FLSA permits states to have higher wage standards than those mandated by federal law, and many states have their own wage and hour laws, some of which are even more rigorous in their requirements than federal law. The US Department of Labor, or DOL, enforces the FLSA, whereas the US Equal Employment Opportunity Commission enforces the EPA.

The FLSA establishes a minimum hourly wage, regulates child labor standards, and establishes the obligation to pay "overtime" wages. Certain jobs or industries are exempt from the FLSA on a partial basis (from overtime requirements) or complete basis (both minimum wage and overtime requirements). Jobs which are outside the coverage of the FLSA are those held by high ranking employees and white collar workers who are paid on a salary basis and have managerial, executive, professional, or administrative functions.

Workers classified as "exempt" employees under the FLSA are not entitled to overtime pay. In contrast, workers in jobs covered by the FLSA are known as "non-exempt" employees. The regulations of the DOL regarding what jobs are exempt or non-exempt are exceedingly complex. Many employers erroneously assume that if an employee has a given title (for example, "Manager of X,Y, Z"), they are exempt under the FLSA. This is an incorrect assumption since job function, and not job title, determines the applicability of the FLSA's requirements. In turn, this requires employers to exercise considerable care in defining job duties and classifying workers for payroll purposes.

Liability for violation of the FLSA can be quite expensive. The DOL investigates any pay practices which allegedly violate the FLSA, and the Department has the authority to bring class actions on behalf of workers against employers who fail to comply with the law. Criminal fines also may be levied against companies that violate the FLSA in a flagrant manner. Finally, workers can bring their own lawsuits against employers under the FLSA to recover up to two years of unpaid overtime pay. If the employer's violation of the law is "willful," the employee can recover up to three years of unpaid overtime wages.

The EPA is an amendment to the FLSA, and requires employers to pay equal wages, regardless of sex, for work of equivalent skill, effort, and responsibility. To defend an EPA claim, an employer must demonstrate that any disparity in wages between jobs is on account of seniority, merit, quantity or quality of production, or factors other than sex. Unlike the FLSA, the EPA applies to all classifications of workers. Violations of the EPA also can pose significant exposure to an employer. Female employees who bring successful EPA claims are entitled to not only lost salary and the recovery of their attorney's fees, but also to liquidated or "double back" damages if they prove a "willful" violation of the law.

5.2 Immigration Laws

In 1986, the US Congress overhauled immigration procedures with a measure entitled the Immigration Reform and Control Act of 1986, or IRCA. It affects all employers regardless of their size. IRCA imposes significant monetary penalties upon any employer who knowingly hires illegal aliens. The statute is enforced through a requirement of extensive record-keeping as to the identity and employment authorization of all new employees. This is done primarily through a document called an "I-9 form." Both an employee and employer must attest to the I-9 form under a penalty of perjury. The I-9 form requires the employee to attest that he or she is authorized to work and that he or she is not an illegal alien; in turn, an employer must attest that it has examined the employee's work authorization documentation and that the documents are in order.

Civil penalties ranging from $100 to $1,000 can be assessed under IRCA against any employer who fails to follow the verification and record-keeping requirements of the law. An employer who knowingly hires an illegal alien also can be subject to civil fines ranging from $250 per unauthorized alien to $10,000 per alien for multiple violations. Furthermore, criminal sanctions are authorized for egregious violations of IRCA. Foreign employers must ensure that their managers have secured appropriate immigration authorization to work in the United States. The immigration process is sometimes slow and cumbersome. It is strongly recommended that companies coming to the United States to do business place the highest priority on securing appropriate immigration authorization.

5.3 Health and Safety Laws

Numerous federal and state laws regulate health and safety in the workplace. The principal federal law in this area is known as the Occupational Safety and Health Act of 1970, or OSHA, and it requires businesses to provide a workplace free from recognized hazards. It covers all types of workplaces, offices, factories, and construction sites, although there are partial exemptions for employers with 10 or fewer employees. All employees working for such covered employers are protected by OSHA, including managers and supervisors. A federal agency called the Occupational Safety and Health Administration enforces the law. OSHA authorizes this agency to conduct unscheduled visits to worksites to inspect for compliance with health and safety guidelines. Among other obligations, OSHA requires employers to correct and abate any workplace hazards, keep records of safety problems, and allow employees to assert their rights under the law without harassment or discrimination. The law also requires employers to keep accurate records of employee exposures to potentially toxic materials, as well as logs of occupational injuries and illnesses. Any occupational injury causing a death or which results in the hospitalization of three or more employees must be reported to the Occupational Safety and Health Administration within eight hours of the occurrence of the incident.

Violations of OSHA can result in civil and criminal penalties. Citations and penalties are issued for violations of safety standards, failure to correct cited violations or keep required records, or willful or repeated violations. Employers are also subject to criminal prosecution for willful violations of standards that result in the death of an employee. Many states have enacted provisions similar to OSHA, some of which (particularly in California) are even more protective of workers than federal law. In addition, these state laws sometimes subject employers to more severe criminal penalties for workplace injuries or deaths than federal law.

5.4 Employee Benefits Laws and COBRA

The Employee Retirement Income Security Act of 1974, or ERISA, is the federal law governing employee benefits in the United States. It regulates both retirement and welfare benefit plans. ERISA is an exacting and complex statute which contains numerous requirements on how companies must establish and maintain pension

and profit-sharing plans, and ensure that pensions are adequately funded and protected. This statute also regulates welfare benefit plans which provide benefits for sickness, accidents, disability, or death.

In order to receive favorable tax benefits associated with qualified retirement and welfare benefit plans, employers are required to disclose certain types of information to the plan participants (*i.e.*, employees and their families), as well as to the US Department of Labor and the IRS, the two federal agencies involved in the enforcement and administration of ERISA. In addition, ERISA imposes fiduciary obligations upon employers to administer their employee benefit plans in strict conformity to the written plans and solely in the interests of plan participants. Penalties under ERISA can be quite severe for failing to provide requested information to employees or for breaching fiduciary duties. Workers, plan participants, and beneficiaries also may file lawsuits in federal courts alleging violations of ERISA.

By virtue of a statute known as the Consolidated Omnibus Budget Reconciliation Act of 1985, or COBRA, ERISA also comes into play whenever an employee is terminated. COBRA amended ERISA in 1986. COBRA generally requires employers of 20 or more workers to offer continuation of health care insurance coverage whenever a termination (or death) results in the loss of coverage of an employee, spouse, or dependent child. An employer must offer this option at the time of an employee's termination unless they are fired for gross misconduct. Employers are not obligated to pay for this coverage. Instead, COBRA generally requires employers to offer workers the opportunity to purchase continuation of insurance coverage from the business for 18 to 36 months at 102% of the applicable group rate.

5.5 Affirmative Action Laws

The subject of affirmative action is often misunderstood by supervisors. US employment discrimination laws generally do not require "affirmative action." Rather, job discrimination laws specifically prohibit employers and supervisors from taking the race, age, religion, disability, sex, or national origin of an employee into consideration in making personnel decisions. In turn, companies and supervisors are not required to affirmatively discriminate in preference of such protected individuals, either by favoring them in hiring decisions or in lowering performance standards so as to retain them as employees. In other words, if two individuals with

equal credentials and experience apply for a job, and one is a white male and the other is an African-American female, federal and state employment discrimination laws do not require the employer to hire the minority employee.

Certain employers, however, are required to engage in "affirmative action" in specific circumstances. A federal regulation known as Executive Order No. 11246 requires certain federal contractors and subcontractors to adopt what is known as an Affirmative Action Plan, or AAP. An AAP establishes procedures, goals, and timetables to increase the hiring, retention, and promotion of minorities and women. For example, employers in the construction industry with contracts in excess of $10,000 with the US government must adopt an AAP. In industries other than construction, AAPs are required for businesses having 50 or more employees and having federal contracts or subcontracts in excess of $50,000.

In general, an AAP must contain a statement of the contractor's commitment to equal employment opportunity principles, as well as technical provisions pertaining to goals and timetables to correct any deficiencies resulting in the under-utilization of minorities and women in certain job classifications or categories. Governmental contractors also must keep detailed records regarding their efforts to recruit and hire minorities and women. In addition, a special office of the US Department of Labor monitors the employment practices of any government contractor with an AAP, and investigates potential violations of regulations and laws governing these matters. Employers covered by Executive Order No. 11246, therefore, have an obligation to engage in affirmative action.

6. Protecting Against Unfair Competition by Former Employees

Protecting against unfair competition by employees (and ex-employees) should be a major concern of any company. This is an especially critical issue whenever a company effectuates mass layoffs. Of course, it goes without saying that a foreign executive is personally subject to these rules like any other employee.

The legal rights and remedies associated with competition by present or former employees are enormously complex in the United States. Civil relief can include damages, injunctions, or both, quite apart from criminal proceedings. Any number

of legal theories can come into play as well, depending upon what an employee did and when the employee did it. Indeed, multiple lawsuits in multiple jurisdictions are not uncommon in such cases.

6.1 Obtaining Written Agreements at the Outset of Employment

A company can avoid these problems by requiring key employees to sign agreements, at the beginning of their employment, acknowledging the company's ownership of patents, trade secrets and other proprietary matters. Such agreements should be written with care so as to ensure the maintenance of an "at-will" arrangement. Without such written agreements, ownership of intellectual property can be in jeopardy. Moreover, if a company believes that an employee should not be allowed to compete against it for a given period of time after the cessation of employment, a written non-competition agreement is essential. An employer may not need to enter into these types of agreements with each and every employee, but care should be taken to secure these agreements to the extent necessary to protect the company's interests.

6.2 Exit Interviews

Companies should endeavor to schedule "exit interviews" for departing employees whenever possible. Such exit interviews serve as an opportunity to remind employees that employer confidences and proprietary data must be kept confidential. In addition, exit interviews provide a means to remind departing employees to obey any applicable non-competition agreements. Such meetings also provide crucial evidence of notice to the employee that the company intends to enforce its rights. Indeed, such meetings sometimes give the company a ground to immediately sue such employees, especially if they make statements to the effect that they do not intend to abide by their secrecy or non-competition agreements. Of course, those final meetings also provide a crucial opportunity to demand (or to confirm) the return of all company documents and property.

In considering this issue, a company should first decide upon which employees or groups of employees are likely to pose the greatest threat as potential competitors. Clearly, an employer should conduct exit interviews with departing employees who had access to the company's intellectual property, key customers, or inside business information. In preparation for the exit interview, employee personnel

files should be reviewed to confirm that appropriate patent, copyright, or other assignments have been executed. If a non-competition agreement has not been signed, the exit interview might be the last chance to obtain such an agreement, albeit for additional consideration. Finally, it would be wise to have two management representatives conduct the interview, so that they can corroborate one another against the departing employee in the event of litigation. Obviously, the managers should make a careful record of the statements made in the exit interview.

SECTION 7
PRESERVING LIMITED LIABILITY

This section generally discusses US law with respect to "piercing the corporate veil," that is, the imposition of vicarious liability making a parent company (US or non-US) liable for the obligations of a US subsidiary. This section also describes operating guidelines to help preserve limited liability when establishing the US subsidiary, and generally discusses US law with respect to successor liability.

1. Piercing the Corporate Veil

A corporation or LLC will provide limited liability only if it is operated properly in a parent/subsidiary situation. If the foreign investor operates in the United States through a branch, there is no limited liability. The overseas company is fully and directly liable for the actions of its US branch. As such, foreign investors rarely establish their US operations as a branch if they wish to limit their liability. Accordingly, this section discusses how to preserve limited liability by organizing and operating through a separate US entity.

