COMING TO AMERICA

THE LEGAL BASICS

FRIED FRANK TECHNOLOGY

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INTRODUCTION

Doing business in the United States can be one of the fastest ways to fuel your company's growth, expand your potential customer base and give you access to new employees and sources of investment capital. However, the US legal landscape initially can seem complex and unfamiliar. Successfully navigating early business and legal interactions often is the difference between success and failure.

The good news is that many of the potential risks facing companies accessing the US market can be mitigated with some advance planning and an understanding of key issues.

"Coming to America: The Legal Basics" highlights some of the legal issues of which companies should be aware when doing business in the US, seeking investment from US sources or entering into contracts governed by the laws of a US state.

You will find links to useful websites at the end of each chapter, and a list of Fried Frank contacts at the end of this guide.

Of course, this publication is intended to serve as a mere introduction to some of the legal and related issues facing companies looking to do business in the US. We have sought to outline key considerations, but this guide is not legal advice and before proceeding you should consult with a Fried Frank lawyer or other qualified legal counsel.

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Chapter One

SERVING US CUSTOMERS

Non-US companies that wish to serve US customers can choose among the following alternative approaches (and variants):

- Serve them from their home country, through the export of goods or services, including the provision of "cloud" services;
- Enter into arrangements with US wholesalers, distributors or agents to act for them in the US; and
- Set up US operations, either through a subsidiary or a branch.

The choice among these alternatives is driven by a number of considerations.

Here are some of the questions that you should ask yourself:

- Is the US market important at this stage of your company's development?
  - Can you afford to serve it actively? Can you afford (at this stage in your development) to ignore it?
  - Is a US market presence important to your ability to secure next stage investment? If so, do your prospective investors insist that you actually set up your own operations in the US?
  - Is a US market presence important to your ability to compete against companies that may be able to achieve scale in the US more quickly than you by virtue of their US presence? If so, does this require on-the-ground operations?
  - Are there other commercial reasons why you need to be on the ground in the US, such as in order to promote sales, collect intelligence on competitors, and spot market opportunities, and do these require actual presence or could you achieve them through agents or distributors?

- If you are seeking US customers:
  - are your products competitive in the US, and will potential customers find you a credible contractual counterparty?

— are your prospective US customers prepared to do business in your home country currency? If not, are you comfortable with pricing in US dollars in sales from your home country?

— are shipping costs from your home country to the US, tariffs, regulations or other trade barriers making you uncompetitive in trying to service US customers from your home country?

— can you address customer service and support issues from your home country, given time zone differences and other challenges?

— are your prospective US customers prepared to do business with an non-US entity? Do you need to operate from a US office, and with a US-incorporated entity, in order for them to be comfortable?

— are your prospective US customers prepared to do business under your home country law? Your existing terms and conditions and forms of commercial contracts are no doubt drafted in home country form and governed by home country law. US companies typically will resist accepting non-US law governed contracts, and consequently may simply decline to do business with you, or respond to your presentation of a home country law contract by providing their own US law governed standard form.[1] Moreover, we think you would find it useful to have your own US law

1. Contract law in the United States is largely a matter of state law, and consequently US law contracts need to be governed by the law of a state, such as New York or Delaware.

governed forms regardless of whether the US counterparty insists that you start with its form contracts, since you will have already worked out standard provisions for those clauses that matter the most to you. Additionally, US law undoubtedly differs in key respects from your home country law, and your home country contract provisions may fail to address regulatory or other legal risk.

- Will entering the US market subject you to regulation to which you are not presently subject, or increase your risk of liability? As discussed in Chapter 7, the US is a highly litigious market, both from a regulatory and private claimant perspective — so a decision to serve the US market, whether from outside the US or with US operations, requires careful consideration of regulatory and liability issues. To what extent, if any, do these issues differ where you do not enter the US yourself, but rather serve the market as an exporter, either directly or through wholesalers or distributors?

- How will your US sales and operations be taxed in the US, and how does the choice among alternative models to serve US customers affect your tax position? As discussed in Chapter 3 below, this is affected by US tax law, your home country tax law, and tax treaties between the US and your home country.

- If you conclude that it is important for you to establish on-the-ground US operations:
    - do you have the means to fund those operations, particularly during a start-up stage, when losses are almost certain?

As discussed below, the key issue is not the costs of initial establishment, which may be reasonably modest, but rather the cost of ongoing operations, including employee costs, premises costs, insurance costs, travel and business expenses and the like.

- do you have the right people to staff a US operation, by sending staff into the US, hiring locally, or a combination of the two? This is a key point for any company that is setting up operations in the US, but it is particularly critical for early stage companies that are more thinly staffed and may find it more difficult to recruit the right people in the US.

- where should you locate your operations in the US?

  - to what extent is that decision influenced by such matters as the locations of key prospective customers or suppliers, locations of potential investors, availability of appropriately trained potential employees, local costs of doing business, availability of governmental incentives, taxes, or other factors?

  - will the locational choice affect your ability to oversee your US operations from your home country, given time zone differences, travel connections and the like?

The rest of this pamphlet (other than the tax chapter) generally assumes that you have made the decision to set up operations in the US, and focuses on certain issues that you may face in doing so. It is important, however, for you to consider the points above – setting up your own US operations is a big decision.

Key Links

www.selectusa.commerce.gov

www.gov.uk/ukti

Chapter Two

CORPORATE STRUCTURING OF YOUR US BUSINESS

Once you have made a decision to set up a US corporate structure, your initial decision is whether to operate through a branch of your home country company or set up a US subsidiary. Except in unusual circumstances, we think that is likely to be an easy decision – set up a subsidiary! The reasons include the following:

- as discussed in the next chapter, the taxation of branches is complex. While there may be some home country tax benefits from the use of a branch, such as an ability to deduct US losses in the home country, branches are directly subject to taxation by two tax authorities with unclear demarcations between them. It is relatively unusual for non-US businesses other than banks (which face special regulatory considerations) to operate through a branch in the US.
- by definition, a branch is a non-US company. This is inconsistent with a commercial objective of holding your company out to US customers as a US business.
- use of a branch directly subjects your non-US business to US jurisdiction and US liability risks. While you may not be able to protect the non-US part of your business from US regulatory and liability risks in any case, there is no reason to make things easy for plaintiffs!

So you have decided to set up a subsidiary. What kind and where?

The organization of US companies is relatively quick and easy. US private corporation law is state law, so you need to choose a state in which to incorporate.

> **We would customarily recommend use of Delaware entities because:**
>
> (a) the corporation law in Delaware is well-developed and settled;
>
> (b) the relevant courts are good;
>
> (c) potential US investors in your non-US parent company will be familiar with Delaware entities; and
>
> (d) perhaps most importantly, lawyers throughout the US are prepared to give basic Delaware corporate law advice and opinions (as might be required, for example, in connection with a financing or lease), whereas otherwise US lawyers typically will only give corporate law advice and opinions in respect of jurisdictions in which they are admitted.

