



An Introductory Guide to Doing Business in the United States

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Introduction

We are pleased to make this introductory guide available to our clients and friends who are considering an investment or business transaction in the United States. It is our hope that these materials will provide you with a ready legal reference as you consider your proposed investment or transaction.

Our experience with the most frequently asked questions and the most common issues in cross-border business transactions has determined the topics we have addressed in this guide. We must remind you that these materials merely contain a summary of selected topics. There are many other U.S. legal issues that may be relevant to your business or proposed transaction.

While we intend the materials in this guide to be reliable and informative, as well as practical and comprehensive, each reader should recognize that it is not possible for us to guarantee that these materials accurately reflect current law at the time the reader is consulting them. Moreover, these materials are not, and should not be considered to be, legal advice. With these caveats in mind, we hope you will find this introductory guide to be helpful.

Finally, we wish to emphasize that most legal issues are not amenable to accurate diagnosis and resolution without the involvement of a capable U.S. lawyer, preferably one having experience in the relevant practice area. We hope that your business brings you to the United States and that Thompson Hine has the opportunity to assist you in achieving your business goals.

Chapter 1: Business Entities

General Considerations in Choosing a Form of Entity

The United States permits a variety of business organization forms, including:

- Corporations (“C” and “S”)
- Limited liability companies (LLCs)
- Partnerships
- Branch offices
- Sole proprietorships

Each type of entity has its advantages and disadvantages. The selection of the best combination will depend upon the particular circumstances. Among the factors that are relevant in choosing an organization structure are:

- Extent of owner liability
- Transferability of ownership
- Perpetual or limited duration
- Number of owners
- Financing
- Tax considerations
- Type and size of business
- Exposure to lawsuits in the United States

The establishment, operation and liability of the various business forms are regulated by the laws of each individual state. While federal law on taxation and securities regulation may influence the choice of a business organization, there is actually little federal law on the establishment of business entities outside of banking and certain federally-chartered companies.

Corporations

A corporation is a legal entity with limited liability for the owners of the shares of its capital stock. It is created by application to the state in which it will be organized (which does not need to be the same as the state where it will operate).

Exceptions to Limited Liability: “Piercing the Corporate Veil”

In certain circumstances, courts may “pierce the corporate veil” and refuse to recognize the corporation’s existence as separate from its shareholders. If a court does this, the shareholders will be personally liable for the corporation’s acts. Examples of situations where courts have pierced the corporate veil include permitting confusion and co-mingling between personal and corporate acts (*e.g.*, paying personal bills with corporate checks); organizing or operating a corporation with insufficient capitalization in relation to its scale of operation and potential risks; and failing to follow corporate formalities.

“C” Corporations and “S” Corporations

A distinction is made in U.S. federal tax laws between “C” corporations and “S” corporations. The labels refer to subchapters of the Internal Revenue Code.

A “C” corporation is treated as a separate legal entity for tax purposes. Income, gains and losses are recognized and reported by the corporation. Income is subject to double taxation, first as corporate earnings and then as shareholder income from dividends.

An “S” corporation, on the other hand, is treated as a flow-through entity for tax purposes so that the shareholders pay taxes on the company’s profits. Its status arises from an election form filed with the Internal Revenue Service (IRS). Failure to file the election automatically renders the corporation a “C” corporation.

In order to obtain “S” status, a corporation may *not* have:

- More than 75 shareholders
- More than one class of stock
- Other corporations as shareholders
- A non-resident alien as a shareholder

Formation

The legal formalities for establishing and governing a corporation must be observed in order to protect the shareholders’ limited liability. Once these formalities are observed, the state’s role is minimal, and the corporation may operate for any lawful purpose.

Historically, the state of Delaware enacted corporate legislation that offered flexibilities generally not found in many other states. Today, however, most of these differences have disappeared and there is no longer a noticeable advantage to incorporation in the state of Delaware.

Each state has its own requirements regarding the capital structure of a corporation. Even so, the minimum capital requirement in most states is nominal. Theoretically, incorporating with a capital stock of \$10 or \$100 is possible, although the ultimate capital structure of a company, and in particular the ratio of its equity to its debt, is a heavily tax-driven decision.

Shareholders in U.S. corporations may be unlimited in number, of U.S. or foreign nationality, and individuals, corporations or other business entities.

The board of directors and the officers govern the corporation. No U.S. law requires labor representation on the board of directors or in management. Generally, there are no restrictions as to residency or citizenship of the directors or officers.

All state corporate statutes require a corporation to appoint an agent in the state of incorporation (and where authorized to do business) to receive official notices from the state and service of process from a court in the event of a lawsuit against the corporation. A statutory agent’s

requirements are set forth in the statutes. The agent must be either an individual or a corporation resident in the state.

To form a corporation, most states require filing of articles (or certificate) of incorporation with the secretary of state (or some other designated official) of the state of incorporation, executed by the incorporator. There must be an appointment of a board of directors by the incorporator, a meeting of the board of directors (or an action in writing) to sell shares to shareholders and appoint officers, and adoption of the bylaws (or code of regulations).

Limited Liability Companies

The limited liability company (LLC) is a relatively new form of business entity that has rapidly gained favor following a ruling by the IRS in 1988 regarding the tax treatment of LLCs. LLCs have the structural characteristics of corporations and the tax characteristics of “S” corporations and partnerships. Simply stated, an LLC possesses both limited liability for its owners and pass-through tax treatment. All 50 states now have enacted LLC statutes.

An LLC is an unincorporated association with a limited duration formed under a specific state law. It may be formed by one organizer and in most states must have two or more members. A member may be an individual, corporation or another LLC. As a result, LLCs have an advantage over “S” corporations in that corporations may be owners. However, many states require more than one member for an LLC, while “S” corporations can have only one shareholder (Delaware and Ohio both permit single-member LLCs).

Partnerships

A partnership is typically defined as “an association of two or more persons to carry on as co-owners of a business for profit.” No written partnership agreement is required to establish a partnership. Often a partnership may exist even where it was not explicitly or formally intended. This occurs because the receipt of a share of profits from a business by person is *prima facie* evidence that he or she is a partner in the business. However, when establishing a serious venture, a written partnership agreement is commonly used to avoid misunderstandings.

In the United States, there are two types of partnerships: general partnerships and limited partnerships. General partnerships are one of the oldest forms of business entities in common-law countries. The primary characteristics of a general partnership are:

- Having two or more partners, who may be individuals or corporations;
- Not requiring each partner to be resident in the state, nor a U.S. citizen or corporation;
- Each partner having a share of the profits and assets of the business; and
- Each partner being jointly and severally liable for any loss or injury caused by any wrongful act or omission of any partner acting in the ordinary course of the partnership’s business.

A limited partnership is a partnership with one or more general partners with unlimited liability, and one or more limited partners whose liability is limited to the amount invested. Unlike a general partnership, forming a limited partnership requires filing a certificate of limited partnership with the state in which formation is desired. A limited partner’s limited liability is

lost if he participates in the control of the business or permits his name to appear in the name of the limited partnership. The limited partners and general partners may be divided into classes, each with different voting and financial rights.

Branch Offices

Forming a branch office means that the parent company has permanent establishment in the United States. A branch is not considered separate from its parent company, and thus the parent company is fully liable for its debts and obligations.