A plaintiff can challenge a corporation's or LLC's limited liability by seeking to convince a court to disregard the concept of the subsidiary as a separate entity from the parent. This results in "piercing the corporate veil" whereby a court imposes liability on the corporation's parent or stockholders based on the actions of the subsidiary. The doctrine of "piercing the corporate veil" is the primary common law theory evoked to hold a parent entity, non-US or domestic, liable for the acts of subsidiaries. Under this doctrine, a stockholder may be responsible for all of a corporation's obligations if he or she deals with the corporation in a manner that ignores its separate corporate identity. In such a case, the corporation will be considered to be the "alter ego" of the stockholder.

The doctrine of "piercing the corporate veil" applies regardless of the nationality of the stockholder. Thus, a US subsidiary may be held the "alter ego" of its non-US parent company, thereby making the non-US parent subject to the jurisdiction of the US courts and liable for all of the subsidiary's obligations. The doctrine applies to LLC's as well. In fact, in a number of jurisdictions, the limited liability company law explicitly refers to the corporate veil-piercing law as being applicable to limited liability companies.

Courts are reluctant, however, to "pierce the corporate veil" and generally only impose liability on stockholders or parents for the liability of subsidiaries in "exceptional cases." What constitutes an exceptional case is somewhat unclear due to the expanse of legal precedent addressing this issue. Case law is riddled with language relating to "piercing the corporate veil," resulting in a myriad of precedents with no consistent holding. Commentators have taken this case law and have identified five categories of cases in which courts traditionally have pierced the corporate veil: instrumentality cases, alter-ego cases, identity cases, sham or shell cases, and agency cases.

The instrumentality test requires a subsidiary corporation to be under the complete control and domination of the parent corporation, and such control is used to commit a fraudulent, wrongful, or unjust act against the plaintiff that proximately causes the plaintiff's injury.

The "alter ego" test requires that there be such unity of interest and ownership between the separate personalities of the parent and the subsidiary that the subsidiary no longer exists independently of the parent and that, if the acts are treated as those of the corporation alone, an inequitable result will follow from recognizing the parent and subsidiary as separate entities. A US corporation will be considered the "alter ego" of its parent where the separateness and autonomy of the US corporation has not been respected by the parent, resulting in some wrong, injustice, or fraud to the US corporation's creditors. The specific conduct that leads to a piercing of the corporate veil need not be the conduct of the non-US parent. The acts of a commonly owned, *i.e.*, an "affiliated" company, US or non-US, may also cause the US corporation to be the alter ego of the US or non-US affiliate.

The identity rule is similar to the instrumentality and "alter ego" approaches, except that it focuses more on the economic integration of the affiliated corporations.

The sham or shell cases arise when a parent or controlling stockholder excessively controls a corporation to the extent that the corporation lacks significant indicia of a separate corporate existence.

Some jurisdictions also recognize the concept of agency to impose intra-group liability.

Taking these theories together, it is possible to extrapolate a number of factors, enunciated by US courts, to be considered in determining if there are sufficient grounds for piercing the corporate veil under traditional theories. The specific factors vary from jurisdiction to jurisdiction, but many jurisdictions analyze:

- whether there is a unity of interest and ownership so that the separate personalities of the corporation and the individual no longer exist, and
- whether adherence to the fiction of a separate corporate existence would sanction fraud or injustice.

2. Factors to Support Veil Piercing

Because it is difficult to predict which state's law would apply in any given lawsuit (the laws of either the state of incorporation, the state in which the corporation has a principal place of business, or the state in which the plaintiff was injured could apply), the following is a basic analysis of the law of company limited liability in the United States. It is important to recognize that the law of one state may be applied differently than that of another and the following analysis should be applied generally and not relied upon if a specific legal issue arises in the future.

One of the leading "alter ego" cases listed 12 factors to consider in determining whether a subsidiary qualifies as the alter ego of its parent:

(1) the subsidiary operates with grossly inadequate capital;

(2) the parent and the subsidiary have common directors or officers;

(3) the parent and the subsidiary have common business departments;

(4) the parent and the subsidiary file consolidated financial statements and tax returns;

(5) the parent finances the subsidiary;

(6) the parent caused the incorporation of the subsidiary;

(7) the parent and the subsidiary have common stock ownership;

(8) the parent pays the salaries and other expenses of the subsidiary;

(9) the subsidiary receives no business except that given to it by the parent;

(10) the parent uses the subsidiary's property as its own;

(11) the daily operations of the two corporations are not kept separate; and

(12) the subsidiary does not observe the basic corporate formalities, such as keeping separate books and records and holding stockholder and board meetings.

The same rules would generally be applied to affiliate relations as in the parent-subsidiary context. In addition, case law relating to either "alter ego" or instrumentality cases has included such additional factors as:

- the subsidiary is described as a division of the parent;
- the subsidiary's business and financial responsibility is referred to as the parent's own;
- the subsidiary's directors and officers do not act independently in the subsidiary's interest but take orders from the parent for the parent's interest;
- inter-corporate transactions, including loans, are not at arm's length and benefit the parent at the subsidiary's expense;
- the parent makes decisions for the subsidiary;
- the two operations are so integrated through commingling of funds, interactivities and common direction and supervision that they should be considered as one enterprise; and
- the subsidiary operates without profit.

Federal courts may apply their own analysis for piercing the corporate veil in cases involving the enforcement of federal statutes or regulations. This analysis resembles that of the state courts. However, while federal courts have focused on many of the same factors, they have sometimes given "less respect to the corporate form" where this would advance federal legislative policies or objectives. This is especially true in cases involving, for example, environmental matters and employee benefits.

Not all of the above-listed factors must be present to pierce the corporate veil and not all of the factors are given equal weight. Typically, no single factor is determinative. In fact, some of these factors will almost always be present in a parent/subsidiary situation, such as common stock ownership, common officers, and interlocking directorates. However, by themselves, such factors are usually insufficient to pierce the corporate veil.

In addition to the foregoing operational factors, most jurisdictions require some showing of fraud or injustice in order to pierce the corporate veil, although these concepts are often ill defined and some of the factors considered overlap with those relating to an "alter ego" determination. For example, Illinois requires a showing of both control and fraud, but at least one court in Illinois used a "fundamental unfairness" approach to disregard the corporate entity and another Illinois court disregarded the separate corporate entity because it presented an "obstacle" to the protection of private rights.

Most federal courts applying federal law require some proof of wrongdoing or fraud before the corporate veil is pierced, although several federal courts have allowed the corporate veil to be pierced when the corporate form was being used to defeat the ends of federal law, especially where environmental laws or regulations were involved.

Under these circumstances, it is difficult, if not impossible, to plan the corporate activities of a non-US parent and its US subsidiary so as to completely avoid a finding (by a court or jury) of fraud or unfairness. Thus, the normal, ethical operation of a US corporation's business is no guaranty that limited liability would be preserved if the operations of affiliates are not kept separate. It is therefore imperative that a non-US parent take steps to avoid situations where a court could pierce the corporate veil. For this reason, the operating guidelines listed below are suggested as a practical approach to the operation of a US subsidiary. In light of courts' general reluctance to pierce the corporate veil, following these guidelines and avoiding certain situations that are legally suspect does not guarantee limited liability but helps minimize the risk that a non-US parent will be held liable for the obligations of a US subsidiary.

3. Operating Guidelines

A non-US parent should take appropriate steps to limit the risk that a US subsidiary could be found to be its "alter ego," instrumentality, or shell in the important areas of capitalization, management, financial relationships, and business operations. These steps, which are discussed in greater detail below, may be summarized as follows:

- Capitalization – The parent must ensure that the US subsidiary has sufficient financial resources (capital and lines of credit) from its inception to conduct business at anticipated levels, all of which should be fully documented.

- Managing the Subsidiary – The non-US parent should not directly manage the US subsidiary's daily business but should act only through the US Subsidiary's board of directors or managers.

- Board of Directors and Officers – The US subsidiary's board of directors or managers should establish the US subsidiary's policies and priorities and should make all major business and management decisions. The US subsidiary's board should hold regular meetings, and act through formal resolutions.

- Corporate Formalities and Records – The US subsidiary should observe and document all corporate formalities, particularly the holding of director and stockholder or member meetings and the observance of all state filing and reporting requirements, and it should appoint a reliable secretary and assistant secretary to document these activities.

- Financial Operations – All loans, interest payments and other financial and business transactions, and any transfer of funds or other assets (including information technology and intellectual property) between the non-US parent and the US subsidiary should be properly paid and documented, and should be made on arm's length terms.

- Other Business Operations – The US subsidiary should maintain its personnel, operations, records and assets separate from the non-US parent.

We discuss each of these factors in more detail below.

3.1 Capitalization

The adequacy of a corporation's capital is an important factor in determining whether to pierce the corporate veil, although US corporate statutes and court decisions give little guidance as to the precise meaning of "adequacy." Unlike many European corporate statutes, most US state corporate laws do not require a certain minimum capital before a corporation may begin operations. All shares subscribed should be fully paid at the time the shares are issued, although some states permit payment in the form of a promissory note or the like. Capital contributions other than money may be valued by the corporation's board of directors without independent appraisal or verification. The board's judgment as to value of consideration will be conclusive absent fraud.

A majority of courts have made it clear that a corporation's capital must be adequate at the commencement of the corporation's operations. The courts have freely pierced the corporate veil where a corporation was organized with virtually no assets but the courts have given little additional guidance as to when capitalization would be considered to be "inadequate." At the least, adequacy of capital must be judged in light of the volume of business that the corporation can be expected to conduct. High capitalization may not necessarily be required in a high-risk business. One court rejected an attempt to pierce the corporate veil of a corporation organized to engage in the hazardous activity of mining asbestos on the basis that it was inadequately capitalized. Courts have also looked beyond capital contributions to see if a corporation has available lines of credit (from the parent or financial institutions) or other resources to enable it to conduct its business properly.

A parent may validly approve the capital budget of its subsidiary without exposing itself to vicarious liability. In addition, a parent should ensure that the US subsidiary is adequately capitalized from the outset of its operations. The parent should immediately allocate and contribute to the US subsidiary assets sufficient for the US subsidiary to commence its operations. This capital infusion could be structured as an initial equity investment in the US subsidiary or as a loan. For the initial capital infusion, however, an equity investment may be preferable to a loan since any inter-company loan should be made at arm's length to protect against a piercing claim. Such an arm's length loan may require the payment of interest at the prevailing commercial rate.

The optimum situation would be to capitalize the US subsidiary at a level that would permit it to obtain from a third party any additional financing it may require. However, this may not be feasible given the nature of the business, the cost of financing or other relevant economic conditions. In many cases, a US subsidiary must look to its parent for financial support in the form of guaranties. If the parent does provide any subsequent financial support to the US subsidiary beyond its initial capital contribution, the support should be fully documented, as discussed in more detail below. Of course, the US subsidiary's initial capitalization itself should be properly documented, with subscriptions approved and shares authorized to be issued by the board of directors or managers, ownership certificates issued where appropriate, and all required reports filed with the state where the subsidiary was formed.

Note that in addition to inquiring as to a company's initial capitalization, a limited number of courts have examined whether a US company is adequately capitalized during periods after its formation. Subsequent undercapitalization might be a relevant inquiry where the corporation substantially enlarges the nature of its obligations sometime after its commencement. However, these decisions appear to have little justification. This distinction is obviously quite significant because every corporation that is insolvent or goes bankrupt is per se undercapitalized as of the time of failure or bankruptcy, even if it was adequately capitalized at its inception. Unlike the corporate laws of some countries, US corporate laws do not require a stockholder or management of a corporation to preserve the corporation's capital in the interest of creditors, and no particular action is required because a certain percentage of a corporation's capital is lost. Undercapitalization at a point following commencement of a corporation's operations should be relevant only where the corporation substantially enlarges the nature of its obligations sometime after commencement of business. Where a corporation emerges from bankruptcy, one should insure that its capital is adequate as of that time.