Once you open offices in the US, the Delaware entity will need to qualify to do business as a foreign corporation or other entity in the relevant states in which you intend to do business, but this is relatively easy and cost-effective.

While there are other alternatives, the main types of entities that we recommend to non-US companies seeking to establish US subsidiaries in Delaware are corporations (similar to private limited companies in many countries) and limited liability companies ("LLCs," a newer vehicle that is a bit more flexible).[2]

In circumstances where a non-US parent is forming a subsidiary in the US for the first time, our preferred structure is a two-tier US structure, with a Delaware LLC topco as a holding company and a Delaware corporation as an operating subsidiary. Customers are more familiar with corporations than with LLCs, so use of a corporation for the operating subsidiary may be more customer-friendly. The additional US holding company tier adds very modestly to cost and facilitates future reorganizations. Use of a Delaware LLC holding company may (modestly) also help in protecting limited liability.[3] However, if the additional cost of the Delaware topco would be problematic for you at this stage, this is a step that could be implemented later. You will also need some basic advice on the fiduciary duties that the Delaware directors will owe to the corporation or the LLC.[4]

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2. LLCs have no counterparts in most other countries. They are perhaps most closely akin to a German GmbH or a French SAS or SARL, or equivalent vehicles in other continental European countries.

US corporations are tax opaque (taxed directly as corporate entities) for US and non-US tax purposes. LLCs can be tax opaque or tax transparent (with tax attributes flowing through to shareholders) for US tax purposes. It is generally desirable for US LLCs to be tax opaque for non-US tax purposes.

3. A US LLC with a UK parent needs to be carefully structured for UK tax reasons (e.g., it will usually be desirable to structure it to issue shares, which is not otherwise customary in a US LLC).

4. The duties owed by directors of a Delaware corporation are well-defined by the Delaware General Corporation Law. The fiduciary duties owed by managers (or members acting as managers) of a Delaware LLC are, in substantial part, subject to the terms of the LLC agreement. In the absence of relevant contractual provisions, however, the fiduciary duties owed by LLC managers/members should be assumed to be comparable to those owed by directors of Delaware corporations.

Once the US subsidiary is set up, you are going to need administrative support for it. Specifically, there will be a number of activities that need to be managed in the United States in order to operate your subsidiary. These include, for example:

(a) payroll and employee benefits;

(b) book-keeping, and filing of federal, state and local tax returns (not limited to corporate income tax – for example, most states and/or localities have a state sales tax, and there are a variety of other kinds of taxes);

(c) tax withholding; and

(d) filing of annual returns (which are reasonably short-form) with the various states in which your US subsidiary is incorporated or does business.

Emerging companies establishing US operations for the first time frequently choose to outsource these activities to an accounting firm (which may in turn use an outsourced payroll provider or benefits provider) rather than incur the expense of hiring an experienced employee to deal with them.

Key Links

www.corplaw.delaware.gov

Chapter Three

US TAX LAW AND STRUCTURING CONSIDERATIONS

This section discusses certain US tax considerations that may be relevant to the different approaches that non-US companies may take to doing business with US customers.

However, tax matters are complex. The determination of tax consequences depends on the specific facts and circumstances of each particular situation. This section provides very general information regarding some relevant US tax matters. It is not tax advice and you should not rely on it in planning your business or to avoid taxes or tax penalties. You should consult a tax advisor concerning US and any other applicable non-US tax consequences if your non-US company conducts activities in the US or transactions with US customers.

If you are seeking to expand your business into the US, one of the most important initial considerations is determining how to structure your transactions with US customers to best accomplish your business goals in a tax-efficient manner. To meet your business objectives, you may seek to export goods or services to the US, license or sell software or other intellectual property to US customers, or provide US customers with access to a cloud or software as a service (SaaS) solution. In order to engage in these transactions, you may wish to open offices in the US, hire US-based employees, contract with US-based agents, or otherwise directly or indirectly perform services or do business from within the US. In addition, you may desire to establish a US-based business entity and/or non-tax reasons. Alternatively, you may plan to enter the US market directly from a non-US country where your operations are currently situated.

In considering these various structuring options, in addition to the business concerns driving the nature of your expansion into the US, and corporate law matters, you should be aware of their respective tax implications.

> One of the primary issues to consider is the extent to which the structure of your business will subject your company to US taxes (directly or indirectly). This generally depends on the nature and extent of a company's connections with the US, which can be broadly separated into three categories:
>
> - conducting transactions with US customers through US-based employees or agents,
> - operating or conducting transactions with US customers through a US subsidiary entity, or
> - conducting transactions with US customers directly from your home country.

Additional analysis is warranted if the non-US company's home country and the US have entered into an income tax treaty and the non-US company is eligible for benefits under such treaty, because the non-US company may be wholly or partially exempt from certain US federal income taxes under such treaty.

Tax Background

US Taxation of US Persons

The US federal government generally imposes income taxes on the worldwide income of individuals who are US citizens or US residents (as determined for US federal income tax purposes) and corporations organized under US law, regardless of where the corporation is managed or controlled.

> **The maximum US federal income tax rate currently is 39.6% for individuals and 35% for corporations.**

US states, counties and cities also may impose income taxes on resident individuals and income or business taxes on corporations and non-resident individuals engaged in business in the jurisdiction, as well as property taxes and sales and use taxes. The US does not have a value-added tax.

US Taxation of Non-US Persons

Individuals who are not US citizens, US tax residents or corporations organized under US law may be subject to income taxes imposed by the US federal government on income from US sources and, in limited circumstances, on income from non-US sources. For this purpose, the “source” of income is determined under US federal income tax principles.

Income that is "attributable to" a US business

- A non-US person engaged in business within the US (as determined for US federal income tax purposes) generally is subject to US federal income tax on the US source and, in limited circumstances, non-US source, net income earned (or deemed to have been earned), from that business (all such income is sometimes referred to as income "attributable to" a US business). This tax is imposed on the US business income at the regular graduated income tax rates applicable to US persons, the highest of which is referenced above.
- In addition, the non-US person will be required to file a US federal income tax return reporting the non-US person's US business income.
- In the case of a non-US person that is treated as a corporation for US federal income tax purposes, the non-US person is also generally subject to a US federal "branch profits" tax at a 30% rate to the extent the non-US person's US business income is not reinvested in the US business.
- If a non-US person's home country and the US have entered into an income tax treaty, and the non-US person is eligible for benefits under such treaty, the US federal net income tax and branch profits tax may be reduced or eliminated under such treaty, as further discussed below.
- In addition, a non-US person conducting business within the US may be subject to US state and local income or business taxes, property taxes and sales and use taxes.