The IRS requires that adequate books and records be maintained to clearly reflect the taxable income of the branch. The tax consequences of establishing a branch are difficult to assess, as the IRS subjects deductions attributable to the branch to a complex set of rules. Often, this requires over-allocation of income to the domestic branch. Nevertheless, the main advantage of establishing a branch will be that losses can be offset against profits of the parent company.

Sole Proprietorships

Despite its liability drawbacks, the sole proprietorship is the most common form of business entity in the United States. The laws of each state govern the operation of sole proprietorships.

The individual sole proprietor is personally responsible for all debts and obligations of the sole proprietorship. However, the sole proprietor may obtain some protection through the purchase of liability insurance.

The income of a sole proprietorship is taxed as ordinary income of the individual sole proprietor. The IRS requires that the sole proprietor maintain adequate books and records. No separate Employer Identification Number (EIN) application is required.

No specific filing is required to form a sole proprietorship. However, the owner will need to obtain any necessary permits, licenses or fictitious name statement (if he is operating under a name other than his own) to do business. No formality, such as a shareholder meeting, is required.

Chapter 2: Business Capital and Financing

Introduction

Capital for a business is generally classified as either equity or debt, although variations within each category can provide some of the characteristics of the other. A typical business will be financed with a combination of debt and equity. The appropriate mix of debt and equity in a business, and their terms, will vary from case to case and should be carefully considered, particularly in light of the relevant tax attributes of the business and its anticipated growth.

In seeking to raise capital, compliance with applicable federal and state securities laws is crucial. The Securities Act of 1933, as amended (the “Act”), governs the offer and sale of equity and debt securities in the United States. Its basic aim is to prohibit sales of securities to the public without adequate disclosure. An issuer of securities must either register the offering with the Securities and Exchange Commission (SEC) or find an appropriate exemption from registration.

When offerings and sales of securities are exempt from registration under the Act, those transactions are referred to as *private placements*. Exemptions will often be available if the proposed investors are chosen with care and appropriate disclosures of information are made to them. The number of prospects to be solicited and the sophistication and net worth of these potential investors are critical considerations in qualifying for an exemption. However, even when exemptions are available, filings may still be required with federal and state securities agencies. Public offerings of securities require registration under the Act. This is the process known as *going public*.

Equity Capital

An investment in equity is rather different from an investment in debt. The claim to a return of investment by an owner of an equity interest will almost always be subordinated to the claims of the business’ creditors. However, that risk is balanced by the potential for the equity investor to realize a return far in excess of the initial investment. The equity investors will normally retain control of the operations of the business within the limits imposed by the terms of any debt instruments. Equity capital will usually take the form of shares in a corporation, membership interests in a limited liability company or partnership interests in a partnership.

Debt Capital

Most of the debt capital provided to businesses in the United States is provided by commercial banks. These banks usually lend money pursuant to the terms of lengthy loan documents. The terms of a loan will be dictated by the character of the borrower, the credit history of the borrower and the security package available for repayment. The material terms to consider in a debt financing include:

- Amount of the loan or loans to be made and the loan type (*i.e.*, revolver, term, line of credit);
- Interest rate to be charged with respect to each loan;
- Repayment terms;

- Financial and other affirmative and negative covenants;
- Fees to be charged by the bank; and
- Environmental review requirements.

A lender will often require the borrower to pledge some or all of its assets to the lender to secure the repayment of the loan. Pledged assets are commonly known as *collateral*. The collateral provided by a borrower can take many forms and may include personal property, both tangible and intangible, and real property. Rights of a lender upon the default of a borrower typically include the right to possession of the collateral, the right to collect proceeds from the collateral and the right to have a receiver appointed. In certain circumstances, the lender may also require a third party to guarantee the payment and performance by the borrower of its obligations under the loan documents.

Bankruptcy Issues

If a borrower becomes financially distressed and unable to repay amounts borrowed, it may become subject to the bankruptcy laws of the United States. These laws have two general objectives. The first is to secure an equitable division of the insolvent debtor's property among its creditors, and the second is to prevent the debtor from taking action that is detrimental to the interests of its creditors. The federal bankruptcy laws can be found in Title 11 of the United States Code (the "Bankruptcy Code").

There are three major types of bankruptcy cases: Chapter 7 Liquidation, Chapter 11 Reorganization and Chapter 13 Adjustment of Debts of an Individual with Regular Income.

In a Chapter 7 proceeding, all non-exempt property of the debtor's estate is liquidated by an appointed trustee, and the proceeds are distributed among the creditors according to the priorities set forth in the Bankruptcy Code.

Chapter 11 is used almost exclusively by a business to restructure its finances so it can continue to operate, provide employment and pay its creditors. In a Chapter 11 proceeding, the debtor is permitted to keep its assets and is given time to prepare a plan to work its way out of its financial difficulties.

Chapter 13 is used only by individuals who have a regular income. It provides such individuals the opportunity to repay their debts over a specified period of time without being pressured by their creditors.

Chapter 3: Litigation and Dispute Resolution

Court litigation is the most widely used method to resolve disputes in the United States, but alternative dispute resolution, including arbitration and mediation, has become more popular in recent years. Each option has its own advantages and disadvantages.

Litigation

Litigation Basics

The United States utilizes an adversarial system of litigation, in which each party is represented by attorneys and cases are presented to impartial judges. Cases may be brought in courts operated by an individual state's judicial system, or, in cases involving federal statutes or cases involving a minimum of \$75,000 and between citizens of different states or foreign countries, in the federal judicial system. One or more United States District Courts are located in each state. Procedural rules may vary widely between jurisdictions, though federal courts are all guided by the Federal Rules of Civil Procedure. Except in certain circumstances, typically involving frivolous claims or other such conduct, each party in a lawsuit must pay their own legal fees. There are few provisions for the prevailing party to recover its legal fees from the losing party.

Litigation is commenced by the filing of a complaint and the service of a summons. Early opportunities for dismissal on legal grounds or to challenge the venue or jurisdiction of the court over the defendant are typically available. A process known as *discovery* is then initiated in which the parties request information from one another and take depositions of persons with relevant information. Depositions and information may also be obtained from third parties through the use of subpoenas. While discovery in American courts is broad, it is not unlimited.

After the conclusion of discovery (and sometimes during discovery), a party may seek *summary judgment*, a pleading supported by facts and evidence that attempts to convince a court that a trial is unnecessary. Although most cases are resolved through settlement or other methods prior to trial, a trial will be held if necessary. Most cases in the United States are held before a jury. After a trial is concluded and judgment entered, that judgment may be appealed to an appellate court as a matter of right. After an appellate ruling, further appeal may be available from the highest court of a jurisdiction (typically a state supreme court or the United States Supreme Court), but such courts may choose not to accept the case.

Litigation is frequently viewed as slow and expensive, but it provides the greatest opportunity to obtain information that would not otherwise be voluntarily available from other parties. Unlike arbitration and mediation, appellate review is readily available of any judicial decision. Litigation may be resolved by settlement at any time. It is common for parties to settle after having obtained sufficient information and having tested their legal theories before the court in summary judgment or other legal motions.

Arbitration

Arbitration is, in many ways, similar to litigation, but is less formal. Many arbitrations are run by commercial organizations such as the American Arbitration Association or by international

organizations such as the International Chamber of Commerce. Arbitrations are presided over by a single arbitrator or a panel of arbitrators, generally selected by the parties from lists made available by the sponsoring organization. Most, but not all, arbitrators are attorneys. Some effort is made to secure an arbitrator who has familiarity with the subject matter of the dispute.