3.2 Managing the Subsidiary

A wholly-owned subsidiary may never be fully independent of its parent. This is particularly true where the subsidiary and the parent have at least some of the same directors and officers. Further, good business practice may dictate that a parent carefully review the operations and financial health of its subsidiary on a regular basis. This oversight and approval, properly conducted, will not automatically make

the subsidiary the "alter ego" of the parent. Direct or indirect ownership of a controlling interest in a corporation entitles the controlling stockholder to exercise the normal incidents of stock ownership, such as the right to choose directors and set general policies, without forfeiting the protection of limited liability. It is expected that a parent will exercise general oversight over a subsidiary, and such oversight is acceptable so long as it does not directly involve managing the subsidiary's daily business.

Appropriate parental involvement includes monitoring of the subsidiary's performance, supervision of the subsidiary's finance and capital budget decisions, and articulation of general policies and procedures. A parent corporation may be directly involved in the financing and macro-management of a subsidiary without exposing itself to a valid piercing challenge. Permitted activities generally include, but are not limited to, parental approval of leases, major capital expenditures, the sale of the subsidiary's assets, subsidiary acquisitions, capital budgets, major decisions, and a parental guaranty of third-party loans. Provided that corporate formalities are maintained, the parent can be involved in the decision-making of significant or extraordinary transactions involving its subsidiary.The fact that parent approval is required for certain extraordinary transactions or ventures does not mean that the parent is controlling the subsidiary.

For a court to pierce the corporate veil on the basis of control, the parent generally must have complete and exclusive domination over the subsidiary's daily activities such that the subsidiary no longer has any legal or independent significance of its own. A valid piercing argument based on control seems to generally require a parent's involvement in the subsidiary's daily or routine activities. Courts appear reluctant to pierce the corporate veil where the parent has decision-making authority on fundamental transactions of its subsidiary, but does not involve itself in the day-to-day activities of the subsidiary. Moreover, by statute, certain transactions, including certain mergers and sales of significant assets, cannot be undertaken by a corporation without stockholder approval.These statutes require stockholder involvement in certain fundamental transactions and demonstrate a legislative intent for involvement by a parent in its subsidiary's extraordinary affairs.

Therefore, it is possible under US law for a US subsidiary to be an independent and autonomous entity, even where the parent generally supervises the subsidiary's activities and has implemented strict cost and business decision controls. To avoid

piercing the corporate veil, however, it is imperative that the non-US parent's supervision and control is largely exercised through the US subsidiary's board of directors.

3.3 Board of Directors and Officers

A US corporation is normally managed by its board of directors and the state of incorporation's laws will govern the board's operation. It is generally preferable to have a board consisting of more than one member (three or five being a common number), perhaps including an outside director or two. A large board, especially one that includes outside directors, would be more likely to observe corporate formalities and to ensure that the US subsidiary is independently managed.

The directors are vested with the responsibility of managing US corporations. Directors exercise all corporate powers not reserved to the stockholders. These powers include management of the corporation, declaring dividends, and the approval or recommendation of significant corporate actions, such as mergers, consolidations, or dissolution. The board typically will vote on management issues at meetings called in accordance with the corporation's by-laws. Holding regular meetings of the directors (and at least one annual meeting of stockholders) is an important way to establish the US subsidiary's independence from its non-US parent.

The management of an LLC is quite flexible and may utilize a board and officers similar to a corporation or operate through managers, who will exercise many of the powers and functions of a managing director of a non-US company. Although managers may not have to meet formally, it is still important that all actions of the LLC be carried out by its managers or their designees.

There is a natural tendency for persons in a US subsidiary to report directly to their counterparts in the non-US parent. It is also natural for the non-US parent to manage certain of the activities of the US subsidiary directly or through an ad hoc oversight committee. However, these informal arrangements would constitute negative factors should someone attempt to pierce the corporate veil. Accordingly, the non-US parent should not direct the activities of the US subsidiary itself. Rather, it should appoint to the US subsidiary's board of directors individuals who are themselves responsible for oversight of the US business and who delegate the management of day-to-day operations to the officers of the US subsidiary.

The non-US parent may appoint to the US subsidiary's board individuals employed by the non-US parent or another affiliate who are responsible for the daily operation of the US business. There is no requirement that directors be citizens or residents of the United States. To the extent practicable, although not specifically required by applicable law, it is advisable that the US subsidiary have at least one or more members on its board of directors that are not affiliated with or directors of the parent. The inclusion of one or more independent directors would help to ensure that the US subsidiary is independently managed and would be a mitigating factor against a piercing claim.

Generally, as long as the directors act as a board and observe appropriate corporate formalities, the fact that they are employees of the non-US parent should not in itself establish the US subsidiary as the "alter ego," instrumentality, or shell of the non-US parent. Common management of the parent and subsidiary does not, by itself, justify piercing the corporate veil. In fact, the US Supreme Court has stated that it is "entirely appropriate for directors of a parent corporation to serve as directors of its subsidiary, and that fact alone may not serve to expose the parent corporation to liability for its subsidiary's acts."

However, common management, if combined with inadequate capitalization and overreaching ownership control exerted by the parent, could support an argument for piercing the corporate veil. Therefore, prudence dictates and we recommend that where practicable, measures be taken, such as the election of one or more independent directors, to limit a plaintiff's arguments that the US subsidiary is simply the "alter ego" of the parent.

Although the US subsidiary may generally be permitted under state law to have a single director, it is more likely to observe corporate formalities and therefore cause the corporation to be independently managed if it has more directors. These directors can then set budgets and policy guidelines while acting as a board (or as a committee of the board), even if through a consent resolution, in observance of the necessary corporate formalities. Moreover, when this group does make a decision for the US subsidiary, it would be doing so as the subsidiary's board of directors (or a board committee) and not as representatives of its non-US parent. This group decision making would help to establish the independence of the management of the US subsidiary.

As discussed in Section 4 – 1.3 (Business Entities – Corporations - Corporate Structure and Governance), directors of a US corporation act only as a collective board; they do not individually represent corporations. Directors owe fiduciary duties to the stockholders and the corporation, and therefore, cannot grant voting proxies to another person or director. The board of directors normally delegates responsibility for the day-to-day operations of a corporation to its officers, generally consisting of a president, one or more vice-presidents, one or more secretaries and a treasurer. The officers are elected by the board of directors and are removable by the directors at any time. It is best for the US subsidiary to have its own officers whenever possible, although a representative of the non-US parent may be appointed as chairperson of the board of directors.

3.4 Corporate Formalities and Records

It is important that each of the officers of the US subsidiary report to the subsidiary's board of directors, not to individual employees of the non-US parent. Although there is no commercial register in the United States by which the authority of the officers may be set out, and written powers of attorney are rarely used, most significant actions that an officer would seek to take on behalf of the corporation (*e.g.*, most banking transactions) require some form of board authorization. For more detailed information on the role and operation of the board of directors and officers of a corporation, see above.There have been cases where the integrity of a corporation has been buttressed by the quality of its corporate records. For example, in one case the court relied in part on the secretary's detailed notes from the corporation's meetings of stockholders to support its holding that the corporation was operated independently from its parent.The secretary of the corporation is charged with maintenance of the corporate records.Thus, because the independence of a corporation might be supported by its corporate records, the selection of a reliable secretary is quite important and many companies select an attorney (inside or outside counsel) to act as secretary (or assistant secretary).

In addition, parties dealing with a US corporation frequently require that the corporate secretary attest to the authority of the officer who actually signs a legal document for the corporation. The attestation of the secretary is not a second signature, but rather a confirmation that the officer who is executing the document has been authorized by the board or the corporation's by-laws to do so. Thus, the secretary (and assistant secretary) also plays a role in ensuring that corporate acts are duly authorized.

Limited liability company members may be less vulnerable to a loss of limited liability solely because they fail to observe the usual company formalities or requirements relating to the exercise of an LLC's powers or management of its business. LLC statutes often recognize that an LLC will be organized and operated more informally than a corporation and that this ought not to cause a loss of limited liability. These statutory provisions provide considerably greater protection for members of an LLC as compared to stockholders of a corporation. On the other hand, this would be of no benefit to a member who utilizes an LLC for fraudulent purposes. Commingling an LLC's and its members' financial and other assets would similarly expose its members to liability.

3.5 Financial Operations

The requirement of independence and autonomy to defeat an "alter ego" argument also extends to a US corporation's financial operations. As far as possible, a corporation should remain financially autonomous or independent from its parent. The US subsidiary should earn, spend and borrow its income and working capital in a manner separate from that of the non-US parent. The companies should also keep separate financial records. Further, to the extent that the US subsidiary looks to the non-US parent for financial support, they should deal at arm's-length, if possible.

The non-US parent and the US subsidiary must each be careful to compensate their respective employees and pay their respective bills. Evidence that a non-US parent paid the salary of the US subsidiary's employees or paid the subsidiary's bills is evidence of an "alter ego," instrumentality, or shell relationship. Further, the parent and the subsidiary should not commingle their funds and assets. Accordingly, the US subsidiary should establish its bank accounts in its own name, make deposits into such accounts of its own income and working capital, and write checks from such accounts to pay its own bills. Bills, invoices and other debts of the US subsidiary should not be paid from the account of the non-US parent, even if the US subsidiary or affiliate later reimburses the parent for the funds. Only officers of the US subsidiary should be authorized to sign checks and borrow money on behalf of the US subsidiary. Contracts to purchase raw materials, supplies and machinery should be in the name of the US subsidiary and not the non-US parent. The US subsidiary should make its own contributions to retirement and other employee benefit plans for its own employees, although the non-US parent may be the plan sponsor or administrator

for the benefit of all of the affiliated companies. We are unaware of any cases where benefits provided by the parent in one country to an employee seconded to the subsidiary of another country constituted a basis for piercing the corporate veil.

Ideally, a corporation would be capitalized at a level that permits it to obtain its own financing without support or a guaranty from the parent or other investors. However, this frequently is not possible. If the US subsidiary desires to borrow money from its non-US parent, then the loan should be negotiated and made at arm's length, as if the subsidiary had borrowed money from an unrelated third party. In such situations, the non-US parent should loan money to the US subsidiary at the interest rate available from third parties, plus any associated borrowing costs. These loans should be secured by whatever collateral the non-US parent would normally request as security for a loan with similar terms. Documents used to memorialize these transactions, including loan agreements and promissory notes, should be based on customary forms. An inter-company loan made at a favorable interest rate and not properly documented may support a veil-piercing effort. If the US subsidiary desires to borrow money from an unrelated third party, then it should make sure that the lender is looking to it as a bona fide borrower and not simply relying on the guarantee or covenants of the non-US parent in the loan documents. Evidence that a lender extended a loan to a subsidiary based largely on the strength of a parent company guarantee may support a piercing argument.

Finally, many parent companies that sell products or services to their affiliates use extended payment terms as a means of providing working capital to the affiliate. While this practice is not objectionable when properly documented and done consistently, if the affiliate encounters financial difficulty, the non-US parent would be in a weaker position to collect its receivables than if a formal working capital loan had been used.

3.6 Other Business Operations

All aspects of the daily business operations of a corporation or LLC are subject to a court's scrutiny on the issue of "alter ego" relationships. Accordingly, the US subsidiary's management should be responsible for day-to-day decisions, including those pertaining to matters such as production, distribution, marketing, advertising and environmental compliance and disposal.

Under Delaware law, a stockholder of a corporation has a right to review the corporation's books and records during business hours for purposes reasonably related to the person's interest as a stockholder. In addition, periodic monitoring of the subsidiary's financial performance and supervision of the subsidiary's finance and capital budget decisions may be exercised by the parent without creating exposure to a valid piercing claim.