Income that is not "attributable to" a US business

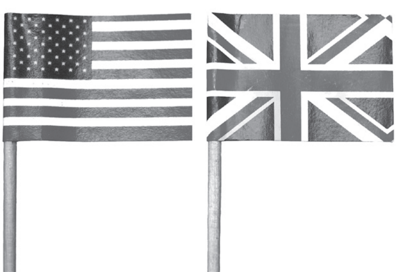
- A non-US person's US source income that is not attributable to a US business, if any, conducted by the non-US person (or, where a non-US person conducts a US business, that is not attributable to a US "permanent establishment," as discussed below) may still be generally subject to US federal income tax imposed on a gross basis to the extent the income is so-called "fixed or determinable" income, a broad category that excludes most gains and certain types of interest income.
- The US payor of this income is required to withhold US federal income tax on the gross amount of the income at a 30% rate, or a lower rate under an applicable income tax treaty between the non-US person's home country and the US, discussed below. The non-US person generally does not have to file a US federal income tax return reporting this type of income unless the tax was not properly withheld by the US payor. This type of income generally is not subject to US state or local taxes.

Treaty Relief

These US federal net and gross income taxes may be reduced or eliminated when the non-US person is eligible for benefits under an income tax treaty between the US and the non-US person's home country.

However, US state and local taxing authorities are not bound by these income tax treaties. For example, a non-US person conducting business within a US state may be subject to income tax imposed by that state, even though the non-US person is exempt from US federal income tax under an applicable US income tax treaty between the non-US person's home country and the US.

For example, there is an income tax treaty in effect between the US and the UK. Accordingly, for a UK company looking to enter the US market it will be important to determine whether the UK company is entitled to benefits under this treaty.



Tax Aspects of Doing Business With US Customers from the US or Abroad

Non-US Company Engaged in Business Within the US

A non-US company may decide to establish a presence in the US by, for example, opening a sales or marketing office in the US or by hiring employees or agents in the US. The specific facts and circumstances determine whether this results in the non-US company being treated as engaged in business within the US for US federal income tax purposes – and, consequently, being subject to US federal net income tax and tax return filing obligations.

The relevant facts and circumstances include the nature, frequency and continuity of the activities conducted by the US-based employees or agents and whether the non-US company is eligible for benefits under an income tax treaty (if any) between the US and the non-US company's home country. Accordingly, it is important to consult with a US tax advisor concerning the tax consequences of establishing a US office or hiring US-based employees or agents.

For example, assume a non-US company's US-based employees or agents have (1) the authority to solicit, negotiate and conclude license or sales agreements with US customers that bind the non-US company to perform other significant services necessary to complete license or sales transactions with US customers, and/or (2) a stock of software from which orders are filled on behalf of the non-US company. These activities may well result in the non-US company being treated as engaged in business within the US for US federal income tax purposes – and, therefore, being subject to US federal net income tax and branch profits tax – unless the non-US company is completely or partially exempt from one or both of these taxes under an applicable income tax treaty between the US and the non-US company's home country, as discussed below.

Whether or not the non-US company is treated as engaged in business within the US for US federal income tax purposes may depend on the scope of the employees' or agents' authority, the frequency and continuity with which that authority is exercised and whether the agents are independent agents (discussed below).

As we have noted above, given both the tax implications and non-tax issues, we do not generally advise non-US companies to operate through a branch in the US. If the non-US company's activities are such as would operate to cause it to be treated as having a branch or "permanent establishment" (see below) in the US, it will generally be advisable for it to set up a US subsidiary.

Treaty Relief

In general, if a non-US company is eligible for benefits under an income tax treaty between the US and the non-US company's home country and does not have a US "permanent establishment" (as defined in such treaty), the non-US company should generally be exempt from US federal net income tax on its US business income, and it may be completely or partially exempt from the US federal branch profits tax, under such treaty.

Accordingly, consideration should be given to whether it is commercially feasible to conduct the non-US company's transactions with US customers in a manner that avoids a US "permanent establishment." Depending on how the applicable income tax treaty defines “permanent establishment,” a non-US company may be able to avoid having a US “permanent establishment” by conducting transactions with US customers inside the US through brokers, general commission agents or other independent agents (e.g., independent sales agents or distributors) acting in the ordinary course of their business in their capacity as such. This may be the case even if these agents have the authority to solicit, negotiate and complete transactions with US customers that bind the non-US company or have a stock of software from which orders are filled on behalf of the non-US company, and these agents conduct these activities with some frequency over a continuous period of time. Of course, any decision to act in the US through independent agents, rather than through employees or a dedicated, dependent agent, could present significant non-tax issues that should be carefully considered.

In addition, depending on how the applicable income tax treaty defines “permanent establishment,” a non-US company may be able to avoid having a US “permanent establishment” if it uses a US office solely for the purpose of storing, displaying or delivering software and storing software to be used solely for those purposes and certain other US-based activities which may be described in the treaty.

In analyzing whether or not a non-US company has a US office or “permanent establishment,” a US-based website or server used to conduct business with customers should be taken into account, as it is uncertain whether such a website or server could be viewed as a place of business or a “permanent establishment” in the US.

If a non-US company is exempt from US federal net income tax under an applicable treaty because it does not have a US “permanent establishment,” the non-US company still may be subject to withholding of US federal income tax on a gross basis – discussed below under “Conducting Business Directly From a Non-US Jurisdiction.”

Conducting Business Directly From a Non-US Jurisdiction

A non-US company may decide to act directly from its home country in its transactions with US customers and otherwise have no presence (e.g., no office, server, website, employees or agents) in the US or, if it is eligible for benefits under an income tax treaty (if any) between the US and the non-US company's home country, operate so as to avoid having a US "permanent establishment" under the treaty, as discussed above.

Even if a non-US company is not engaged in business in the US or does not have a US "permanent establishment" under an applicable income tax treaty, the non-US company may be subject to gross basis withholding of US federal income tax on so-called US source "fixed or determinable" payments it receives in respect of transactions involving computer software.

- The payments that may be subject to this US withholding tax include (i) royalties for the license of a copyright in a computer program or other intellectual property, (ii) rents for the lease of a copy of a computer program or other intellectual property, and (iii) payments from a sale of a copyright in a computer program or sale of other intellectual property that is contingent on the productivity, use or disposition of the copyright or other intellectual property.
- The general rate of US withholding tax on these items is 30%. However, if the non-US company is eligible for benefits under an income tax treaty between the US and its home country, the rate of US withholding tax imposed on these items may be reduced under such treaty.
- Note that there are complex US federal income tax rules and judicial decisions that determine how various types of transactions in intellectual property are to be characterized for US federal

income tax purposes; these authorities are uncertain in scope and may result in payments being subject to US withholding taxes even if they are not labeled as "royalties," for example, or even if the payor is not a US person. Accordingly, it is important that a non-US company consult a US tax advisor concerning the US tax consequences of the non-US company's transactions in intellectual property.

If a non-US company is eligible for benefits under an income tax treaty between the US and its home country, in order to claim a complete or partial exemption from US federal withholding tax under the treaty, the non-US company would have to provide to its US customer a US tax form, called Form W-8BEN, that indicates the non-US company's US taxpayer identification number (for a company, generally its US employer identification number). A non-US company would obtain a US taxpayer identification number by filing a US tax form, called Form SS-4, with the US Internal Revenue Service. The non-US company's obtaining a US taxpayer identification number, in and of itself, should not result in the non-US company being subject to US federal income tax or withholding of such tax.