Arbitrations are typically conducted pursuant to the provisions of a contract between the parties, but may also be agreed to after a dispute arises. Arbitrations are also subject to state and federal statutes, and at times, conflicts arise over the arbitrability of the dispute. The ruling in an arbitration is intended to be binding on the parties.

Discovery is not available as a matter of right in arbitration but is frequently allowed, within the discretion of the arbitrator. Evidentiary rules that apply in litigation do not apply in arbitration. An evidentiary hearing is held before the arbitrator, who then issues a decision. Decisions may represent a compromise and, unless requested, may not be accompanied by an explanation of the arbitrator's reasoning. The rulings from an arbitration are not ordinarily subject to appeal except in egregious circumstances. The arbitration ruling is readily converted into a judgment that may be enforced.

In part because of the lack of formality and the avoidance of clogged court dockets, arbitration is generally viewed as faster, more efficient and less expensive than litigation. The lack of evidentiary and procedural safeguards can be a risk, particularly if the arbitrator is unfamiliar with the subject matter of the dispute, and there is little opportunity for resolution of the matter prior to the hearing. While arbitration is frequently less expensive than litigation, much of the cost may be required to be paid up front in the form of a deposit based on expected hearing and study time for the arbitrator(s).

Mediation

Unlike litigation and arbitration, mediation is a non-evidentiary process that is not designed to produce a binding result. Instead, the purpose of mediation is to assist the parties in reaching an amicable resolution of the dispute between them. In a private mediation, the participants choose a mediator, who then schedules the mediation with the parties (generally including both the attorneys and corporate representatives). Each party typically gives a statement, and the mediator then meets with the parties both jointly and separately. The mediator may point out strengths and weaknesses of a case and convey offers of settlement between the parties.

Mediation is often employed as a method of dispute resolution in the early states of litigation, and in some jurisdictions is required by the court. In such instances, the parties select a mediator from a list supplied by the court and engage in a process similar to that used for a private mediation. Because mediation is not generally chosen by the parties in such circumstances, these mediations are seldom successful, though they may provide a basis for further settlement discussions during litigation.

Mediations typically last a day or less, and therefore are prompt and cost-effective when compared to litigation and arbitration. Unlike litigation and arbitration, client representatives may actively engage in the dialogue along with the attorneys. However, no definitive outcome can be guaranteed, and in matters where relatively little information is available to the mediator and the parties, resolving a dispute in its early stages through mediation may be difficult.

Chapter 4: Trade Regulation (Import and Export)

Firms engaging in business with the United States must take U.S. international trade laws into account. These laws govern both imports into the United States from other countries and exports from the United States to other countries. Companies are sometimes surprised to learn the extraterritorial reach of these laws. They often apply to transactions conducted by U.S. persons with non-U.S. individuals or entities, and to transactions that involve U.S. merchandise or technology, even when the transactions take place outside the United States. A casual conversation with a non-U.S. citizen can be deemed to be an “export” of technology, illustrating the pitfalls that arise when dealing with the intricate U.S. regulation of international transactions.

Imports Into the United States

The U.S. government imposes general substantive requirements on imports into the United States, as well as limitations or prohibitions on the import of certain goods, including those that have been determined to be unfairly traded.

Substantive Requirements

Importers are responsible for knowing the applicable import laws. U.S. Customs and Border Protection (“Customs”) and other federal agencies are responsible for administering U.S. regulations related to importing into the United States and ensuring that U.S. laws are followed. They do this primarily through review of select entries and auditing of importers’ overall importing procedures, rather than through detailed scrutiny of individual import transactions.

Customs relies upon importers to provide detailed information regarding each import, including information pertaining to classification, valuation, country of origin and country-of-origin marking. These requirements can be further complicated depending on a variety of circumstances, such as the relationships between the parties to the import transaction and the nature of the merchandise being imported. For example, if the buyer and seller of imported merchandise are related, special valuation rules apply. If textile or food products are being imported, special country-of-origin rules and additional labeling requirements may apply. The rules applied can vary depending upon the particular country of exportation involved.

To ensure that all documentation is properly prepared, Customs relies upon substantial civil and criminal penalties, including liability for false statements and fraudulent declarations. While U.S. import requirements are quite complex, Customs does not expect perfection from importers. Instead, importers must exercise *reasonable care* in their import activities. While this standard is not well-defined, Customs has said that reliance on the advice of a customs expert is one element of satisfying this standard. Companies intending to sell in the United States should, therefore, ensure that these transactions are reviewed by a customs expert, such as a customs broker, attorney or consultant, to help avoid extensive delays, monetary penalties or denial of import privileges.

Restrictions on Imports

Like many other governments, the U.S. government maintains laws that limit the importation of goods traded under circumstances involving harm to domestic industry, as well as imports that may impact U.S. national security or foreign policy. These U.S. laws are generally consistent with World Trade Organization (WTO) obligations, but not all are the subject of specific WTO agreements.

Certain unfair trade activities are addressed by U.S. antidumping and countervailing duty laws. Antidumping duties are special duties imposed, in addition to any other applicable tariffs, on goods that are imported for sale at less than fair value. These goods have been determined to have caused, or threaten to cause, material injury to a domestic industry producing the same product.

Countervailing duties are similar to antidumping duties, in that they seek to protect domestic industry from unfairly priced imports. Countervailing duties can be imposed when imported products have been determined to have benefited from the conferral of a financial contribution to a specific firm, group of firms, industry or group of industries. Subsidies can take the form of manufacturing, production or export subsidies. Both the antidumping and countervailing duty regimes are administered by the U.S. International Trade Commission and the U.S. Commerce Department's International Trade Administration. Antidumping and countervailing duty actions can be initiated by U.S. companies or self-initiated by the U.S. government.

Additional U.S. laws are available to limit imports. The U.S. government, in some cases, provides domestic industries with temporary relief from increased imports even if the imported merchandise is not being unfairly traded. These safeguards, considered emergency measures, are available where increased imports have caused or threaten to cause serious injury to a domestic industry. This can take the form of increased duties or quantitative restrictions (*i.e.*, quotas). U.S. laws also provide relief from the importation of merchandise that infringes a valid copyright, trademark or patent. Under these laws, the importation of affected merchandise can be prohibited.

National security and foreign policy considerations can be used to limit imports into the United States. If a domestic industry deemed essential to national security is found to be threatened by certain imports, these imports can be restricted. The U.S. government also imposes complete or partial embargoes on certain countries, such as Cuba and Iran, prohibiting the importation of merchandise from those countries into the United States.

Dealing with ongoing or potential U.S. trade actions can involve a variety of political and legal strategies, as well as monitoring of import trends and manipulation of U.S., home-market and third-country sales patterns. A foreign company that is involved in a trade case, or that operates in an industry where trade actions are common, needs to consider its U.S. business strategy in light of a possible trade action. Consultation with an attorney or trade expert who focuses on trade litigation can help avert an action or minimize its impact should one be filed.