If a parent and subsidiary use the same work force and the same business offices, then that joint use may be evidence of an "alter ego" relationship. Accordingly, the non-US parent and the US subsidiary should hire and fire their own employees. Informal transfer or sharing of employees among affiliates has been a prominent factor in showing an "alter ego" relationship. If a non-US parent's employees are to be transferred to the US subsidiary, we recommend that they cease being employees of the non-US parent and become employees of the US subsidiary, rather than "seconded" employees of the non-US parent. If individuals are to be employed by the US subsidiary, but are trained at a non-US parent's facilities, they should be on the US subsidiary's payroll. Employees of the non-US parent who are temporarily in the United States working for the US subsidiary should not enter into contracts on behalf of the subsidiary and should limit their contact with third parties as much as possible. If the companies must share the services of employees, time spent at each company should be accurately recorded and paid for separately. However, sharing services of employees should be discouraged. If a non-US parent hires employees of the US subsidiary to perform services for it or its respective clients, then the subsidiary should bill the parent at the same rate it would charge unrelated third parties for the same services.

Each corporation also should keep separate business offices, mailing addresses and telephone numbers. If the non-US parent and the US subsidiary are going to conduct business with each other, or provide equipment or services to each other, then such arrangements should be documented properly and a fair market value should be charged for such items. If one corporation uses office space, tooling, equipment or other assets owned by another, it should pay the other rent equal to fair market value.

4. Successor Liability

If the parent or another entity proposes to transfer or contribute assets to the US subsidiary, then the US subsidiary should consider methods to limit its exposure to successor liability and other claims.

As a threshold matter, certain states have bulk sales laws in which the purchaser must ensure that the proceeds from the transfer in bulk are applied to pay the debts of the seller. However, many states have repealed or refused to implement this requirement and instead require the seller to simply notify its creditors of the impending transfer in bulk. If the seller has not received sufficient consideration from the bulk transfer to pay its creditors, then the creditors may attempt to receive satisfaction from the asset purchaser on a successor liability theory. It is possible that if the selling corporation dissolves or does not have sufficient assets to satisfy its liabilities following the asset transfer to the purchaser (*i.e.*, the US subsidiary), the US subsidiary could be named in a pre-existing litigation against the selling corporation or could be sought by creditors to satisfy pre-existing obligations of the selling corporation. Therefore, it is important to review the current state of successor liability law in the United States.

4.1 Overview of Successor Liability Law

Under the successor liability theory, the successor of a business may be liable for the debts of the seller in certain limited situations. However, under the common law of most states, a corporation that purchases all or substantially of the assets of another is generally not liable for the debts or torts of the seller. There are four common law exceptions to this rule, which are present when:

- the successor corporation expressly agrees to assume the liabilities of the seller;
- there is a de facto merger of the selling and purchasing corporation;
- the purchasing corporation is a mere continuation of the selling corporation; and
- the transaction was made in bad faith for the purpose of avoiding creditors.

Some of the factors that have led courts to impose successor liability on an asset purchaser under the traditional rules have been where the successor corporation continues the business of the selling corporation, with the same stockholders, management, employees and physical plant, and otherwise retains the same identity as the predecessor corporation. In such cases, courts have often held that it is inequitable to deprive plaintiffs of a remedy against the successor corporation.

In products liability cases, several states, including New Jersey and Pennsylvania, have broadened these exceptions to impose liability upon successor corporations that substantially continue the operations of the selling corporation, known as the substantial continuity exception, or that continue to produce the same products line as the selling corporation, known as the products line exception.

In addition, a number of states, including New York and Pennsylvania, have imposed a duty to warn on successor corporations when the successor corporation has knowledge of a defect in a product and establishes a relationship with the selling corporation's customers. Some courts have found a successor corporation liable for failure to warn in cases in which the successor corporation was not liable as an asset purchaser.

While each of the above liability tests has separate elements that must be considered to determine whether the US subsidiary could be held liable for claims brought against the selling corporation, certain common elements among the tests include whether:

- the US subsidiary acquires all or substantially all of the seller's assets;
- the selling corporation continues to exist following the asset transfer to the US subsidiary; and
- the US subsidiary establishes a relationship with the seller's customers.

If the transaction establishing the US subsidiary does not meet any of the above factors, it is unlikely that plaintiffs would have a basis to directly impose liability upon the US subsidiary for the debts or torts alleged against the selling corporation. To meet these factors, however, the US subsidiary should be established as a separate entity from the selling corporation in a manner that minimizes the connections between the two companies and emphasizes the distinctions between the separate entities. One method of emphasizing the distinctions between the entities would

be for the selling corporation to continue to exist and operate following the establishment of the US subsidiary and to maintain sufficient assets to satisfy any potential liabilities resulting from the US litigation.

4.2 Traditional Exceptions to Successor Liability Rule

4.2.1 Assumption of Liabilities

Courts typically look to the asset purchase agreement pursuant to which the parties agree to the transfer of assets to the successor to determine whether there was an express or implied agreement to assume the liabilities of the selling corporation. If there is no express or implied agreement that the US subsidiary would assume pre-existing liabilities of the selling corporation, then the US subsidiary likely would not be held liable for these liabilities of the selling corporation under this test.

4.2.2 De Facto Merger

Under US corporate law, when two corporations merge, the surviving corporation is generally liable for the pre-merger debts and torts of the selling corporation. Courts have held that when a corporate transaction does not necessarily meet all of the formal requirements of a merger, the successor corporation may still be held liable for the debts and torts of the selling corporation if the transaction is substantively similar to a merger. There are four basic elements that are generally applied for a court to find a de facto merger of corporations such that the successor corporation would be held liable for the torts of the seller:

- continuation of the enterprise;
- continuity of stockholders through use of stock as consideration;
- the selling corporation ceases to exist, either immediately, or soon after; and
- the purchaser only assumes obligations necessary to continue the seller's business.

4.2.3 Mere Continuation

Under the mere continuation test, courts impose successor liability on an asset purchaser when there is an identity of ownership and management, a retention of the seller's name, the purchaser's use of the same physical location, and a retention

of the same employees. Liability under the mere continuation doctrine has been imposed when the purchasing corporation acquired only a single business unit from a selling corporation when it continued to operate the unit in the same manner as the selling corporation. However, if the selling corporation continues to exist and could provide a remedy for plaintiffs, it less likely that a court would impose liability on an asset purchaser.

4.2.4 Fraudulent Intent to Evade Debts

Courts have held that when a corporation sells its assets with the fraudulent intent to avoid liability, the successor corporation could be held liable for the torts of the seller. Early courts imposing liability on this basis observed that by stripping its assets such that it could not satisfy its creditors, a seller is perpetrating a fraud on its creditors. The elements of the fraudulent intent test are:

- an identity of ownership between the corporations;
- an intent to avoid liability; and
- the selling corporation is stripped of its income producing assets.

In a frequently cited case, the predecessor corporation faced massive asbestos liabilities and sold its only profitable businesses to a corporation that had the same stockholders as the predecessor. The court in that case held that liability could be imposed even if the purchasing corporation provided adequate consideration for the selling corporation's assets because the remaining assets held by the predecessor were insufficient to meet its potential liabilities, and the plaintiffs were being deprived of future income that the profitable assets might generate. Another court has disregarded the argument that the seller received adequate consideration because of the difficulty in determining the value of a going concern. Courts have suggested, however, that the overriding concern is whether the parties entered the transaction with the intent to hinder or defraud creditors or whether they acted in good faith.

4.3 Expanded Views of Liability

4.3.1 Continuity of the Enterprise

A minority of US courts has expanded the traditional mere continuation exception described above into what has been described as a "substantial continuity" or "continuity

of the enterprise exception." This exception differs from the mere continuation exception because a continuity of stockholders is not required under the continuity of the enterprise exception. The general elements of the test are:

- continuity of management, personnel, physical location, and assets;
- dissolution of the predecessor corporation;
- purchaser's assumption of the ordinary business obligations and liabilities; and
- successor corporation's presentation of itself as continuation of predecessor's operations.

This test appears to have been adopted, for example, by Alabama courts. The continuity of the enterprise exception has been rejected, however, in Maryland and New York, among other states. Because the continuity of the enterprise exception requires the dissolution of the selling corporation, the US subsidiary could reduce its potential exposure by requiring the selling corporation to remain in existence, refrain from any dissolution and maintain sufficient assets to discharge its potential liabilities.

4.3.2 Products Line Continuation Theory

In certain states, courts have imposed liability on successor corporations that continue to produce the same product lines as the selling corporation. Under this theory, known as the products line continuation theory, the following elements must be satisfied in order to impose liability on the successor corporation:

- the purchaser acquires all or substantially all of the manufacturing assets of another corporation;
- the purchaser undertakes the same manufacturing operation as the seller, and retains seller's identity (*i.e.*, holds itself out as the ongoing concern of the seller);
- the purchaser maintains the same product, personnel, property, and clients as the seller; and
- the purchaser benefits from seller's goodwill.

Courts may also consider whether the plaintiff has a remedy against the selling corporation, whether the successor corporation has the ability to assume a risk-spreading role, and the fairness of imposing liability on the successor corporation. Courts have held that when a plaintiff has a remedy against the selling corporation, liability under the products line exception cannot be imposed.

The rationale for this doctrine is that the seller is not available, but the purchaser benefited from the seller's reputation The exception has been applied to an intermediate successor corporation. Some courts have held that the plaintiff must also demonstrate that the transfer of assets destroyed the plaintiff's ability to recover against the selling corporation.

The products line exception has not been adopted in the majority of US courts. Because this theory of liability has not been adopted in the majority of US jurisdictions, it would be an unlikely basis for a valid claim against the US subsidiary.

4.3.3 Failure to Warn

Courts have also held that when a successor corporation establishes a relationship with the customers of the selling corporation and has knowledge of a defect in the selling corporation's product, the successor corporation may be held liable for a failure to warn customers of the selling corporation. This basis for liability is distinct from other successor liability claims because in a failure to warn case, the court must analyze whether the plaintiff had an actual relationship to the successor corporation and not whether the pre-existing liabilities of the selling corporation transferred to the successor corporation. Courts have noted that a successor corporation may be held liable for its own failure to warn a plaintiff of a product defect. The elements for the failure to warn test have been identified as:

- the successor corporation benefits from the seller corporation's goodwill;
- the successor corporation represents itself as the same enterprise as the seller;
- the successor corporation affirmatively undertakes responsibilities of the seller, such as providing service to the seller's customers; and
- the successor has actual or constructive knowledge of a defect.

Liability for failure to warn may not require that the selling corporation cease its operations because the basis for liability appears to be that the successor corporation has established a relationship with the selling corporation's customers.Therefore, an important consideration when establishing the US subsidiary is the extent of any relationship the US subsidiary would have with existing customers of the selling corporation. To the extent that the US subsidiary's relationship with existing seller customers would be limited, this would help protect the US subsidiary from failure to warn claims. However, it is likely that the US subsidiary would maintain relationships with existing seller customers, and therefore, the US subsidiary should seek indemnification from the selling corporation for potential liabilities that may be based on failure to warn claims.

Because a failure to warn claim against the US subsidiary may arise independently of liabilities that may be found to have transferred from the selling corporation, potential claims of existing seller customers may require additional analysis. For example, some courts have held that a plaintiff who has actual knowledge of a hazard prior to an injury cannot establish that an additional warning was required.

SECTION 8
INCOME TAX ISSUES

The following is a summary of the US federal income tax system as it affects foreign-based entities doing business with or in the United States. It is important to note that different issues may arise in connection with foreign individuals that chose to do business in the United States. Moreover, the following discussion is limited to federal income tax issues. There are a number of income, sales, use, franchise and other taxes that can apply at the state or municipal level, in addition to the US federal income tax. The United States does not currently have a national sales tax or value added tax.

The United States has tax treaties with almost every industrialized nation. Typically, if a treaty applies, a foreign-based multinational must be considered to have a "permanent establishment" in the United States before it will be considered to be subject to US income tax. The question as to when a foreign entity has established a permanent presence in the United States is particularly critical in the context of a foreign entity's sales through a US distributor, as discussed in more detail below.