This Form W-8BEN generally is valid for three calendar years following the year in which it is signed by the non-US company, unless information provided on the form materially changes during that time period. The Form W-8BEN is not filed with the US Internal Revenue Service, but rather must be retained by the US customer.

Conducting Business Through a US Subsidiary

If a non-US company's US activities rise to the level of conducting business in the US for US federal income tax purposes, and having a US “permanent establishment” under an applicable income tax treaty (if any) between the US and the non-US company’s home country, consideration should be given as to whether the non-US company should conduct transactions with US customers through a subsidiary that is a US corporation or a US limited liability company (LLC) that is taxed as a corporation for US federal income tax purposes.[5]

This should enable the non-US company to avoid having to file US federal income tax returns itself. Instead, the US subsidiary would be subject to US federal income tax on its worldwide net income and applicable US state and local taxes, and it would have to file US federal income and other applicable US tax returns (the company generally would be subject to gross basis withholding of US federal income tax at a 30% rate). If the non-US company’s home country and the US have entered into an income tax treaty, and the non-US company is eligible for benefits under such treaty, these distributions may be completely exempt from this withholding tax or subject to this withholding tax at a reduced rate under such treaty (for an eligible UK company, the rate may be zero or 5% under the US-UK income tax treaty).[6]

It is important that the non-US parent and the US operating subsidiary deal with each other on an arm’s length basis in order to minimize the risk of disputes with tax authorities as to whether income has been earned in the US or the home country jurisdiction.

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5. As noted above, if the non-US company is resident in the UK and a US LLC is used, UK tax issues will need to be addressed.

6. For example, with respect to UK companies, any distribution or dividend paid by the US subsidiary to its UK parent company generally will be exempt from UK corporation tax. However, the UK tax rules on distributions are complex, and specific UK tax advice should be sought.

These arrangements should be addressed in services agreements, IP and technology licensing agreements and similar documents that set out the arm's length basis on which the parent and subsidiary are doing business with each other. You will need the assistance of tax accountants who are knowledgeable concerning the relevant tax rules of the US and your home country jurisdiction in setting the charges under these agreements.

Key Links

US Internal Revenue Service – www.irs.gov

Chapter Four

US EMPLOYMENT AND BENEFITS LAW

An understanding of US employment and employee benefits law will facilitate the entry of your business into the US market. Properly structuring your benefits and compensation arrangements will equip your company to attract and hire American talent and receive the most favorable tax treatment for your company's benefits programs.

You will have to consider a number of key questions in structuring compensation and benefits arrangements for US employees:

- Are your business associates properly designated as employees or independent contractors?
- Will it be beneficial for your company to enter into employment contracts with key employees?
- Should your key employees be bound by non-competition restrictions?
- Are you in compliance with applicable antidiscrimination laws?
- Have you entered into non-qualified deferred compensation arrangements with your employees, and, if so, have these arrangements been properly structured to avoid adverse tax consequences to the employee?
- If you provide equity incentive compensation to your employees, have you structured your program to be consistent with US tax and securities laws?
- Do you wish to provide your employees with an opportunity to make equity investments in the company?
- Have you considered the appropriate compensation packages to be offered to US employees?

Employees vs. Independent Contractors

US law distinguishes between employees and independent contractors for tax purposes. Generally, employers must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment taxes on wages paid to an employee. With payments to an independent contractor, you do not generally have to withhold or pay any taxes, although certain reporting obligations do apply.

The correct classification of your business associates depends on the nature of their relationship with you. Key factors include (but are not limited to) whether they have set hours of work, work on your premises, or work for more than one company, as well as whether you pay for their business and travel expenses or provide them instructions or training. While these factors can be helpful to consider, classifying employees and independent contractors is ultimately a facts- and circumstances-based determination.

If employees and independent contractors are improperly classified, an employer can be subject to certain penalties and other unaccounted-for liabilities. In particular, if certain employees are incorrectly classified as independent contractors, they may be entitled to certain benefits reserved for your employees, such as participation in your retirement benefit or healthcare plans.

Terms of Employment

Under the laws of most US states, an employer can terminate an employee at will at any time without liability (other than for accrued amounts), unless the employer and employee have a contract that provides otherwise.

You may wish to enter into employment contracts with key employees in order to memorialize the terms of your relationship. Such contracts typically address the following:

- Scope of duties and responsibilities
- Term of employment
- Compensation and benefits
- Grounds for termination (with or without "cause," death, disability, voluntary resignation, etc.), notice requirements, and severance pay or benefits
- Restrictive covenants (i.e., confidentiality, employee invention, non-disparagement, non-competition and non-solicitation clauses)
- Consideration of relevant tax provisions
- Arbitration provision

Even if you do not have a full employment contract with certain employees, you will typically want to have a short-form agreement in place with them that addresses confidentiality and ownership of intellectual property.

Under US law, employees enjoy certain protections, including minimum wages, health benefits, and time off from work. In addition to vacation, employees have a right to time off from work in the form of unpaid leave. Certain states have policies regarding mandatory payment for accrued but unused time off that can be burdensome in the absence of employer-adopted alternate policies.

Non-Compete Obligations

You may choose to have your employees sign non-competition agreements in order to limit their ability to compete with the company or in the same industry after terminating employment. The way that courts review these clauses and the likelihood that a clause will be enforced vary by state. Generally, in order to be enforceable, such clauses have to be reasonable in time, scope and geography and cannot unduly restrict the ex-employee's ability to earn a living in his or her field. In any case, employee non-competition agreements are highly unlikely to be enforceable in California.

In addition, when determining the enforceability of such clauses, that may permit the court certain flexibility in whether to apply the restriction to the maximum extent permitted by law or allow the court to throw out an entire provision if it is deemed overbroad. Knowledge of the applicable state law is key when drafting such arrangements.

Antidiscrimination Law

At the federal level, the US Equal Employment Opportunity Commission (EEOC) enforces laws that prohibit discrimination based on race, color, religion, national origin, sex, age, genetic information, or status as a mother or pregnant woman. The states and certain major municipalities like New York City similarly have laws banning discrimination in employment with which an employer should be sure to become familiar.

To minimize the risk of potential litigation, employers may wish to offer departing employees separation payments or benefits in exchange for release of liability for all claims connected with their employment. Under the Age Discrimination in Employment Act (ADEA), rules and restrictions may apply to ensure that employees knowingly and voluntarily consent to the waiver. If such employee waivers are desirable, an employer should discuss them with an attorney to make sure they will be enforceable.

Deferred Compensation Arrangements

Under certain plans or arrangements, an employer may wish to provide compensation to an employee at a time later than when it is actually earned. These deferral arrangements can involve equity awards, bonus or severance payments, or other forms of compensation. Under the US tax code, it is important to structure such arrangements correctly so that tax is deferred until the time when the employee actually receives income. If not properly structured, certain amounts may be inadvertently includible in income and possibly subject to additional tax and interest penalties.