Exports from the United States

U.S. export laws apply in a variety of transactions, including those that might not appear to involve an export from the United States. These laws control:

- Exporting of merchandise, technology and services from the United States to another country
- Importing of certain merchandise into the United States
- Manufacturing or resale abroad of merchandise using U.S. technology or U.S.-origin merchandise
- Transactions between U.S. persons and certain countries, entities or individuals

Depending on the nature of the items being exported or the nature of the transaction, various U.S. agencies might be implicated, including the U.S. Commerce Department's Bureau of Industry and Security ("BIS"), the U.S. State Department's Directorate of Defense Trade Controls ("DDTC") and the U.S. Treasury Department's Office of Foreign Assets Control ("OFAC").

Prohibited Transactions

The U.S. government has imposed partial or complete trade embargoes against various countries which are typically administered by OFAC. Under these embargoes, almost every transaction by a U.S. person with Cuba, Iran or Sudan or their nationals or agents is prohibited. The U.S. government also has designated entities and individuals, such as denied parties or global terrorists and narcotics traffickers, with whom U.S. persons are typically forbidden to deal.

Export License Requirements

Export license requirements can generally be divided into two types: those related to defense articles and services, which are administered by DDTC, and those related to commercial products, software and technology, which are administered by BIS. Other agencies are also involved with particular types of commercial items, such as nuclear equipment and materials. For defense articles and services, virtually all exports must first be licensed or otherwise approved by DDTC. Not all of the items that are governed by these regulations are obvious. The regulations also govern a number of dual-use items whose immediate military applications are not readily apparent. For commercial items, only certain transactions require an export license or other approval; this depends upon the sensitivity the U.S. government has assigned to the item being exported and the country to which it is being exported. Export licenses are typically required for items that the U.S. government, and often other governments, perceive a need to control for national security, missile technology, nuclear/chemical/biological weapons proliferation or antiterrorism reasons.

Because of the broad meaning given to the term *export* by U.S. authorities, U.S. requirements are far-reaching. For example, in addition to the shipment of merchandise from the United States to another country, the U.S. government considers exports also to include the release of technology by any means (*e.g.*, telephone call, face-to-face discussions, email correspondence or access to electronic systems located in the United States), wherever the release might take place. This

includes, for example, sharing manufacturing drawings or specifications with a non-U.S. person (*i.e.*, someone who is not a U.S. citizen or permanent resident), even if the exchange takes place within the United States. This is known as a *deemed export*.

U.S. export control requirements should be thoroughly evaluated by any company considering doing business in the United States or with U.S. companies. These requirements carry with them severe penalties, sometimes for inadvertent violations. They have recently become the focus of enhanced enforcement activity.

Anti-Bribery

The U.S. Foreign Corrupt Practices Act (the “FCPA”) addresses bribery of government officials. Under the FCPA, it is unlawful to give, offer or promise anything of value to any foreign official, foreign political party, official of a foreign political party or candidate for foreign political office, for the purpose of gaining any improper advantage. This prohibition applies to direct payments as well as payments through third parties. The FCPA applies to U.S. persons, including foreign companies with securities listed on U.S. stock exchanges and foreign companies or individuals who further improper payments while in the United States.

The FCPA has a very broad extraterritorial reach, and in certain circumstances, even can apply to non-U.S. citizens who use an instrumentality of U.S. interstate commerce in furtherance of an illegal payment. The FCPA also includes indirect anti-bribery requirements, which govern certain publicly traded companies, in the form of mandatory record-keeping and accounting provisions. These provisions are meant to prevent improper payments and the establishment of corporate slush funds such as those sometimes used to finance bribery payments. Although the FCPA contains affirmative exceptions for certain types of payments not deemed to be a foreign policy concern, there is no *de minimis* floor for payments, so consultation with an expert in the field is recommended before any potentially covered payments to a foreign government official are made by a covered entity or person.

Chapter 5: U.S. Tax Considerations

Income and Withholding Taxes

Foreign companies that wish to expand their business operations to the United States can operate their businesses in various forms, including corporations, partnerships and branches. The U.S. income tax consequences generally are similar regardless of the form chosen. If the corporate form is chosen, the income earned by the U.S. subsidiary corporation is taxed up to a maximum U.S. federal income tax rate of 35%. In addition to the U.S. federal income tax, various state and local jurisdictions impose income, gross receipts or franchise taxes on the U.S. subsidiary corporation at tax rates ranging from 1% to 10%. For planning purposes, many companies use 40% as the combined federal, state and local income tax rate. Dividends paid by a U.S. subsidiary to its foreign shareholders are subject to U.S. withholding tax at a 30% rate, but this rate can be reduced by tax treaty.

Other State and Local Taxes

State and local jurisdictions impose a wide variety of other taxes on businesses. For example, states impose a tax on real property held by a business, based on a percentage of the assessed value of the real property. Similarly, most states also impose a personal property tax on tangible personal property held by a business (such as machinery, equipment and inventory), based on a percentage of the assessed value of such property.

State and local jurisdictions impose sales and use taxes on retail sales of goods and, in some cases, on retail sales of various services. Sales and use tax rates typically range from 3% to 8%. However, neither the federal government nor any state or local jurisdiction imposes a value-added tax.

Chapter 6: Intellectual Property

Patents

Patents protect any new and useful process, product, machine, manufacture or composition of matter. A patent can be obtained on an improvement of an existing invention so long as the modification is not obvious. Natural laws, physical phenomena and immoral inventions are not patentable. Patents are classified into the areas of mechanical, electrical or chemical devices. Software and business methods are also patentable. Medical procedures are patentable, but these patents are not enforceable against licensed physicians.

A patent application requires a written description, enablement, best mode, drawing and at least one claim. The United States has a first-to-invent system, and a patent term runs for 20 years after the effective filing date. After the invention is disclosed to the public, the inventor has one year to file or the invention enters the public domain. An experimental use for perfecting the invention prior to filing is not considered a public disclosure. Design patents protect the ornamental appearance of a useful object and run for 14 years after the filing date.

A patent gives its owner the right to exclude others from creating or using the patented invention. Infringements are filed in federal court and may be a literal infringement of the patentable invention or an infringement by an equivalent invention. Remedies include injunction and damages for lost licensing revenues. If a patented item is marked with a patent number, then damages accrue from the time of the infringement. Damages for unmarked items accrue from the time the infringer is placed on notice of infringement.

Copyrights

Copyrights are used to protect original works of authorship contained in a fixed tangible medium of expression such as literary, musical, dramatic, choreographic, pictorial graphical, sculptural, motion picture, sound recording and architectural works. Copyright protects an expression of an idea, not the underlying idea itself. A functional item cannot be copyrighted, but computer software code is copyrightable. A copyrighted work can also have two or more joint authors. The employer is the author of a work for hire.

Copyright term is life plus 70 years. The term for a work for hire, anonymous work or pseudonymous work is the shorter of either 95 years from first publication or 120 years from first creation. The proper format to indicate that a copyright exists is the copyright symbol or the word "copyright," followed by the year, followed by the author's name, for example, ©2007 Thompson Hine LLP.

A copyright gives the author the exclusive right to reproduce, distribute, perform, publicly display and prepare derivative works. A limit to an author's exclusivity right and a defense against infringement is fair use, which can be established by proving educational or library use, parody or first sale doctrine. Software users are permitted to create copies as a backup or archive.

Infringement can be direct, contributory or vicarious. Remedies for copyright infringement include injunction, damages for lost profits, impounding and destroying infringing articles, attorney fees and criminal sanctions for willful infringement done for commercial financial gain.