1. Choice of Entity

Foreign-based entities that wish to do business in the United States have to make a threshold determination regarding whether they want to operate through a distributor or through an entity that is treated as a branch, partnership, or corporation for US federal income tax purposes. One of the most unique features of the United States income taxation system is that *any* of the foregoing forms of doing business can be accomplished through an entity that provides limited liability protection for all of its owners, as discussed in greater detail in Section 4 (Business Entities). This approach differs considerably from the approach of most other countries which typically do not limit the liability of an owner of a branch, or all of the owners of a partnership.

1.1 US Taxation of Foreign Companies Selling Products Through a Distributor

As mentioned before, typically if a treaty applies a foreign-based company must be considered to have a "permanent establishment" in the United States before it will

be considered to be subject to US income tax. There are two basic types of permanent establishment. The first type of permanent establishment is called a "fixed facility" permanent establishment. To have a fixed facility permanent establishment, the foreign company must generally have an actual physical presence in the United States for some period of time. The second type of permanent establishment is called a "dependent agent" permanent establishment. A permanent establishment is created through a dependent agent anytime an employee (or agent) of a foreign company negotiates and concludes contracts in the United States on behalf of the foreign company.

A common fact pattern involves a foreign-based entity that sends sales representatives to the United States on a sporadic basis, and the foreign entity does not otherwise maintain any sort of fixed physical presence in the United States. Even if the sales representatives market the foreign entity's products and generate sales orders, the activities of the sales representatives may not create a taxable presence, provided that the sales representatives refer all sales contracts back to the foreign home office for consideration and execution. On the other hand, a dependent agency permanent establishment will most certainly result if the representatives have the authority to both negotiate and conclude contracts in the United States on behalf of the foreign-based entity.

It is important to note that, regardless of the foregoing, a foreign entity that invests in US real property (*e.g.*, land, buildings, fixtures) will always be subject to US federal income tax on any gain recognized with respect to the real property. Thus, if a foreign entity buys a plot of undeveloped land in New York and sells it for a gain two years later, the foreign entity will be subject to US corporate income tax on the gain even though the foreign entity may not have had any other connection with the United States.

1.2 US Taxation of Foreign Companies Doing Business Through a Branch

A foreign-based entity can form a branch by simply conducting activity in the United States – *i.e.*, a so-called "pure branch." Alternatively, it can form a single-member limited liability company. Unless the foreign-based entity makes an affirmative election to the contrary, the limited liability company will be completely disregarded for US tax purposes. A single-member limited liability company that is disregarded for US tax purposes is typically referred to as a "hybrid branch."

The US federal income tax consequences of conducting business through a pure branch and a hybrid branch are the same. The advantage of a hybrid branch, however, is that the foreign-based entity has limited liability protection.

Whether or not the foreign-based entity's branch activities are subject to US taxation depends on:

- whether or not a tax treaty applies, *i.e.*, whether the branch has a taxable presence in the United States; and
- the nature of the activities conducted through the branch.

If it is determined that a foreign entity has a taxable presence in the United States, it will be required to file a Form 1120-F with the US government and report any income that is subject to US taxation. As a practical matter, foreign- based entities typically refrain from doing business in the United States through branch form in order to avoid having to file a US federal income tax return. The foreign corporation will have to pay tax on its income at marginal rates which range from approximately 15% to 35%, depending on the amount of taxable income.

There is no favorable corporate income tax rate for capital gains. Thus, if a corporate income tax is imposed, the same rates apply, regardless whether the income is ordinary (*e.g.*, income from the sale of inventory) or capital (*e.g.*, the sale of building or equipment).

1.3 US Taxation of Foreign Companies Doing Business Through a Partnership

A foreign-based entity can form a US partnership by executing a contract with another party to do business in the United States and share the profits from that business. This is referred to as a "general partnership." Alternatively, the foreign entity can form a limited partnership under the laws of one of the states. Finally, the foreign entity can form a limited liability company with multiple owners. Unless an affirmative election is made to the contrary, the limited liability company will automatically be considered a partnership for US tax purposes. A limited liability company that is treated as a partnership for US tax purposes is typically referred to as a "hybrid partnership." With some exceptions not addressed in this chapter, the US federal income tax consequences of conducting business through a general partnership, limited partnership and a hybrid partnership are generally the same.

The advantage of a hybrid partnership is that all of its partners have limited liability protection whereas none of the partners in a general partnership have limited liability and at least one partner in a limited partnership lacks limited liability.

The US tax consequences of operating in partnership form are very similar to the tax consequences of operating in branch form, discussed above. Specifically, the United States will impute the partnership's activities to its partners. If those activities are significant enough that the foreign partners are considered to have a taxable presence in the United States, then each of those foreign partners must file a Form 1120-F in the United States, report the appropriate share of their income, and pay any tax due thereon. As a practical matter, foreign-based entities typically refrain from operating in partnership form to avoid having to file a US federal income tax return. However, as noted above at the end of Section 4 (Business Entities), for certain types of foreign-based entities, such as closely-held German companies, for example, significant tax savings can result from operating in the United States through a partnership.

The main difference between a partnership and a branch is that a partnership, by definition, has multiple owners. Hence, it is possible for a partnership to specially allocate certain items of income or deduction between and among its partners. It is not possible to specially allocate the income or deductions of a branch.

1.4 US Taxation of Foreign Companies Doing Business Through a Corporation

A foreign-based multinational can form a domestic corporation under the laws of any one of the US states. Domestic corporations (and not their foreign parents) are required to report their taxable income on a Form 1120 every year and pay tax due thereon. Domestic corporations are subject to corporate income tax at rates ranging from approximately 15% to 35%.

2. Distributions from a Branch, Partnership or Corporation

2.1 General Consideration

Distributions by a branch, partnership or corporation to its owner, partner or shareholder are potentially subject to US withholding tax if the distribution

is made out of earnings. To the extent the distribution is made by a branch or a partnership, the tax is imposed under the US "branch profits tax" regime. To the extent the distribution is made by a corporation, the tax is imposed under the normal withholding rules. This withholding tax is imposed on a gross basis and the rate can be as high as approximately 30% if no treaty is in place. Under certain circumstances, including the holding of various ownership levels, applicable tax treaties will often reduce the withholding tax rate to about 5%, and more recent treaties have even reduced the rate to 0%.

2.2 Limited Partnership Structure

Due to tax advantages, certain European businesses, for example, often select a limited partnership structure when operating in the United States. For example, a US limited partnership with a corporate general partner can substantially reduce combined US-German distributed profits taxation for its German individual participants (whether or not they are resident in the United States).

For the discussion below, Germany is taken as an example. The results are similar for businesses from most other European jurisdictions:

The limited partnership generally will be structured so that it will be treated as a partnership for US tax purposes. A US or German entity controlled by the limited partners of the limited partnership functions as the general partner. The primary benefit of the limited partnership structure from the German owners' viewpoint is the elimination of German taxation on the US business profits via application of the US-German income tax treaty. Under the treaty, German taxable income of a German resident individual or a German company does not include certain items of income which, pursuant to the treaty, are not exempt from tax by the United States. Income of a US permanent establishment of a German individual or company qualifies for this exemption from German income taxation. Thus, under such a structure, the US business profits are generally subject only to US income taxation and can be distributed to the German partners without an additional income tax in Germany. For reasons that are beyond the scope of this Handbook, such a structure generally is relevant only for closely-held German companies, such as those set up as a *Kommanditgesellschaft* in Germany.

A limited partnership structure also can present an advantage over a US corporate structure with respect to US business losses, if any. The relevant German taxpayer

may elect to deduct US permanent establishment losses in Germany where they can offset income from other sources. Generally, such losses would be recaptured only as and to the extent that the US permanent establishment or any other US permanent establishment of the German taxpayer earns profits in subsequent years.

The amount of US operation losses which can be deducted by a German resident taxpayer in Germany is limited essentially to the capital he or she has paid in and quite probably the loans he or she has made to the business. Thus, if the limited partnership incurs losses in any year, its German limited partners should fund those losses with capital contributions or loans so as to be able to obtain a German tax deduction for them.

3. Sales of Branches, Partnership Interests, Shares in a Corporation

The following discussion assumes that if a foreign corporation owns a US branch or a partnership, that the branch or the partnership constitutes a taxable presence in the United States and that the branch or partnership only owns assets physically situated in the United States. If a foreign corporation owns a US branch and sells that branch for a gain, the foreign corporation will be subject to US corporate income tax on the gain. Similarly, if the foreign corporation sells a US partnership interest at a gain, it will be subject to US corporate income tax on the gain.

Conversely, when a foreign corporation sells the stock of a domestic corporation, no tax is generally imposed. The United States does not impose an income tax on non-resident individuals or corporations when they dispose of stock of a domestic corporation. The one exception to this rule is for domestic corporations that happen to own a significant amount (more than 50% by value) of real property (*e.g.*, land and buildings) physically situated in the United States.

4. Calculating Income of a Branch, Partnership or Corporation

Normally, the profit or loss of the branch, partnership or corporation will be measured in US dollars. In computing income and deductions, US taxpayers generally must use the accrual method of accounting, and are permitted to compute income on

the basis of a calendar year or a fiscal year. A corporate taxpayer is normally required to keep inventories whenever the production, purchase or sale of merchandise is an income-producing factor in its business.

As a general rule, all ordinary and necessary business expenses may be deducted in computing income subject to taxation. This general rule is subject to several limitations which, among other things, preclude a corporation from deducting payments for fines, kickbacks, and expenses incurred to produce tax-exempt income. There are also special rules limiting deductions for travel and entertainment expenses and charitable contributions.

A deduction may be taken for depreciation of assets, including intangible assets like goodwill or going concern value, that are used in a trade or business. The rate at which depreciation may be claimed differs depending on the property at issue.

5. Consolidated Returns

The United States does permit corporations to file consolidated returns. To be eligible, at a minimum, one US corporation must own at least 80% of the voting power and 80% of the value of a lower-tier corporation. If a group of corporations is eligible to file a consolidated return, the losses generated by one corporation can be used to offset the profits of another corporation, subject to certain limitations which are not addressed here. However, if the two US corporations are each owned directly by the foreign parent, they cannot file a consolidated tax return. Thus, it is typically beneficial for a foreign corporation that owns 80% or more of two or more US corporations to own those corporations through a US holding corporation that then files a consolidated return for the entire group.

Only corporations can file consolidated returns. Branches and partnerships generally cannot be part of a consolidated group of corporations. The one exception to this rule is for limited liability companies or state law partnerships that elect under US law to be taxed as corporations. If the limited liability company or partnership makes an election to be taxed as a corporation, then it can conceivably join with other corporations to file a consolidated return.

6. Rules for Related Party Transactions

The Internal Revenue Service, or IRS, is authorized to allocate or apportion income, deductions, or credits between or among related taxpayers whenever it is determined that non-arm's length dealing has distorted the income of any of them. Parties that are under common control must therefore deal with each other on a basis that achieves the same economic results as if they were not under common control. Thus, when a foreign-based multinational sells inventory to its corporate subsidiary in the United States, it must do so at a price that reflects what an unrelated party would pay, if the product were sold to that party on the same terms.

7. Tax Procedures and Administration

7.1 Filing of Returns by Taxpayers

A federal income tax return of a corporation must be filed within 2-1/2 months after the end of its taxable year. Automatic extensions of the time allowed to file such returns are routinely granted for up to three months.

7.2 Audit and Administrative Appeal Process – Litigation Remedy

Not all US tax returns are audited. The IRS can spot-check returns or specific issues. If the IRS has audited a return, it issues a report of proposed changes. Taxpayers who disagree with a change proposed by the IRS in their reported tax liability are permitted to have an independent review of their case with a view to disposing of the dispute before litigation. First, an aggrieved taxpayer is entitled to appeal an adverse decision by the division that examines its return to a higher level of authority within the IRS (usually a regional Appeals Office).