Equity Compensation Incentive Program

Equity compensation incentive programs provide a means for employees to share in the financial success of the business. There are various ways to structure equity compensation arrangements, depending on the business model and the employer's goals. The structure of the program will have tax implications, which should be discussed with an attorney. Terms of incentive award grants include the form of award, the vesting schedule, and the termination provisions (forfeiture and repurchase rights).

Employers should be aware that there are certain tax and securities rules governing the grant of equity compensation awards. In particular, with respect to granting stock options or stock appreciation rights, it is often important to use a sound valuation method, as prescribed under treasury regulations, for determining the awards' exercise or base price in order to avoid certain adverse tax consequences.

Employee Equity Investments

If your employees make equity investments in your business, those stock purchases must comply with federal law. Every offer and sale of a security (including options) must be registered with the SEC unless an exemption under the Securities Act is available. Certain exemptions are available for issuances to employees of private companies, but require careful compliance with their conditions.

In addition to federal law, each state has its own laws governing the offering and sale of securities (referred to as "Blue Sky" laws).

Compensation Packages

In order to attract and hire US employees, it is important to offer compensation packages that compete with others available in your market. Employers should consider the following elements of a comprehensive compensation and benefits package:

- **Incentive compensation**. Employers may wish to provide certain forms of incentive compensation, such as annual or long-term bonus opportunities.
- **Health and welfare benefits**. In the US, employers often provide employees access to health and welfare benefits and may help share the costs of applicable insurance premiums. While historically US employers have generally been able to choose whether to provide such coverages to employees, recent changes in federal law require certain employers to provide medical insurance to certain employee populations.
- **Retirement savings**. In the US, it is common for employers to offer retirement savings programs. An employer may provide opportunities for retirement savings under defined contribution plans that receive favorable tax treatment or may sponsor a defined benefit pension plan. Retirement programs must be carefully structured to comply with applicable law.
- **Additional perquisites**. Employers should consider whether they wish to provide additional benefits such as flexible spending programs, commuter reimbursement, car allowance, etc.

Key Links

US Equal Employment Opportunity Commission – www.eeoc.gov

US Internal Revenue Service – www.irs.gov

Chapter Five

INTELLECTUAL PROPERTY IN THE US

In the United States, the intellectual property (IP) that gives your company its competitive edge can be protected through a combination of registering your IP with government authorities, and contracting with business partners, employees, consultants and other third parties to allocate IP ownership and delineate use parameters. Discussed here are the primary US IP categories, considerations for protecting your US IP in dealings with employees and third parties, and certain US-specific data privacy considerations.

Categories of Intellectual Property

IP is legally owned intangible property. In the US, these rights are protected under state law and/or federal law, depending on the nature of the IP right.

The primary categories of IP in the US are:

- patents (covering processes, methods, devices, manufactured goods, compositions of matter);
- copyrights (covering different works of authorship, such as printed matter, computer software, sound recordings and audiovisual works);
- trademarks (names, brands, symbols, slogans, designs); and
- trade secrets (business, financial and technological information that is confidential and commercially/economically valuable).

The US Patent and Trademark Office (USPTO) is the federal agency that grants patents and registers trademarks, while the US Copyright Office handles copyright registration.

Patents

What are they?

Patents are a government-sanctioned monopoly on the right to practice an invention. Patents are granted in exchange for disclosure of the invention to the public, and are issued for inventions that are novel, useful and non-obvious. Utility patents are the most common type of patent and protect inventions with specific functions, such as manufactured goods and chemicals. There are also design patents (protecting the unique physical appearance of manufactured objects) business method patents (protecting unique ways of conducting business), and plant patents (protecting asexually reproduced plant varieties).

How are they protected?

The federal Patent Act protects an owner's exclusive right to his or her invention for 20 years from the filing date of the US application (design patents last for 14 years).

How do you obtain a patent?

To obtain a patent, a patent application is submitted (typically through a registered patent attorney) to the USPTO, which then conducts a substantive evaluation of the invention and, through the "patent prosecution" process, determines whether a patent should be granted. After issuance, the owner must pay periodic fees during the life of the patent to maintain the patent in effect.

What are the advantages of protection?

The federal Patent Act allows a patent owner to enjoin and recover damages for patent infringement in the event an individual or entity engages in the unauthorized making, use, sale, offer for sale or import of an invention covered by a US patent. This can be done by filing suit in federal court or before the International Trade Commission (ITC). The ITC offers expedited proceedings and can grant broad exclusion orders against infringing imports. As patent litigation in federal court can be a very expensive process, the ITC has become a popular venue for both US companies and foreign companies with a US presence.

Cross-border considerations

The USPTO will review international applications filed pursuant to the Patent Cooperation Treaty (PCT), of which both the UK and US are signatories. As a result, a US patent application can claim "priority" to the filing date of its counterpart patent application in the UK (and vice versa).

Copyrights

What are they?

Copyright protects original works of authorship, such as writings, musical recordings, computer programs and tangible artwork. In the US, this protection lasts for the life of the author plus 70 years (older copyrights may have different durations, as there have been many changes to the US copyright laws).

How are they protected?

While copyright protection vests automatically upon the creation of an original work of authorship, in order to sue for infringement of a US copyright, the copyright at issue may need to be registered with the US Copyright Office. Registration is obtained by filing an application with the US Copyright Office, paying a small fee, and in most cases, sending a copy of the work to the Library of Congress.

What are the advantages of protection?

A copyright owner has the exclusive right to reproduce, distribute, perform and display the work, and to create derivative works based on the original work. The federal Copyright Act allows the owner to enjoin and recover damages for infringement. Statutory damages are also available if the work is registered before the infringement commences or within three months of publication.

Cross-border considerations

Under the terms of a key international copyright treaty (commonly referred to as the "Berne Convention"), the non-US owner of a copyrighted work first published outside the US cannot be required to apply for or obtain a US copyright registration in order to sue for copyright infringement in the US.

Trademarks

What are they?

Trademarks are brands and logos that are used to identify the goods of companies and distinguish their goods and services from those of their competitors. Service marks are conceptually identical to trademarks, except they are used to distinguish services, rather than goods. Words, phrases, symbols and designs can all operate as trademarks (and service marks).

How are they protected?

Trademarks may be protected under common law "unfair competition" principles or through state or federal registration.

- **Common law and state protection**. Under the common law, trademark rights vest automatically when a company uses the mark to identify the source of its goods or services in commerce. Protection under the common law continues for as long as the mark is used commercially. State registrations provide protection only in that state. Under common law, unregistered trademarks will only be protected in the territory in which the trademark is in use, and state registrations are protected only in that state. Seeking federal registration is recommended if possible, as federally registered marks are protected throughout the US.