Trademarks

A trademark is a word, symbol or combination thereof used to identify the source of a good and distinguish the good from similar goods. Similarly, a service mark identifies a service, a collective mark identifies a member of an organization and trade dress identifies the total image and overall appearance of a good or service. A mark cannot be generic, merely descriptive, geographically descriptive or confusingly similar to an existing mark.

A mark is eligible for registration by the first person to use it in interstate or international commerce. Marks are filed with the United States Patent and Trademark Office and, if approved, are published so that interested parties have 30 days to object to the mark. Registrations remain in force for 10 years and may be renewed indefinitely. Within five years of registration, an action can be brought to cancel the mark based on the mark being generic, functional, abandoned, previously registered fraudulently, immoral, deceptive, scandalous or disparaging. After five years, a trademark owner may file to make a mark incontestable. If the U.S. mark registration is filed within six months of the filing in another country, then the U.S. application will be deemed to have been filed at the same time as the earlier foreign application.

Proof of infringement entitles a trademark owner to seek relief in both federal and state court. Remedies include injunction, order impounding or destruction of infringing goods and damages for lost profits. Willful infringement may entitle the holder to legal fees and triple actual damages.

Trade Secrets

A trade secret is a formula, pattern, compilation, program, device, method, technique or process that derives economic value for not being known or readily ascertainable. A customer list, for example, is a compilation trade secret. Trade secrets are subject to reasonable security measures, such as an employee confidentiality agreement, and are governed by individual state common law and standardized by the Uniform Trade Secrets Act, derived from the Restatement of Torts 757.

There is no registration for a trade secret. The duration is as long as the information comprising the trade secret can be kept secret. Until tested in litigation, there is no formal legal recognition of definition of any particular trade secret.

A trade secret can be misappropriated by theft, improper use or public disclosure. Remedies include injunction, damages and criminal penalties for industrial espionage of up to \$5 million and 10 years imprisonment, with fines of up to \$10 million and 15 years imprisonment if a theft is committed for the benefit of a foreign government.

Chapter 7: Labor and Employment

Employment at Will

The labor market in the United States is characterized by the principle of *employment at will*. The employer and the employee are entitled to end the employment arrangement at any time without showing cause. The employment relationship in the United States is less regulated than that in most other highly developed economies. This results in a highly mobile workforce. Employment at will also provides employers with flexibility to grow or downsize to respond to changes in market conditions.

Employment Contracts

Employers may choose to enter into written contracts with some employees, primarily the more skilled and highly compensated individuals. An employment contract clarifies the employee's duties to the company and generally guarantees the employee continued employment for a certain period of time. It also may provide the employer some protection from the employee trying to harm the employer at the end of the employment relationship.

Labor Unions

Once a powerful force in American labor, unions have steadily declined in membership and influence over the past 50 years. Approximately 12 percent of the private workforce is now unionized. Unions must demonstrate acceptance by 50 percent of the workforce in a vote conducted by the National Labor Relations Board. Once a union is certified, the union representatives bargain with the employer for an employment contract governing the rights and duties of the workers. Unions also represent aggrieved workers in disputes with the employer. Union contracts generally last for multiple years. In order to obtain bargaining power, when negotiating contracts, unions may call a strike in which union members withhold their services.

Benefits

American employees look to their employers to provide work-related benefits in the areas of health care and supplementary pension savings. Most health insurance is provided by employers and not through the government. Although the government provides some retirement benefits through the Social Security system, many employees look to their employers to provide additional retirement benefits. In many cases, one-third of all compensation comes in the form of health care and retirement benefits.

Laws Governing Workers' Safety

Both federal and state governments enforce laws for the safety and protection of workers. All serious injuries must be reported to the Occupational Safety & Health Administration (OSHA). OSHA investigates accidents and levies fines for unsafe conditions. OSHA also sets standards for workers' exposure to toxic substances in the workplace.

Workers' Compensation

Individuals who are injured in the workplace or who become sick as a result of workplace conditions are provided medical services and income protections. Employers are required to provide benefits through either private or government-sponsored insurance programs.

Wages

Except where governed by union contracts, employers and employees negotiate their wages directly. Less-skilled employees generally are compensated on an hourly basis and are paid a premium after working 40 hours in any week. State and federal laws also impose modest minimum wage requirements. Higher-level employees may be classified as exempt from hourly wage requirements and can be paid a salary not tied to hours worked.

Litigation

In addition to governmental protection for employees, numerous federal and state laws allow employees to challenge the treatment they receive in the workplace through the courts. Litigation over employment disputes is more common in the United States than in most other highly-developed countries. Defending against employee lawsuits is a part of doing business in the United States.

Equal Employment Laws

Numerous federal and state laws prohibit discrimination in the workplace and provide for equal opportunity employment. The federal law prohibits discrimination on the basis of race, national origin, color, religion, sex (including pregnancy), age or disability. An employee who believes that he or she has been discriminated against can seek redress through government agencies or may bring a private lawsuit.

Unemployment Compensation

Employees who lose their jobs are provided a portion of their pay for a limited period, if they have been terminated from their employment through no fault of their own. The payments are administered by the government and are paid through taxes on employers.

Chapter 8: Immigration

All individuals employed in the United States must have work authorization. U.S. citizens and permanent residents have indefinite, unlimited work authorization. The scope of work authorization for foreign nationals in the United States under a temporary status varies. Some individuals have work authorization on account of their visa status and do not need further approval from the immigration service to undertake employment. Some individuals need specific authorization from the immigration service in order to undertake employment. Others are completely barred from working on account of their visa status.¹

The employment-based visa categories, such as L-1, H-1B, TN, O-1 and E, allow for work authorization. In other words, once granted the visa status, no further approval from the immigration service is needed to begin employment. The scope of the allowed employment has limitations.

Below is a summary of the common, employment-based visa categories.

- **L-1 Classification:** This classification is available to foreign nationals who have been continuously employed abroad for at least one year within the three years preceding the application for admission and are seeking to enter the United States temporarily to continue work for the same employer or its affiliate, parent or subsidiary. Additionally, the individual must be entering the United States to work in an executive or managerial position or one that involves specialized knowledge. If working in the United States in a managerial or executive position, the foreign national will qualify for L-1A status, which carries with it a maximum duration of seven years. If working in the United States in a specialized knowledge position, the foreign national will qualify for L-1B status, which carries with it a maximum duration of five years. An individual entering under L-1 status is only authorized to work for the company submitting the L petition.
- **H-1B Classification:** The H-1B classification is available to foreign nationals who are coming to the United States to perform services in a specialty occupation that requires theoretical and practical application of a body of highly specialized knowledge and the attainment of a baccalaureate or higher degree, or its equivalent, as a minimum requirement for entry into the occupation in the United States. This status normally carries with it a maximum duration of six years, but additional extensions are available so long as the labor certification process (the first step toward permanent residency for many foreign nationals in this category) is started no later than the end of the fifth year in H-1B status. An issue facing this category is the cap. The number of H-1B visas that can be issued each year is far fewer than the number of applicants. In fact, in recent years, the available H-1B visas have been accounted for just months after becoming available. An individual entering under H-1B status is only authorized to work for the company submitting the H petition. The individual can, however, seek new H-1B sponsorship with other companies.