If a matter cannot be settled with the Appeals Office, a taxpayer is sent a formal notice of deficiency and may obtain judicial review of the asserted deficiency by filing a petition in the US Tax Court before paying the tax. Alternatively, if the taxpayer pays the deficiency, it may still obtain judicial review of the matter by suing for a refund in either the appropriate US federal district court or the US Claims Court.

7.3 Statute of Limitations

Assessment of any internal revenue tax must generally be made within a three-year period beginning with the later of the date a return is filed or the date the return is due. The tax generally must be assessed within the succeeding three-year period after that date. This general period of limitations on assessments applies to interest and penalties as well as tax. If no return is filed or if the return is fraudulent, there is no statute of limitations on assessment and collection of the tax as well as interest and penalties.

APPENDIX A
US ACQUISITIONS CHECKLIST

Comment: This sample checklist is designed to provide a high-level overview of the general matters typically addressed by legal counsel in the course of an acquisition of a privately-held US corporation. It is not by any means comprehensive, and should be reviewed carefully to determine what additional matters should be covered within the context of a given transaction in light of the particular buyer, seller, target, industry and transaction structure, among other factors. As with all sample documents, this document is not a substitute for familiarity with applicable laws and market practice. It should be reviewed carefully and customized before use.

1. Initial due diligence

(a) Preliminary investigation of business

(i) Financial statements

(ii) Business operations

(b) Confidentiality agreement

(i) Access to information about target

(ii) Confidential treatment of target information

2. Regulatory considerations

(a) Foreign investment approvals

(i) CFIUS investigation: national security

(1) Notice requirements

(2) Investigations and time limits

(ii) Government restrictions on non-US. ownership

(1) Defense: federal

(2) Banking and other financial institutions: state and federal

(3) Insurance: state

(4) Air and maritime transport: federal

(5) Ownership of ships and aircraft: federal

(6) Communications and power: federal

(7) Railroads: state

(8) Towing, salvage, and dredging: federal

(9) Fishing: federal

(10) Natural resources: federal

(11) Agriculture: state

(12) Other real estate: state

(b) Other limitations and notices

(i) Hart-Scott-Rodino premerger notice

(ii) Takeover and public tender legislation

(1) Federal: Williams Act

(2) State legislation

(iii) Other securities law considerations

(1) Proxy rules: merger

(2) SEC registration or exemption if shares or other securities used as consideration

(c) Bulk transfers

(i) Notice to creditors

(ii) Other formalities

3. Structuring the transaction

(a) Purchase price

(i) Shares or other equity securities

(ii) Cash or debt securities

(b) Choose acquisition vehicle

(i) Non-US parent

(ii) New or existing local subsidiary

(1) Formalities to establish new corporation or limited liability company

(2) Time requirements for new corporation or limited liability company

(c) Choose form of acquisition

(i) Share or membership interest acquisition

(1) Simplicity

(2) Continuity of business

(3) Contracts, permits, and tax attributes

(4) No transfer taxes

(5) Assume all liabilities

(ii) Asset acquisition

(1) Complexity

(2) Transfer taxes

(3) No continuity of contracts, permits, or tax attributes

(4) Assume only transferred liabilities

(iii) Merger

(1) Simplicity/complexity

(2) Some continuity of business, contracts, or permits

(3) Possibly avoid transfer taxes

(4) Assume all liabilities

4. Principal documentation

(a) Letter of intent

(i) Outline of transaction

(ii) No-shop (no overt solicitation of other buyers)

(iii) Access to information

(iv) Confidentiality

(b) Acquisition agreement

(i) Description of transaction

(1) Transfer of assets, equity, or merger

(2) Price and payment terms

(3) Price allocations in asset transfers

(4) Price adjustment

(ii) Liabilities assumed in asset transfers

(iii) Representations and warranties (see Legal due diligence, item 5, below)

(iv) Covenants

(1) Conduct of business

(2) No-shop

(3) Confidentiality

(4) Standstill

(5) Consents to assignment and nonassignable contracts

(6) Future employment of key personnel

(v) Conditions to closing

(1) Representations true and covenants performed

(2) No adverse change in business

(3) Related agreements executed

(4) Legal opinions

(5) No litigation affecting transaction

(6) Government approvals (Hart-Scott-Rodino, etc.)

(7) Other consents and approvals (material contracts, leases and licenses, loan agreements, etc.)

(8) Transfer or issuance of material permits

(vi) Closing (See item 7 below)

(vii) Indemnification

(1) Coverage

(2) Threshold or deductible amount

(3) Survival of obligations (time limits)

(4) Source of funds (escrow, holdback)

(viii) Dispute resolution and governing law

(1) Arbitration/mediation/conciliation

(2) Choice of forum

(c) Other agreements

(i) Noncompetition agreement

(1) Parties covered

(2) Scope (time, field, and geography)

(3) Legality and enforceability

(4) Tax elements

(ii) Employment agreements

(1) Key employees

(2) Selling shareholders

(3) Tax elements

(iii) Leases and licenses

(1) Nontransferable or nontransferred property

(2) Commingled property

(iv) Services agreement

(1) Transition to permit target to achieve stand-alone capability

(2) Essential commingled services

(v) Parent or other guaranties

(vi) Ongoing supply or distribution agreements

(vii) Escrow agreement(s)

(viii) Intellectual property agreement(s)

5. Conduct legal due diligence (Also ensure appropriate coverage in the representations and warranties contained in the acquisition agreement.)

(See Appendix B for a sample information request list.)

6. Organize acquisition vehicle

(a) Formalities

(i) Reserve name in relevant states

(ii) File certificate or articles

(b) Capital

(i) Prepare and execute share certificates or LLC interest certificates

(ii) Enter share issuance in record books

(c) Management/corporation

(i) Hold organizational meetings of shareholders and directors

(ii) Adopt bylaws

(iii) Elect directors

(iv) Elect officers

(v) Authorize acquisition and execution of acquisition documents

(d) Management/limited liability company

(i) Operating agreement

(ii) Elect manager(s)

(iii) Elect officers, if any

(e) Other organizational matters

(i) Obtain taxpayer identification number

(ii) Prepare minute books

(iii) Qualify to do business in necessary states

7. Closing

(a) Transfer documents

(i) Stock powers

(ii) Deeds

(iii) Bills of sale

(iv) Assignments of agreements

(v) Assignments of intangible assets

(b) Payment

(i) Wire transfers or cashier's checks

(ii) Promissory note

(iii) Escrow

(c) Corporate formalities

(i) Shareholder/member and director approval

(ii) Election of new directors

(d) Other matters

(i) Related agreements – obtain

(1) Noncompetition agreements

(2) Employment agreements

(3) Leases and licenses

(4) Service agreements

(5) Escrow agreement

(ii) Obtain legal opinions

(iii) Update certificate or articles of incorporation, ensure acquisition agreement representations are true and correct as of closing

(iv) Obtain certified articles of incorporation or association and good standing certificates

(v) Obtain resignations of managers, officers or directors

APPENDIX B
SAMPLE INFORMATION REQUEST

(short-form, acquisition of stock)

Comment: This sample document is an example of a starting point for drafting an initial document request list to be provided to the target of a US private stock acquisition transaction. (In the context of an assets acquisition transaction more detailed provisions with respect to assets may be required.)

This sample is designed as an initial request, with the ability to follow up with further inquiries. It is not by any means comprehensive, and should be reviewed carefully to determine what additional matters should be covered within the context of a particular transaction. For example, one additional area that is likely to require adjustment in the context of a particular transaction is the time period covered by requests. In this sample, most such time periods are set at five years, but they may need to be adjusted, for example, to reflect the realities of the target's records and staff and the buyer's interests and priorities.

As with all sample documents, this document is not a substitute for familiarity with applicable laws and market practice. It should be reviewed carefully and customized before use. Bear in mind that it does not address non-documentary due diligence activities such as in-person interviews with management, customers, vendors, and internal and external auditors, among other activities.

INITIAL INFORMATION REQUEST

In connection with the possible transaction under discussion, we would appreciate your assistance in locating and assembling the documents and other information described below for our review.To the extent that it would not be overly burdensome, we would appreciate it if you could arrange to have the information sent by overnight courier to us at:

[_____]
[_____]
[_____]
[_____]
Attn: [_____]

We are willing to review the balance of the information at **[target name]**'s principal offices.

As you compile the information, please keep in mind the following:

1. Please organize your responses in accordance with the numbering on this list.

2. Unless the context indicates otherwise, the terms "contract" and "agreement" also include any commitment, understanding, or other consensual obligation, whether written or oral. If any contract or agreement has not been reduced to writing, please summarize the terms.

3. For any requested documents, please include copies of all amendments and supplements.

4. If the Company or any subsidiary uses a standard form of a requested contract (such as a form of employment agreement) that has been executed by a number of parties, then you only need to provide one copy of the standard form contract, along with a written summary of the variant terms (such as salary, term, etc.) of the executed contracts.

5. If a request is not applicable, or if the Company and its subsidiaries have no information responsive to a request, please so state. If information other than the type specifically requested would appear to fulfill the purpose of the request, please provide the information together with an explanation of how it relates to the request.

6. If you have already provided a requested document to another representative of **[buyer name]**, please so indicate.

We also anticipate that, during the course of our due diligence review, we may need to review additional materials that this initial request does not describe.

If you have any questions or comments with respect to these requests, or if any requests are overly burdensome, inapplicable, immaterial, or irrelevant, please call [_____] at (__) ___-_____.

Thank you very much for your assistance in this matter.

1. Organization and Corporate Records

1.1 **Charter**.The Company's and any subsidiaries' charter documents.

1.2 **Bylaws**.The Company's and any subsidiaries' bylaws.

1.3 **Minutes**. Minutes of all meetings of the Company's and any subsidiaries' board of directors, board committees, and shareholders, including any written consents in lieu of a meeting.

1.4 **Historical documents**. Documentation relating to:

- all aspects of the incorporation and initial organization of the Company and any subsidiaries, including assignments and assumptions; and
- the Company's historical business activities, including acquisitions, restructurings, reorganizations, dispositions, and repurchases.

1.5 **Organization and divisions**. Organizational and ownership charts or other information relating to the Company and its subsidiaries, divisions, joint ventures, and all other entities directly or indirectly affiliated with the Company.

1.6 **Corporate maintenance**. All available good standing and tax status certificates, along with a list of each other jurisdiction in which the Company or any subsidiary is qualified to do business or otherwise operates.

1.7 **Shareholder communications**. All reports, proxy statements, and other communications to shareholders of the Company or any subsidiary since_____,

1.8 **Stock records**. A schedule of all shares authorized, issued, outstanding, or held in treasury, for each of the Company and its subsidiaries, along with stock ledgers or books for the Company and its subsidiaries. If any part of the issued shares is unpaid, provide the details.

1.9 **Securities agreements**. All agreements relating to the Company's and its subsidiaries' securities to which the Company or any of its subsidiaries is a party.This includes stock option plans, forms of stock option agreements, agreements to issue securities, agreements to purchase or redeem securities, ESPPs, stock bonus plans, phantom stock plans, and agreements to register securities with the SEC.

1.10 **Shareholders' and similar agreements**. All agreements to which the Company or any subsidiary is a party or of which the Company has knowledge, relating to voting, disposition, or acquisition of securities of the Company or any subsidiary or relating to any capital stock of the Company that has been pledged or is held in a fiduciary or nominee capacity.

1.11 **Equity compensation**. A schedule of all outstanding restricted stock, options, and stock appreciation rights, indicating whether each is an ISO or NQSO, as well as the holder, exercise price, schedule for exercise, and other terms.