- **Federal protection**. Federal registration grants the owner the exclusive right to use the registered mark throughout the US on or in connection with the goods or services for which the mark is registered. Federal registration also gives notice to the public of the registrant's ownership of the mark and provides a legal presumption of ownership nationwide. Registration also reduces the risk of others adopting the registered trademark, as the USPTO will not issue another registration for the same (or confusingly similar) trademarks for the same (or similar) goods or services as those for a current registered trademark. Also, as all US trademark applications and registrations are included in the USPTO's searchable database (tess2.uspto.gov), others that are considering adopting the trademark will know that it is a subject of a federal registration.

When searching the USPTO database and choosing a mark under which to conduct business in the US, it is important to remember that a trademark is protectable and can be enforced even without a registration. Accordingly, the USPTO database may not provide a complete summary of marks already in use that may conflict with your desired mark.

How do you register?

To obtain a federal registration, you file an application with the USPTO. If you are using the mark, you can apply for a use-based registration, and if not, you can file an "intent to use" application (ITU). The USPTO conducts substantive examinations of trademark applications and publishes them for opposition, so that any interested parties can oppose registration of the mark. Once your trademark has been registered, you must make certain filings and pay certain fees to maintain the registration. The federal trademark application process is typically easier to navigate than the patent application process, but working with trademark filing counsel can be helpful in obtaining the broadest possible scope for your registration and in overcoming any objections to your application that are raised by the USPTO.

How do you enforce your rights?

The federal Lanham Act and state statutes protect trademark owners against unauthorized uses of the same or similar marks that are likely to cause confusion to consumers.

Cross-border considerations

As a UK company, you may file an international application with the USPTO pursuant to the Madrid Protocol by submitting your UK application to the USPTO for review. However, because of differences between UK and US trademark applications, you may consider having US counsel adapt your UK application so that it conforms to US standards. Companies in the UK or other countries that are members of the Madrid Protocol trademark treaty may file an international application with the USPTO pursuant to the treaty. Alternatively, you may file a new US application with the USPTO instead of submitting an international application.

Before filing an application to register your company's name or brand in the US, you should strongly consider hiring a service provider or counsel to conduct a US trademark clearance search to determine whether others are already using your mark (or similar marks) in connection with similar goods and services in the US. This can help you avoid infringing the trademarks of other companies in the US and aid in your brand development and branding strategies for the US market.

Trade Secrets

What are they?

A trade secret is confidential information of a commercial nature from which the holder derives an economic benefit. A trade secret may be a secret process, formula, device or customer list. The most famous example of a trade secret is the Coca-Cola formula, which The Coca-Cola Company has guarded as secret for decades.

How are they protected?

Trade secrets are predominantly protected by state law, and many states follow the guidance provided by the Uniform Trade Secrets Act. While there is no federal registration system for protecting trade secrets, trade secret law safeguards information for as long as it remains confidential. Owners of trade secrets must take affirmative measures to protect that confidential information, both within their organizations and in their commercial dealings. Confidentiality or non-disclosure provisions and agreements are commonly included in employment and commercial agreements to contractually obligate the parties to maintain the confidentiality of trade secrets. In addition, security measures, such as restricting access to a facility, document or even source code that embodies the trade secret can also be key to maintaining your trade secret.

How do you enforce your rights?

When a trade secret has been misappropriated, the owner of a trade secret may bring a claim for misappropriation under state law. The Economic Espionage Act also makes some thefts of trade secrets a federal crime.

Dealing With Employees and Contractors

Who owns a patent?

In the US, inventions created by an inventor (whether an employee or an independent contractor) are owned by the inventor, unless otherwise agreed to in writing. Because an inventor owns his or her invention, it is best practice to enter into invention-assignment agreements with all employees and independent contractors. To avoid confusion about the timing of an assignment, use present-tense language in your contract that states the employee or independent contractor "hereby assigns all present and future rights," instead of potentially future-looking language, such as the employee or independent contractor "will assign rights." If future-tense language is used and the employee or independent contractor assigns his or her rights to a subsequent party, that party may have prevailing rights (although the employee or independent contractor may be liable for a breach of contract).

Who owns a copyright?

A “work made for hire” is a copyrightable work created by an employee within the scope of his or her employment or a work commissioned from an independent contractor by a third party. The copyright in a work for hire is owned by the employer or commissioning party. Importantly, under US copyright law, software code is generally not a work made for hire when created by an independent contractor, even if the parties agree that such code is a “work made for hire.”

How to protect your trade secrets?

Employers should make sure that they have trade secret and information security policies in place to ensure that access to confidential information is limited to those personnel and consultants that need to access such information and to maintain physical and technological security measures restricting unauthorized access. Employers should also ensure that employees and consultants are bound by appropriate confidentiality and non-disclosure agreements, potentially with perpetual obligations for trade secrets.

Dealing With Partners

Joint Ownership

How does joint ownership work?

Joint ownership may seem an easy way to avoid difficult negotiations over IP rights. However, as noted below, the default rules under US law for joint IP ownership may lead to unexpected results. Many of these rules can be modified by contract, so it is wise to protect any IP jointly owned with another individual or entity in accordance with specifically negotiated contract language. It is also important to be mindful of the variation in joint ownership rules among the different types of IP and across US and non-US jurisdictions.

- Patents. Default rules dictate that each co-owner may license or assign his or her interest in a joint patent without consent from other co-owners or a duty to account to the other owners for licensing income. However, all co-owners must be party to an infringement suit against third-party infringers.
- Copyrights. Default rules provide that each co-owner may use, license or assign his or her interest in a joint copyright, but each co-owner must account to the other owners for his or her share of profits earned.
- Trademarks. Joint ownership arrangements are not typically recognized for trademarks. This is because trademarks signify a single good or service. However, it may be possible for owners of a joint venture entity that uses a mark to co-own and co-register that mark.

Data Privacy Considerations

Generally speaking, personal data is any data that can be used to identify an individual. Although personal data is exchanged every day – for example, in employment contracts, customer and supplier databases and credit card transactions – compliance with US federal and state laws that govern the collection and maintenance of personal data may require careful attention. Laws and regulations differ widely between the US and the UK/EU (and even within the US). Consider hiring counsel to ensure that your business's policy adheres to the relevant US laws. Below are a few important statutes to keep in mind when creating your company's data privacy policy.

The Federal Trade Commission Act

The Federal Trade Commission Act (FTC Act) prohibits unfair or deceptive commercial practices. While the FTC Act does not require a company to have a privacy policy in place, if the company does have a privacy policy, it must abide by it. Under the FTC Act, the FTC has held companies liable for failing to comply with privacy policies expressed on their website, making material changes to privacy policies without providing adequate notice to customers, and failing to have adequate controls in place to safeguard the personal information held by them.

Children's Online Privacy Protection Act

The Children's Online Privacy Protection Act (COPPA) regulates the collection of personal data from children under the age of 13. Under COPPA, any website that caters to children must contain a clearly visible privacy notice, and notify parents and obtain verifiable parental consent before collecting any personal information from users who are children.