¹ For instance, the common name for the B-1 visa – the business visitor visa – is misleading because a hallmark characteristic of that visa status is the prohibition against gainful employment. When entering under the business visitor visa, an individual can attend meetings, seminars and the like, but he or she cannot engage in gainful employment.

- **E Classification:** The E classification is known as the treaty trader/treaty investor visa, and it is available to foreign nationals from countries with which the United States has a treaty to allow the foreign nationals to enter the United States (1) to solely carry on substantial trade between the United States and his or her home country or (2) to solely develop and direct the operations of an enterprise in which the foreign national has invested or is actively in the process of investing a substantial amount of capital in a bona fide enterprise. In order to be eligible for this status, three general elements must be present: (1) a treaty must exist between the United States and Country X; (2) majority ownership or control of the investing or trading company must be held by nationals of Country X; and (3) country citizenship must be held by each employee or principal of the company who seeks E status under the treaty. An individual entering under E status is authorized to work only for the company sponsoring the E petition and will receive a two-year admission. An extension can be sought.

- **O Classification:** This classification allows a foreign national to come to the United States to perform services for an employer relating to an event or events, if the foreign national is a person who has extraordinary ability in the sciences, arts, education, business or athletics. A very high standard must be met to establish extraordinary ability. In order to be eligible, the foreign national will have to show sustained national or international acclaim by providing evidence of:

 - Receipt of a major, internationally recognized award, such as the Nobel Prize; or
 - At least three of the following forms of documentation:
 - ♦ Documentation of the alien's receipt of nationally or internationally recognized prizes or awards for excellence in the field of endeavor;
 - ♦ Documentation of the alien's membership in associations in the field for which classification is sought, which requires outstanding achievements of their members, as judged by recognized national or international experts in their disciplines or fields;
 - ♦ Published material in professional or major trade publications or major media about the alien, relating to the alien's work in the field for which classification is sought, which shall include the title, date and author of such published material and any necessary translation;
 - ♦ Evidence of the alien's participation on a panel, or individually, as a judge of the work of others in the same or in an allied field of specialization to that for which classification is sought;
 - ♦ Evidence of the alien's original scientific, scholarly or business-related contributions of major significance in the field;
 - ♦ Evidence of the alien's authorship of scholarly articles in the field in professional journals or other major media;

- ♦ Evidence that the alien has been employed in a critical or essential capacity for organizations and establishments that have a distinguished reputation; or
- ♦ Evidence that the alien has either commanded a high salary or will command a high salary or other remuneration for services, evidenced by contracts or other reliable evidence.

There is no cap on the number of O visas that can be issued; the high standard that must be met to establish eligibility limits the number issued. Additionally, the visa will be issued for the duration of the event to be carried out in the United States, but no more than three years. However, an extension can be sought.

Chapter 9: Real Estate

Whether a foreign investor is expanding its operations in the United States or acquiring a U.S. company that possesses significant real estate interest, prudent counseling and acute knowledge of local influences is critical for a full comprehension of site location, leasing, acquisition, development and/or financing.

Many factors will influence the choice of a facility location. Almost every state has created programs to provide economic incentives for businesses or investors. These include abatement of real estate taxes, diversion of real estate tax payments to fund the construction of infrastructure to support real estate development and abatement or reduction of sales or employment taxes. These incentives typically are obtained by application to the appropriate legislative authority. If the incentive application is approved, the enterprise will often be required to enter into an agreement with the political subdivision, submit reports and subject itself to monitoring to ensure that there is continued compliance with the conditions required for the incentive.

Additionally, the availability of modes of transportation will also influence site location. While an office facility may only require commuter transportation, industrial and manufacturing facilities may require freight rail, navigable rivers or freight air depots. Generally, in the United States, vehicular traffic is unimpeded. Rail lines are often separated between light rail for passenger and freight lines for the transfer of products and equipment. If navigable waters are required or available, environmental regulations should be reviewed to determine if there are impediments to the development of the waterways or wetlands. The types and quantities of utilities available for use should be investigated. While utilities are widely available, certain capacities, local nuances or moratoriums may adversely impact additional use. The availability and sophistication of the labor pool and livability factors are also important.

The decision of whether to buy or lease real estate for a business is important. Ownership and leasing of property in the United States is well-protected and facilitated by comprehensive public records, a good body of law and protection by the courts. Therefore, the decision to own or lease real estate is typically driven by business concerns rather than legal concerns. While outright ownership of property often gives the owner more control over the property and potential appreciation in value, it includes a significant investment of capital, credit and management skills. Often, investors who are making a product wish to spend their money in the research, development, manufacture, marketing and delivery of the product and not in the ownership of real estate. Leasing is a viable alternative for these parties.

Leasing involves executing a written lease agreement that provides for periodic payments and other obligations in exchange for the right to use the property for a term of years. There are many different types of leases in the United States that have different ramifications for accounting purposes and the degree to which the tenant is responsible for particular property costs (such as insurance, operating expenses and real estate taxes). A *triple net* lease is one whereby a tenant makes a base payment of rent to the landlord but is responsible for most other costs in connection with the operation of the premises. A *gross lease* is one that entitles a tenant to use the property in return for a periodic lease payment, and there are no or few additional costs passed through to the tenant. In the gross lease, the landlord is taking the risk of having estimated accurately the costs of insurance, operating and taxes. A landlord that knows its business well

may also be able to make more money on this type of lease. In this type of lease, the tenant is able to use the property for a predictable cost, but the lease is a complex document with many potentially hidden costs for the tenant. The prudent tenant will have a good broker advising them to ensure the lease is compatible with market terms, and a good attorney to protect against hidden costs.

In the United States, the primary sources of debt capital for real estate acquisition are banks, life insurance companies and other issuers of commercial mortgage-backed securities. Local or regional thrift institutions provide additional sources of debt capital. Real estate investment trusts (REITs), pension funds, life insurance companies and foreign investors provide the bulk of equity capital. It may be prudent for the foreign investor to involve a lender in the acquisition process even if the investor does not require funds to acquire, but plans to finance later. This is so the lender can do his or her due diligence along with the investor. The investor can address any issues the lender might have prior to the acquisition of the real estate, when the investor has the most leverage. Financing can also be considered by a tenant in connection with leasehold improvements. In this situation, a tenant should ensure that it has the appropriate provisions in its lease that will permit the mortgaging of its leasehold.

Chapter 10: Environmental

Overview

Businesses are subject to a wide variety of federal, state, and local environmental laws and regulations. Environmental laws generally attempt to prevent the discharge of hazardous substances in quantities that harm people or the environment by regulating the discharge of hazardous substances and pollutants to the land, air and water. In general, the key to environmental compliance is to recognize that the majority of substances in use at an industrial facility or other business might be defined as hazardous or as a pollutant under a statute, and that every point of discharge or potential discharge of a substance from a facility must be evaluated to determine if it is regulated under the environmental laws.

The regulatory scheme to prevent discharges has the following basic components:

- Requiring permits for the discharge of certain substances into the air and water;
- Regulating the storage, handling, transportation and disposal of hazardous substances and wastes;
- Imposing procedural and substantive requirements on new facilities and certain modifications of existing facilities;
- Requiring detailed monitoring, reporting and record-keeping for certain activities;
- Requiring that facilities report releases of many substances into the environment and clean up such releases;
- Preventing the release of substances into groundwater by several strategies, the most important of which currently relate to disposal of wastes on land and the regulation of underground storage tanks; and
- Regulating specific substances, such as polychlorinated biphenyls (PCBs) and asbestos.