1.12 **Anti-takeover and change of control matters**.All documents relating to anti-takeover measures, including shareholders' rights plans. All agreements that would be adversely affected by the contemplated transaction or that contain non-assignment or change of control provisions.

2. Financial Information

2.1 **Financial statements**. All annual and quarterly financial statements for the past five years and the latest interim financial information available for the Company and its subsidiaries.

2.2 **Budget and projections**. Internal budgets, estimates, and projections for the Company and its subsidiaries (including commentary on the assumptions made).

2.3 **Inventory**. Summary of inventory as of the most recent practicable date.

2.4 **SG&A**. Breakdown of selling, general, and administrative expenses by division and subsidiary.

2.5 **Geographic breakdown**. Breakdown of sales, operating income, and assets by country or region.

2.6 **Product breakdown**. Breakdown of sales, cost of goods sold, sales expense, marketing expense, and research & development expense by product.

2.7 **Contingent liabilities**. Detail of all significant contingent liabilities.

2.8 **Off-balance sheet transactions**. All contracts relating to, and descriptions of, off-balance sheet transactions.

2.9 **Pro forma**. Detail of any pro forma balance sheet line items.

2.10 **Accounts receivable**. Detail of all accounts and notes receivable, as of the most recent practicable date, including aging information.

2.11 **Currency**. Detail of foreign currency adjustments.

2.12 **Reserves**. Detail of all reserves.

2.13 **Intra-company trade**. Detail of trade between the Company and its affiliates for the last five years.

2.14 **Capital expenditures**. Description of capital expenditures for the last five completed fiscal years and the current and upcoming fiscal years (to date and budget), along with a description of any outstanding commitments for capital expenditures in excess of $_____.

2.15 **Operational reviews and changes**. Detail of any strategic review, restructuring, reorganization, or major operational changes undertaken in the last five fiscal years or proposed.

2.16 **Accounting changes**. Detail of any changes in accountants or accounting policies, principles, and procedures during the last

five fiscal years or any such changes that are proposed. Include any analyses or correspondence relating to the selection or application of accounting policies.

2.17 **Exceptional and non-recurring items**. Detail of exceptional and nonrecurring items for the last five completed fiscal years, the current fiscal year (budget), and the next fiscal year (forecast).

2.18 **Analysis**. An analysis, for the last three fiscal years, of:

- turnover;
- contribution;
- operating profit or loss;
- divisional costs;
- prepaid expenses;
- deferred income and expenses;
- depreciation policy;
- working capital (on a monthly basis); and
- dividends.

2.19 **Controls**. All materials establishing or describing the Company's and its subsidiaries' internal control over financial reporting and disclosure controls and procedures.

2.20 **Correspondence with accountants**. All correspondence from or to independent accountants within the past five years, including all management letters from accountants, all reports by accountants to management (including directors), all audit reports, and all letters from the Company's or any subsidiary's attorneys to accountants.

2.21 **Services provided by accountants**. Description of all services provided by any accounting or auditing firm to the Company or any of its subsidiaries during the last five years, or that such a firm has been engaged to provide in the future.

Include a description of any other relationships with any such firm or its personnel and a description of any interest in the Company owned by any such firm or its affiliates or personnel.

2.22 **Accounts and financial assets**. List of all accounts of any nature and any safe deposit boxes of the Company at any bank or other financial institution and all other financial assets of the Company (including securities, instruments, and cash).

3. Real and Personal Property

3.1 **Owned real property**. List of all real property owned (whether or not currently owned) in whole or in part by the Company and its past or present subsidiaries, together with the property's location and brief description, a description of all encumbrances, and any appraisal reports.

3.2 **Leased real property**. List of all real property leased (whether or not currently leased) in whole or in part by the Company and its pastor present subsidiaries, together with the property's location and brief description and a summary of the lease date, term, termination rights, renewal rights, and rent. All leases relating to such real property and all leases as to which the Company or any of its subsidiaries is a lessor.

3.3 **Owned personal property**. List of all personal property owned with a value in excess of $_____or that is otherwise material, including a description of all security interests and encumbrances on that property. Include inventories, machinery, equipment, tools, furniture, office equipment, computer hardware, supplies, materials, vehicles, fixtures, and other personal property.

3.4 **Leased personal property**. List of all personal property leased or otherwise used without ownership with a value in excess of $_____or that is otherwise material, together with a summary of the extent of the Company's right of use, lease date, term, termination rights, renewal rights, and rent. Include inventories, machinery, equipment, tools, furniture, office equipment, computer hardware, supplies, materials, vehicles,

fixtures, and other personal property. Provide all leases relating to such personal property and all leases as to which the Company or any of its subsidiaries is a lessor.

3.5 **Lien searches**. Results of all lien searches.

3.6 **Agreements**. All agreements that restrict or encumber real or personal property owned by the Company or any of its subsidiaries, including mortgages, deeds of trust, rights of first offer or refusal, and security agreements.

3.7 **Title insurance**. All title insurance policies for properties owned or leased by the Company or any of its subsidiaries.

4. Intellectual Property and Information

4.1 **Schedule**. A schedule of all patents, trademarks, copyrights, service marks, and applications for any of the foregoing that are used in the Company's or any subsidiary's business or that relate to the Company's or any subsidiary's business or name, indicating those owned, those subject to adverse claims, jurisdictions of registration, and registration status.

4.2 **Non-owned**. A list indicating each item on the above schedule that is not owned by the Company or one of its wholly-owned subsidiaries or that is involved in adverse claims or litigation. For each item listed, identify the owner of the item and provide license or other royalty agreements.

4.3 **Proprietary information**. A description of trade secrets and non-patented proprietary information, along with all related contracts or other written documents.

4.4 **Internet**. A schedule of Internet websites and domain name registrations, identifying each domain name and including the registry, the date of registration, and the date of any renewals.

4.5 **Agreements**. All agreements relating to intellectual property, including licensing, technology sharing, use of technology or information, disclosure of information, and confidentiality.

4.6 **Current and potential matters**.A description of all interference, infringement, or unfair competition matters, whether current or potential. Include copies of any communications to or from third parties and any internal studies, relating to the validity, value, or infringement of patents, technology, trade secrets, trademarks (including service marks), trade dress, copyrights, software, and domain names.

4.7 **Software**. A description of any software in which the Company or any subsidiary has rights, whether as owner or licensee.

5. Contracts–General

5.1 **Standard forms of agreements**. All standard forms of agreement that the Company or any subsidiary uses with customers or suppliers in the ordinary course.

5.2 **Warranties**. Forms of all warranty, rental, service, maintenance, and support agreements provided by the Company or any of its subsidiaries, including any deviations from standard language.

5.3 **Customers**. A list of all customers who since__, have accounted for or will account for at least [1%] of the Company's consolidated revenues in any [twelve-month] period.

5.4 **Prospective customers and contracts**. All agreements involving an amount in excess of $_____to sell or supply products or perform services. Copies of all outstanding bids, quotations, or tenders by the Company or any subsidiary for any contract that may involve the receipt of over $ _____ in consideration.

5.5 **Suppliers**. All material supply or requirements agreements to which the Company or any of its subsidiaries is a party, and all agreements involving an amount in excess of $_____for the future purchase of, or payment for, supplies, products, or services.

5.6 **Licensing, franchise, and conditional sales**. All licensing agreements, franchises, and conditional sales agreements to which the Company or any of its subsidiaries is a party.

5.7 **Sales, agency, franchise, dealer, and distribution**. All sales, agency, franchise, dealer, and distribution agreements and arrangements.

5.8 **Strategic alliances**. All joint venture, partnership, strategic alliance, corporate partnering, and similar agreements to which the Company or any of its subsidiaries is a party.

5.9 **Acquisitions and dispositions**. All significant documents relating to any acquisitions or dispositions by the Company or any of its subsidiaries, including any acquisition or disposition of corporate shares, companies, divisions, businesses, or significant assets, as well as any mergers, consolidations, reorganizations, or similar corporate transactions, other than purchases of goods in the ordinary course of business.

5.10 **Indemnity**. All agreements that obligate the Company or any subsidiary to indemnify a third party or to be responsible for consequential damages, where the potential obligation of the Company or the subsidiary is not insignificant.

5.11 **Noncompetition**. All agreements (current or proposed) that prohibit, limit, or restrain the Company or any subsidiary from engaging in or competing in any business activity.

5.12 **Research and development**. All agreements pertaining to research and development.

5.13 **Other material agreements**. All other current material agreements and arrangements between the Company (or any subsidiary) and any other party that involves the expenditure or receipt of over $_____of consideration.

6. Credit Facilities

6.1 **Long- and short-term debt**. A schedule of all long- and short-term debt, including capitalized leases, guarantees and other contingent obligations, and any anticipated changes to the amounts outstanding.

6.2 **Debt documentation**. All documents and agreements that evidence borrowings (or borrowing availability) in excess of $_____, whether secured or unsecured, by the Company or its subsidiaries.This includes indentures, loan and credit agreements, promissory notes, and other evidence of indebtedness and guarantees.

6.3 **Other financing documentation**. All documents and agreements that evidence other financing arrangements in excess of $_____.This includes sale and leaseback arrangements, installment purchases, intra-group credit arrangements, and agreements under which the Company is obligated as guarantor, surety, co-signer, or endorser.

6.4 **Correspondence with lenders**. All correspondence with and reports to lenders, other debt security holders, and trustees, since_____,_____, including all consents, notices, or waivers of default from lenders and all compliance certificates or reports submitted by or on behalf of the Company, its subsidiaries, or its independent public accountants.

7. Insurance

7.1 **Insurance**. A list of all insurance policies and self-insurance programs applicable to the Company and its subsidiaries, identifying as applicable the type of coverage provided (for example, "commercial general liability insurance"), the basis on which coverage is provided (for example, primary, excess, or excess umbrella), the "named insured," the policy number, the name and address of the insurance carrier, the annual premium, the policy period, the liability limits, and claims recoveries and payouts in the last five years. Provide copies of all existing insurance policies and related documents, along with a description of any self-insurance program, retrospective premium program, captive insurance program, or inter-group premium reimbursement agreement in which the Company or any of its subsidiaries has participated during the past five years.

7.2 **Analyses**. All insurance-related analyses or reports, whether prepared internally or by consultants.

7.3 **Directors' and officers' liability**. Copies of all liability insurance policies for directors and officers of the Company or its subsidiaries.

8. Taxes

8.1 **Returns and filings**. All federal, state, local, and foreign tax returns and filings (including all schedules, statements and attachments thereto) of the Company and all subsidiaries for the last five years.

8.2 **List of other jurisdictions**. List of all jurisdictions (whether domestic or foreign) in which the Company or any subsidiary does not file tax returns, but in which it maintains an office, a stock of goods, employees, or an agent who is a resident of the jurisdiction in which the agent solicits orders.

8.3 **Determination letters**. All IRS determination letters received by the Company or any subsidiary.

8.4 **Open years**. List of all open years (federal, state, local, and foreign) with respect to the Company and all subsidiaries.

8.5 **Audits and reports**. All federal, state, local, and foreign audit and revenue agents' reports and any notices of proposed or final adjustment to the Company's or any subsidiary's tax liability received in the last five years.

8.6 **Agreements with taxing authorities**. All agreements, ruling requests, consents, elections, waivers, settlement documents, and correspondence filed or made during the last five years with any federal, state, local, or foreign taxing authority, including any agreements relating to the statute of limitations.

8.7 **Compliance**. All documents relating to the Company's and its subsidiaries' compliance with material tax laws and regulations.

8.8 **Schedules**. Schedules of:

- all pending tax liabilities;
- tax basis in assets;
- all tax carry-over attributes (including net operating loss, foreign tax credit, and capital loss carry-overs) and any limitations;
- tax-free transactions not disclosed on returns;
- transfer pricing information;
- tax reserve calculation; and
- depreciation.