State laws

Many states (most notably California and Massachusetts) have laws that regulate the use, disclosure and maintenance of private information of their citizens collected by companies. The laws vary from state to state, so you should ensure that if you collect data from citizens of a state, you are complying with that state's laws.

Key Links

US Patent and Trademark Office – www.uspto.gov

US Copyright Office – www.copyright.gov

Chapter Six

US IMMIGRATION LAW

The skills and experience of current employees are often critical to the success of a new operation in the US. As a result, foreign businesses that wish to enter the US market should carefully consider US immigration law early in the planning stages.

Through a variety of visa programs, the US government offers an array of options for owners and employees of foreign-based businesses who wish to enter the US market. Each visa program has unique requirements and is appropriate for different business purposes. While some visas allow for long or permanent stays, other programs only facilitate entry into the US for a short period of time. Thus, in choosing a US visa program, a key consideration is the length of time necessary for the accomplishment of the particular business objective.

Short-Term Business Trips to the US

Business owners may sometimes need to travel to the US for short periods of time to conduct or anticipate business. The following are some of the types of visas that may be appropriate for these situations.

Visa Waiver Program

The Visa Waiver Program allows for travel to the US without a visa. It is available to people from 37 foreign countries, including many European countries and the UK, for "limited business purposes," but not employment in the US.

Duration of stay: Qualified participants may stay in the US for 90 days. However, there is no opportunity for extension.

Key requirements

- Participants must be a national of a qualifying country.
- If traveling by air or sea, participant must have a return or onward ticket.
- Only certain limited business activities are permitted (e.g., attending meetings and conferences).
- Participants must obtain an Electronic System for Travel Authorization (ESTA) registration and authorization before traveling.

Visitor Visa

Visitor visas are also available to individuals who wish to enter the US for short periods of time. The B-1 visa is intended for temporary visits specifically for business purposes.

Although the B-1 visa is attractive because it allows for a longer stay than the Visa Waiver program, it is important to note that the program requires that the recipient not be gainfully employed by a US business during his or her stay. As a result, this visa is usually used for investigating possible business opportunities, negotiating contacts, attending conferences, consulting with colleagues and establishing initial contacts.

- **Duration of stay**: Admission period is determined by the US Customs and Border Protection Office and can be granted for a period of up to six months. Maximum stay of six months, with the possibility of an extension of up to an additional six months.

Key requirements

- Only certain limited business activities are permitted. B-1 visa recipients cannot work for or be paid by any US source (except for reimbursement of expenses).
- B-1 visa applicants must demonstrate that they possess economic, family and social “ties” external to the US that are significant enough to ensure they will leave the US at the end of their stay.

Long-Term Stays and Working in the US

Foreign business owners and employees may need to enter the US for a substantial amount of time to open a new office or operation. Such a visit, although not permanent, may require a lengthier visa program.

“L” Visa Category

The “L” visa is best used to facilitate the transfer of non-US employees from related entities abroad to established operations in the US or for purposes of establishing a new office. “L” visas are divided into two categories: (1) visas for managers and executives (L-1A visa) and (2) visas for employees with specialized knowledge (L-1B visa).

- **Duration of stay**: “L” category visa recipients entering the US to establish a new office will be allowed a maximum initial stay of one year, while all other recipients will be allowed a maximum initial stay of three years. Requests for extensions of stay may be granted until the employee has reached the maximum limit of five years (in the case of an L-1A visa) or seven years (in the case of an L-1B visa). However, depending on the country of origin, “L” visas may expire earlier than the period described in the foregoing.

Key requirements

- The employee must have been continuously employed by the foreign company abroad for at least one year within the previous three years and is being transferred to a parent, subsidiary, affiliate, branch or joint venture operation in the US.
- Petition approval must first be obtained from US Citizenship and Immigration Services before the visa is applied for at a US Consulate.

L-1A Visas: Managers and Executives

The L-1A visa can be used to transfer a foreign executive or manager who has previously worked in the foreign parent company in one of those capacities to the US in order to perform a similar function. One benefit of this particular program is that the employee does not have to be a national of a particular country.

L-1B Visa: Employees With Specialized Knowledge

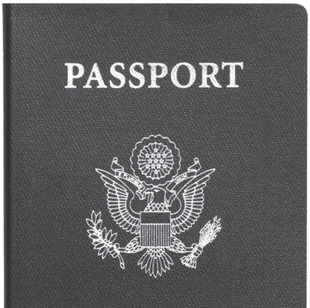
The L-1B visa can be used to transfer a foreign employee who has "specialized knowledge" to the US to work at an established business or to open a new operation that is related to the overseas entity.

“E” Visa Category

This visa program is often used by businesses that wish to send an employee to the US to establish a new operation. One benefit of this program is the local application process. Unlike “L” visas, the application process for “E” visas is conducted at the US Consulate in the country in which the employee resides. No prior approval from the US Citizenship and Immigration Services is necessary. However, in most cases, the initial application must be sent to the relevant US Consulate for review and approval before the US Consulate issues the visa to the employee.

“E” visas can be procured for employees of foreign businesses when the employee is a national of a country with which the US has a significant trade treaty and the foreign employee is entering the US to (1) engage in substantial international trade; or (2) develop and direct the operations of an enterprise which has or is investing in the US.

- **Duration of stay**: “E” visas are issued for a maximum of five years. Typically, the initial “E” visa will be issued for two years for smaller organizations or organizations with smaller investments, with renewals being issued for up to five years at the discretion of the US Consulate. At the US port of entry, despite the length of the “E” visa, visa holders will be admitted to the US for a period of up to two years each time they enter the US during the validity of the “E” visa.



E-1 Visa: Treaty Traders

E-1 visas can be granted to employees of a foreign entity that (1) is established in a country that has made a trade treaty with the US and (2) is entering the US to engage in substantial international trade.

Key requirements

- The foreign parent company must have a US subsidiary, affiliate or US branch operation. However, a US entity does not need to have a foreign entity in order to qualify for E-1 status.
- The foreign national's country's trade must be "substantial" and at least 50% of it must be with the US.
- The company must be owned 50% or more by foreign nationals from a qualifying country.
- The employee must show that he/she will hold a supervisory position in the USA operation and has the requisite skill for the post.

E-2 Visa: Treaty Investors

E-2 visas may allow for the authorization of employees of a foreign entity that (1) is established in a country that has made a trade treaty with the US and (2) is investing significant capital into a US business. Again, there is no requirement that a foreign entity exist in order to obtain E-2 status.