Federal and State Environmental Agencies

United States Environmental Protection Agency (USEPA)

The USEPA is the federal agency responsible for implementing most of the nation's environmental programs. The USEPA's responsibilities include rulemaking, permitting, enforcement and providing support to state and local environmental agencies. The USEPA was established in 1970 in order to consolidate the disparate federal pollution programs of a half-dozen federal agencies. It is an independent agency whose administrator reports directly to the president.

The USEPA's headquarters are in Washington, D.C., but its offices are spread across the country. As a general rule, national regulations and policies are developed at headquarters and

implemented by the USEPA's 10 regional offices, either directly or through oversight of USEPA approved and funded state programs.

State Role in Environmental Regulation

Congress created a cooperative federal/state partnership for regulating activities affecting the environment. While the USEPA is the primary agency responsible for the implementation and enforcement of environmental laws nationally, many of the federal environmental statutes enable the USEPA to authorize a state to administer its analogous regulatory program within its borders in lieu of the federal program. Such authorization generally depends upon the USEPA's finding that the state has adopted and provided for the enforcement of a program that has all of the basic elements of and is at least as strict as the federal program.

The federal environmental statutes generally do not preempt state and local governments from exercising their own authority. State statutes frequently establish entire regulatory programs complete with administrative, civil and criminal enforcement mechanisms, which are independent of federal law. States also can control activities affecting the environment by initiating lawsuits based upon common-law principles such as public nuisance, strict liability and ultra-hazardous activity.

The USEPA retains its enforcement authority, even in states authorized to administer their own air, water and hazardous waste programs. In authorized states, the USEPA has the power to enforce the requirements of the state program provided that the USEPA gives notice to the state before commencing enforcement proceedings. In some cases, facility owners and operators who are subject to a state enforcement action may also be the subject of an independent federal enforcement action for the same offense.

Major Environmental Programs

Air Pollution

The federal Clean Air Act and parallel state statutes regulate a wide range of activities that may cause air pollutants to become present in the ambient air. Not all emissions are regulated, but it is the obligation of the discharger to ensure that all regulated activities comply with the Clean Air Act.

Wastewater and Storm Water Discharges

The federal Clean Water Act and parallel state statutes regulate discharges to most surface waters. Direct discharges of wastewater or storm water from discrete conveyances called *point sources* (e.g., pipes, culverts) to lakes, rivers and streams all are prohibited unless the discharger has a permit from the USEPA or a state with a USEPA-approved permit program. Industrial discharges to publicly owned treatment works also are subject to permitting requirements.

Hazardous Wastes

The federal Resource Conservation and Recovery Act (RCRA) and parallel state statutes impose strict, detailed requirements on the storage, handling, generation, transportation, treatment and

disposal of hazardous wastes. The RCRA imposes closure and cleanup requirements for certain treatment, storage or disposal facilities. The RCRA also imposes requirements to deal specifically with the problems of leaking underground storage tanks. The underground storage tank regulations require the reporting and cleanup of spills of regulated substances.

Superfund

The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA or “Superfund”) makes a wide variety of persons liable for the government’s costs to clean up releases of hazardous substances to the environment. The “potentially responsible parties” under the CERCLA are those who own or operate facilities from which hazardous substances are released, arranged for the disposal of hazardous substances which came to be located on a CERCLA cleanup site or transported hazardous substances to a disposal facility (if the transporter selected the disposal facility).

CERCLA liability is retroactive and strict in that it applies to releases of hazardous substances that occurred before the CERCLA was passed, and irrespective of whether the method of disposal was in accordance with the laws and regulations then in effect. Liability is joint and several in that any single liable party may be compelled by the federal or state government to pay for the entire cleanup.

Toxic Substances

The federal Toxic Substances Control Act (TSCA) governs the manufacturing, processing, distributing, using, storing and disposal of certain toxic substances, including PCBs and asbestos. The TSCA requires that manufacturers provide data to the USEPA on the health and environmental effects of chemical substances and mixtures. Potential contamination of the food chain and the environment from the use of pesticides is addressed by the Federal Insecticide, Fungicide and Rodenticide Act (FIFRA). The FIFRA requires that all pesticides sold or distributed in the United States be registered with the USEPA.

Enforcement of Environmental Laws

Federal and state environmental laws contain extensive enforcement mechanisms to assure that businesses comply with existing environmental requirements. Three aspects of environmental laws that set them apart from most other U.S. laws are the emphasis on strict liability, extraordinarily broad inspection and information-gathering powers given to government agencies and the extensive role of the public in shaping compliance and enforcement policy.

Violators of environmental laws may be required to pay substantial fines and penalties. Generally, the USEPA or state agency can also order compliance or obtain a court injunction. Moreover, environmental statutes allow members of the public to directly sue a violator in certain situations for injunctive relief and civil penalties. Most environmental laws prescribe criminal penalties, including fines and imprisonment, for knowing or negligent violations.

Chapter 11: Product Liability

Introduction

Although it varies by state, typically, a plaintiff may bring a product liability action under strict liability, negligence or breach of warranty theories, or under applicable state product liability statutes. This discussion focuses on theories of liability, legal defenses and damages available in a typical product liability claim in the United States.

Strict Liability

Elements

To establish a strict liability claim, a plaintiff must prove that the product was defective, that the defect existed when the product left the manufacturer's control, and that the defect was the direct and proximate cause of the plaintiff's loss. The focus is on the product, not the manufacturer's conduct or whether the manufacturer acted reasonably. Even if a manufacturer exercises all due care in manufacturing or designing the product, the manufacturer will be liable if the product is found to be defective. A manufacturer is not an insurer of its product and is not required to sell a product that is accident-proof; the mere happening of an accident does not mean that a product is defective. In order to prevail on a strict liability claim, a plaintiff must identify a specific defect in the product and show that the product was unreasonably dangerous.

Under a strict liability theory, a manufacturer can be liable for a design defect, manufacturing defect or failure to warn. These claims are usually established with the testimony of an expert, such as a mechanical or electrical engineer or a human factors expert.

Design Defect

A product will be considered defective in design if the foreseeable risks associated with the design exceed the benefits of the design, or if the design is more dangerous than the ordinary consumer would expect when used in an intended and reasonably foreseeable manner.

Factors in determining whether a product is defectively designed are:

- The nature and magnitude of the risk of harm;
- The likely awareness by users of the risk;
- The likelihood of causing harm;
- The extent of compliance with applicable standards;
- The utility, performance and safety advantages of the design;
- The technical and economical feasibility of alternative designs; and
- The nature and magnitude of risks associated with alternative designs.

In most cases, the plaintiff must introduce reliable expert testimony which establishes that a technically feasible alternative design was available at the time the product was sold that would have prevented the harm for which the plaintiff seeks damages without impairing the usefulness or intended purpose of the product.

Manufacturing Defect

A manufacturing defect claim arises where the manufacturer fails to manufacture the product as designed. A plaintiff must prove that when the product left the manufacturer's control, it deviated in a material way from the manufacturer's design specifications, formulas or performance standards, or from otherwise identical units. A product may be defective in manufacture even though the manufacturer exercised all possible care in its manufacture.