8.9 **Tax sharing and other agreements**. All tax indemnification, tax sharing, or tax allocation agreements involving the Company or any subsidiary and other members of an affiliated or unitary group in effect during the last five years (including any joint venture or other agreements that have the effect of tax allocation agreements), stating how each agreement was carried out during the past five years.

8.10 **Opinions**. All legal or accounting tax opinions received by the Company or any subsidiary during the past five calendar years.

9. Management and Employee Matters

9.1 **Officers and directors**. List of officers and directors of the Company and its subsidiaries.

9.2 **Structure**. Organizational charts illustrating the Company's management structure on a consolidated basis.

9.3 **Employees**. Biographies of key employees of the Company and its subsidiaries, and a list of all employees and consultants, indicating those who received compensation exceeding $____ in the last fiscal year and, for all employees with non-immigrant work authorization, their current visa status and the validity of that status.

9.4 **Employment and similar agreements**. All employment, consulting, change-of-control, or severance agreements to which the Company or any subsidiary is a party or by which any of them are bound.

9.5 **Other agreements**. All confidentiality or noncompetition agreements to or by which any current shareholder, director, officer, manager, employee, agent, or independent contractor is a party or is bound (a) if the agreement pertains to or affects the Company, the Company's and its subsidiaries' business, or the performance of services for the Company or any subsidiary, or (b) if the agreement is known to the Company.

9.6 **Plans**. Documents representing the following plans relating to the Company or any subsidiary or affiliated company, along with all correspondence with participants, beneficiaries, or regulators relating thereto:

- any bonus, incentive compensation, profit sharing, retirement, pension, group life insurance, death benefit, disability, accident, cafeteria, health, major medical plan, medical expense reimbursement, dependent care, sick leave, holiday, vacation, stock option, stock purchase, stock appreciation right, stock bonus, employee stock ownership, savings, consulting, deferred compensation, supplemental unemployment benefit, welfare, salary continuation, severance pay or termination pay, change in control, worker's compensation, or other employee benefit plan, program, policy, arrangement, or understanding; or
- any plan, program or arrangement that is an "employee pension benefit plan" or an "employee welfare benefit plan" as defined in Section 3 of the Employee Retirement Income Security Act of 1974.

9.7 **Other plan information.** For each plan, program, policy, arrangement or understanding listed in response to the above question:

- a schedule of the employer and employee contributions, premium payments, and other costs;
- any actuarial report, financial statement, or financial summary;
- any IRS Form 5500 (or 5500-C or -R), 5310, or 5330;
- any annual reports (PBGC Form 1), "reportable event" notices, or notices of intent to terminate a plan, filed with the PBGC;
- any applications for determination upon termination of a plan filed with the IRS;
- a summary of claims with respect to disability, severance pay or termination pay, change in control, or worker's compensation plans or policies; and
- a list of "multiemployer plans" within the meaning of ERISA §3(37).

9.8 **Collective bargaining**. Any collective bargaining agreements and codes of practice relating to any labor union or other representative body of employees, to which the Company or any of its subsidiaries is a party.

9.9 **Redundancy**. Details of any redundancy arrangements applied by the Company or any subsidiary and the estimated cost of any redundancy plans. A list of all employees made redundant or dismissed in the last 12 months or any employees made redundant or dismissed before that date in respect of which any claim is still outstanding (including a summary of all claims).

9.10 **Immigration**. Description or copies of the Company's and its subsidiaries' immigration compliance procedures.

9.11 **Code of conduct**. All codes of ethics or conduct maintained by the Company and its subsidiaries, with a description of all waivers therefrom during the last five years.

10. Environmental, Health, and Safety Matters

10.1 **Hazardous items**. List of all hazardous substances (including any hazardous, toxic, radioactive, or infectious substance, material, pollutant, contaminant, or waste, as defined or listed under any environmental law) that have been or are used, stored, generated, treated, handled, released, or disposed of (including off-site disposal) by the Company or any subsidiary.

10.2 **Permits**. All permits, licenses, registrations, notices, approvals, certifications, contingency plans, certificates of destruction, and other authorizations of the Company or any subsidiary relating to any environmental law.

10.3 **Company reports**. All internal reports (or available reports prepared by third parties) concerning environmental matters relating to current or former properties of the Company or any of its current or former subsidiaries. Include emission monitoring and sampling test results and any other laboratory analysis or results, including any boring logs.

10.4 **EPA and similar documents**. All statements or reports given by the Company or any subsidiary to the federal Environmental Protection Agency or any state or foreign department of environmental regulation or similar regulatory entity. All notices, complaints, suits, or similar documents sent to, received by, or served upon the Company or any subsidiary by the federal Environmental Protection Agency or any state or foreign department of environmental regulation or similar regulatory entity.

10.5 **Disposal facilities**. Description of all wells, above-ground or underground storage tanks, disposal pits, landfills, surface impoundments, or other waste disposal facilities that the Company or any subsidiary has used or is using to store or dispose of hazardous substances or petroleum products.

10.6 **Audits and reports**. All environmental audits undertaken by or in the possession of the Company or any subsidiary, and any assessments, reports, or analyses for purposes of future environmental expenditures or liabilities or concerning compliance with waste disposal regulations (hazardous or otherwise).

10.7 **Disposal of regulated substances**. All contracts involving the handling, treatment, storage, transportation, recycling, reclamation, or disposal of any substance subject to regulation under any law or regulation and used in, generated by, or pertaining to the Company or any subsidiary.

10.8 **Health and safety**.All material inspection reports, violations, or notices relating to health or safety matters.

10.9 **Real property**. A description of:

- all prior uses of real property owned, used, or leased by the Company or any subsidiary, to the extent different than the current use; and
- all environmental liens or superliens on property owned or operated by the Company or any subsidiary.

11. Trade Operations

11.1 **Imports**. If the Company and its subsidiaries, taken together, import in excess of $_____annually in merchandise or materials from outside the United States, a description of the import process, procedures, safeguards, and dealings with the US Customs Service.

11.2 **Exports**. List all countries into which the Company or any subsidiary sells or provides products or services, along with the annual dollar levels of sales into each country. Include any agreements and documents involving sales to or dealings with countries subject to comprehensive or limited US trade and investment sanctions and a description of the export process, procedures, safeguards, and any applicable export controls.

11.3 **Foreign Corrupt Practices Act**. In connection with contracts with foreign governments, foreign government entities, or foreign state-owned or state-operated enterprises (including joint ventures), all sales representative, commission agent, dealer, and consultancy agreements and arrangements.

12. Compliance with Legal Requirements; Legal Proceedings; Disputes

12.1 **Correspondence with regulators**. All correspondence with, reports to, or filings with:

- the Securities and Exchange Commission or any state or foreign securities or "blue sky" regulatory authorities;
- any other regulatory authority that regulates any portion of the Company's or any subsidiary's business; and
- a copy of the Company's most recent filing under the Hart-Scott-Rodino Antitrust Improvements Act.

12.2 **Orders**. All orders, writs, judgments, injunctions, decrees, and settlement or similar agreements, to which the Company or any of its subsidiaries is a party or is bound.

12.3 **Pending or threatened matters**.A description of the current status of each action, arbitration, audit, examination, investigation, hearing, litigation, claim, suit, administrative proceeding, governmental investigation, or governmental inquiry, whether pending or threatened, affecting the Company or its subsidiaries or any of their businesses, assets, or operations.

12.4 **Governmental violations and infringements**. All correspondence, reports, notices, or filings related to any dispute, alleged violation, or infringement by the Company or any subsidiary of (or otherwise relating to the status of the Company's or any subsidiary's compliance with) any federal, state, local, or foreign law or governmental regulation, order, or permit, including matters relating to:

- equal employment opportunity;
- unfair labor practices;
- bribery or corrupt practices;
- occupational safety and health;
- antitrust;
- intellectual property; and
- environment.

12.5 **Permits**. All governmental approvals, clearances, consents, waivers, licenses, permits, registrations, certifications, and other authorizations, that are held by or relate to the business, assets, or securities of the Company or any subsidiary.

12.6 **Customer complaints**. A schedule of the quantity of recalls and customer complaints for each of the last five years, including an analysis of the complaints, the corresponding resolutions, and related annual costs.

12.7 **Agreements and payments**. Description of any oral or written arrangements, providing copies of any written agreements, between the Company and any officer or employee of any government or any governmental department, agency, or instrumentality or any entity owned or controlled by any such officer or employee. Please provide information with respect to any payments made to any such persons within the last five years.

12.8 **Breaches or defaults**. List of all agreements of the Company or any subsidiary under which a breach or default has occurred or is claimed to have occurred, describing the breach or default. Include separately all agreements for which consummation of the contemplated transaction would result in a conflict, violation, breach, default, or right to withdraw, suspend, cancel, terminate, or modify the agreement.

13. Relationships with Related Persons

13.1 **Agreements**.Any agreements with or pertaining to the Company or any of its subsidiaries and to which any current or former director, officer, shareholder, or affiliate of the Company is a party. Include any loan or transfer of assets between the Company or any subsidiary and any of these persons.

13.2 **Receivables and payables**. All documents relating to any receivables from or payables to any director, officer, or shareholder, or affiliate of the Company.

13.3 **Other transactions**. All documents relating to any other transaction between the Company or any of its subsidiaries and any director, officer, or shareholder, or affiliate of the Company.

13.4 **Conflicting interests and arrangements**. Describe any direct or indirect interest of any affiliate, shareholder, director, officer, or other senior management of the Company in any corporation or business that competes with, conducts any business similar to, or has any present (or contemplated) arrangement or agreement with (whether as a customer or supplier) the Company or any subsidiary.

14. Investments and Transactions

14.1 **Equity investments**. All documents evidencing ownership of a 5% or more investment in any entity and information with respect to any agreement to acquire a 5% or more investment in any entity by the Company or any subsidiary.

14.2 **Offering documents**. All offering circulars, private placement memoranda, syndication memoranda, or other securities placement documents, prepared or used by the Company or any of its subsidiaries during the last five years.

14.3 **Engagement letters**. Any engagement letters or contracts with any financial advisor, investment banker, finder, business broker, or similar service provider pursuant to which there might be any

obligations in any type of proposed transaction. A list of all advisors retained, including fees payable to them and claims for payment, and copies of all related indemnification agreements.

15. Miscellaneous

15.1 **Powers of attorney**.All current powers of attorney held on behalf of the Company or any subsidiary.

15.2 **Business descriptions**. All recent reports, studies, or analyses regarding management, marketing, sales, or similar matters relating to broad aspects of the Company's or its subsidiaries' business, operations, products, or services.

15.3 **Competitors**. Provide a list of the primary competitors of the Company and its subsidiaries.

15.4 **Brochures [and pricing information]**. Marketing and other descriptive brochures prepared within the past five years regarding the Company or any subsidiary or any of their products, services, or events. [Provide a current price list for all products and services sold, licensed, or leased by the Company or any subsidiary.]

15.5 **Press releases**. All press releases issued by the Company or any subsidiary during the last five years and available press clippings that refer to the Company or a subsidiary.

15.6 **Analyses**. Recent analyses of the Company (or the industry or industries in which it operates) prepared by investment bankers, engineers, management consultants, accountants, or others. This includes marketing studies, credit reports, analyst reports, internal studies of the business or industry, and other types of reports (financial or otherwise).

15.7 **Consents and notices**. List any filings that the Company or any stockholder or subsidiary must make, any notices that the Company or any stockholder or subsidiary must give, and any approvals, clearances, consents, ratifications, waivers, permits, or other authorizations that the Company or any stockholder or

subsidiary must obtain prior to executing any agreements or consummating or performing any transactions contemplated in connection with the contemplated transaction.

15.8 **Other**.Any other document or information that, in your judgment, is significant with respect to the Company, its subsidiaries, or any portion of their businesses or that should be considered and reviewed in connection with assessing the Company's and its subsidiaries' business and financial condition.

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