Failure to Warn

A manufacturer also can be liable for a failure to warn at the time of sale or post-sale. A product will be defective for failure to warn if the manufacturer knew or should have known of a risk of harm from the product, and failed to provide the warning that a reasonable manufacturer would have provided in light of the nature and seriousness of the harm. Manufacturers can be liable for providing no warning at all or an inadequate warning.

There are several limitations on a manufacturer's duty to warn. A manufacturer has no duty to warn about open and obvious risks or a risk that is a matter of common knowledge. A manufacturer has no duty to warn sophisticated users or learned intermediaries about dangers of which they are or should be aware. A manufacturer also will not be liable if the lack of a warning or an inadequate warning was not the proximate cause of the plaintiff's accident – in other words, if a better warning would not have changed the plaintiff's conduct.

Effect of Plaintiff's Fault

In most states, the plaintiff's contributory negligence is not a defense to a strict liability claim. In others, the plaintiff's percentage of contributory negligence can be used to offset the manufacturer's liability, but only if that state has a product liability statute that allows for apportionment of liability under those circumstances.

Negligence

Elements

A plaintiff may also file a negligence claim in a product liability action. These claims are typically for negligent design, manufacture or failure to warn. Unlike a strict liability claim, a negligence claim focuses on the manufacturer's conduct – whether the manufacturer acted reasonably in designing or manufacturing the product or warning about dangers associated with the product.

To establish a negligence claim, a plaintiff must prove the existence of a duty, a breach of that duty and an injury proximately caused therefrom. The existence of a duty depends on the foreseeability to the manufacturer of the injury. The test for foreseeability is whether a reasonably prudent manufacturer would have anticipated that an injury was likely to result from the performance or nonperformance of an act.

Effect of Plaintiff's Fault

In contrast to a strict liability claim, the plaintiff's percentage of contributory negligence is always a defense and will offset the manufacturer's liability in a negligence claim. In many states, if a plaintiff is more than 50% negligent, the plaintiff may not recover damages against the manufacturer. Because contributory negligence is always a defense and reduces a plaintiff's recovery in a negligence claim, most plaintiffs only pursue strict liability claims against manufacturers.

Breach of Warranty/Statutory Claims

In a few states, plaintiffs may bring product liability claims for breach of an express warranty or for breach of an implied warranty of merchantability or fitness for a particular purpose. In some states, in order to bring these claims, privity of contract is required between the plaintiff and the manufacturer. In other states, breach of warranty claims are considered contract claims, and can only be brought to recover damages for economic losses (not for personal injury or property damages).

Many other states define their product liability laws by statute. Usually these statutes incorporate many of the concepts discussed in this chapter.

Defenses

There are several defenses to a product liability claim. These include the plaintiff's contributory negligence/assumption of the risk, unforeseeable product misuse, superseding/intervening cause, a material alteration or modification of the product after sale, compliance with applicable governmental standards associated with the product and compliance with the state of the art.

Damages

In a product liability action, a plaintiff can recover compensatory damages for death, physical injury, emotional distress, property damage, past and future lost wages, diminished earning capacity, past and future medical expenses and loss of enjoyment of life. A plaintiff can also recover punitive damages (designed to punish the manufacturer) if it is determined by clear and convincing evidence that the manufacturer's conduct showed a flagrant disregard for safety.

Chapter 12: Agency, Distribution and Franchising

Overview

The relationship between a manufacturer or other supplier and its agents and distributors is governed mainly by the contract between the parties. This is also true of the relationship between franchisors and franchisees. However, there are a variety of statutory requirements and legal precedents that impose restrictions on the initiation, operation and termination of such contracts.

Agents

Agents represent manufacturers and other suppliers in the solicitation of orders and are generally compensated by a commission. The relationship with agents is generally subject to fewer restrictions and, in most states, can be terminated on relatively short notice (such as 30 days) if the contract so provides. However, agent relationships are subject to various state laws that require that the agent's final commission be paid promptly after termination (ranging from five business days to 45 days). Failure by the supplier to pay the commission in accordance with these statutory requirements could subject the supplier to double or triple damages plus attorneys' fees.

Distributors

The relationship of suppliers with distributors, who buy products from suppliers and resell them, is subject to more extensive restrictions.

Antitrust Laws

U.S. antitrust laws, as well as similar state laws, prohibit certain activities that are considered harmful to competition. Private parties can bring suit for violations and, if successful, collect triple damages and attorneys' fees.

For instance, it is illegal for a supplier and a distributor to agree on the minimum price at which the distributor resells the products. An agreement would include a price forced on a distributor by coercion (such as by threatening termination). This is illegal *per se* – that is, without examining the actual competitive effects. The U.S. Supreme Court has recently taken a case which could result in some changes to this rule.

Other restrictions on a distributor may be legal or illegal under the antitrust laws depending on the *rule of reason* – that is, depending on whether such restriction is likely to hurt competition. For instance, the appointment of a number of exclusive distributors in different territories in the United States in which the distributors are not allowed to sell outside their territories is generally permissible. However, such exclusive territories could be illegal under the rule of reason if the supplier had a large market share in the product being distributed because the exclusive territories would prevent intra-brand competition, which could be the only effective competition under the circumstances. Also, exclusive territories are permissible only if imposed by the supplier or manufacturer (that is, a vertical restriction). If these exclusive territories resulted from an agreement among the distributors (that is, a horizontal agreement) they would be illegal *per se*.

State Termination Laws

Some individual states or territories have statutes that limit the ability of a supplier to terminate its contract with a distributor. For instance, Wisconsin and Puerto Rico have statutes that prohibit terminating (or not renewing) a supplier's contractual relationship with a distributor except for good cause. Other states have similar laws that apply to distributors who are classified as franchisees. In addition, many states have similar laws restricting termination of distributors in certain industries, such as farm equipment dealers and alcoholic beverage distributors.

Franchise Laws

Suppliers dealing with distributors in the United States must also take into account the franchise laws that sometimes apply to distributors, even unintentionally.

The definition of a franchise for legal purposes is significantly broader than the normal business understanding of that term. For legal purposes, a franchise involves three elements: a business is substantially associated with the franchisor's trademark; the franchisee pays a fee; and the franchisor has significant control over, or provides significant assistance in, the franchisee's method of operations.

Under some circumstances, a distribution relationship will have all three elements. For instance, if a distributor is selling trademarked goods of a supplier, the trademark element is usually met. The significant control or assistance element is likely to be met by a distributor whose business depends on its supplier for a high percentage of the products it buys for resale. Payments by a distributor to a supplier of bona fide wholesale prices for inventory would not be a franchise fee, but payments for training, or required purchases of equipment and marketing materials, could be franchise fees.

If a distributor is classified as a franchisee, then the franchise/distribution contract may not be entered into without the franchisor/supplier first providing a lengthy disclosure document with information about the franchisor/supplier, the principal executive officers of the supplier, the litigation history of the supplier and audited financial statements of the supplier. In addition, in 14 states, these disclosure documents must be registered and, in some cases, approved by state regulators before they may be used.

In addition, some states have franchise laws that prohibit termination of a contract with a franchisee without good cause, which would apply to a distributor if the distributor is classified as a franchisee. These states include those with franchise disclosure and registration laws such as California and Illinois. There are also states without franchise registration and disclosure laws that nevertheless have laws prohibiting termination without good cause, such as Arkansas and New Jersey.