Key requirements

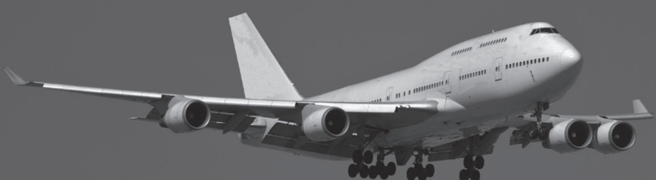
- Applicant must have the same nationality as the foreign entity or the ultimate owners of the entities.
- Applicant must be engaged in an executive or supervisory capacity or have special qualifications essential to the enterprise.
- Applicant must be entering the US for the sole purpose of developing the investment enterprise.
- Both E-1 and E-2 applicants must demonstrate that they intend to depart the US upon the expiration or termination of their visa status.

"H" Visa Category

"H" visas are reserved for persons that belong to specialty occupations. For the purposes of transferring current employees to the US, there are three bases for an employee to receive permission to enter the US using an "H" visa: (1) the employee is highly skilled; or (2) the employee has technical skills necessary for a particular task; or (3) an employee needs to enter the US for training.

This visa program may be attractive because unlike “L” visas, no qualifying relationship needs to be established between the US employee and the foreign entity. In addition, unlike the “E” visa, there is no common nationality requirement. However, only 65,000 regular “H” visas and an additional 20,000 “H” visas for US master’s degree (or higher) holders are available each fiscal year and the US Citizenship and Immigration services often receives more than this number of applications. In such cases, they will conduct a lottery to determine which applications will be reviewed.

Duration of stay: Recipients of “H” category visas can remain in the US for up to a total of six years, with “H” visa status being granted for up to three years at a time.



H-1B Visa: Highly Skilled Workers

This visa is often used for highly skilled workers that have a university degree or an equivalent combination of education and experience.

Key requirement

- Approval of application to US Department of Labor; petitioning companies must prove the employee will be paid a fair wage and will not displace US workers.

H-2B Visa: Technical Workers

H-2B visas are intended for technical workers needed for particular tasks. For instance, an employee could receive authorization to remain in the US to install and teach US workers how to operate new machinery under this program.

Key requirement

- Approval of application to US Department of Labor.

H-3 Visa: Employee Training

H-3 visas are appropriate for aliens coming to the US to be trained.

Key requirement

- The training received by the employee must not be available in the employee's home country.

Permanent Relocation to the US

To facilitate long-term operations in the US, it may become necessary or desirable for employees to permanently relocate to the US. Usually, this is done through an application for a Green Card, although there may be an exception for investors.

Green Card (Permanent Residence)

Applicants generally apply for Green Cards based on employment by showing that they have a job offer. Employers can "sponsor" employees for permanent residency by presenting evidence of such a job offer.

Key requirements

- In some cases, the applicant must already have a temporary, unexpired visa.
- Applicants who are granted Green Cards will become subject to US income taxation.
- Applicants must comply with certain maintenance requirements, such as maintaining the intent to remain resident in the US, even if currently residing elsewhere.

EB-5 Visa

This special class of visa is reserved for individuals who make substantial investments in the US economy. Individuals must meet several requirements to receive permanent residency through this means.

Key requirements

- Applicant must make a major investment in a "new USA enterprise."
- A "major investment" is usually defined as one that is in excess of US$1 million. In some cases, an investment of US$500,000 can be sufficient if it is made through a pre-approved scheme in a "Targeted Employment Area."
- A "new USA Enterprise" can be a newly created business, the expansion of an existing business, or a new enterprise resulting from the purchase and restructuring of a US business.
- Applicant must show that his investment benefits the US economy, for example, through job creation (specifically the creation or preservation of at least 10 jobs for US workers).

Key Links

US Citizenship and Immigration Services – www.uscis.gov

US Department of State Bureau of Consular Affairs – travel.state.gov

Embassy of the United States, London – london.usembassy.gov

Chapter Seven

THE US LEGAL SYSTEM AND LITIGATION

It can be useful for a non-US business seeking to enter the US market to be familiar with the American legal system and the dynamics of litigation in the US.

US Federalist Governmental Structure

The United States is a federal republic composed of 50 states and the District of Columbia, each of which has its own government and laws. In addition to the laws of the individual states, the US Constitution establishes a Federal Government which has the power to enact national laws in specifically enumerated areas. Federal laws take precedence over state laws.

Despite its constitutional limits, the Federal Government adopts many laws that directly impact the way business is conducted in the US. For example, the US Constitution gives Congress the power to regulate international and interstate commerce.

> As a result, Congress regularly enacts laws relating to trade, traffic and transportation among individual states and between the US and other countries.

US Federal Government

The Federal Government comprises three branches, each of which has unique powers and responsibilities.

- **Legislative Branch**. A bicameral Congress comprising elected representatives in the House of Representatives and the Senate. This branch is responsible for the creation of federal statutory law.
- **Executive Branch**. The President is the head of the US Executive Branch, which is made up of Federal departments and agencies.
- **Judicial Branch**. Comprises the federal courts.

State Governments

Similar to the Federal Governmental structure, the 50 states and the District of Columbia have their own autonomous governments comprising legislative, executive and judicial branches.

US Federal and State Judicial Systems

The US judicial system mirrors the federalist governmental structure; it is divided into federal and state courts.

Federal Courts

The judicial branch of the United States Federal Government is a three-tier hierarchy.

- **The Supreme Court**. The Supreme Court is the highest court in the US and only decides cases that are appealed from lower courts. Its rulings control both federal and state courts.
- **Courts of Appeals**. The Courts of Appeals are the intermediate appellate courts of the US federal court system and are composed of thirteen courts or "circuits," twelve of which are geographically defined. The thirteenth court, the US Court of Appeals for the Federal Circuit, has nationwide jurisdiction over certain appeals based on their subject matter, including, notably, most patent claims.
- **District Courts**. These are trial courts under the federal court system. Each state has at least one district court, but more populous states may have several.

State Courts

Each US state has its own court system that is independent of the federal court system and all other state systems. Generally, state judicial systems comprise trial, appellate and supreme courts.

US Sources of Law

There are numerous sources of law in the US, and it is important to understand which laws may govern your business activities and potential litigation.

Statutes. Statutory law in the US is passed by the legislative bodies of the federal and state governments.

Common law. Following the common law tradition of English law, US federal and state courts routinely make uncodified law through legal decisions. US state common law is very important to businesses in the US because it governs most contract and tort law claims. Understanding how judges apply and interpret the common law is crucial to predicting potential legal outcomes and gauging litigation risk.

Administrative agency rulings. Agencies are authorized to create rules in order to implement laws passed by the Legislative branches of federal and state governments. For instance, the Securities Exchange Commission (SEC) is a federal agency whose goal is to protect investors and the integrity of US securities markets. SEC rules govern the offer and sale of securities in interstate commerce and disclosure requirements for publicly traded companies.

Treaties. Ratified US treaties supersede all other laws besides the Constitution. Non-US business owners may receive benefits (such as tax and immigration benefits) as a result of various treaties between their home countries and the US, such as tax treaties and treaties of commerce and navigation.

Managing Litigation Risk

In predicting and managing the risk of a dispute with an individual or entity that results in federal or state court litigation, it is helpful to understand a few dynamics of US litigation:

- With certain exceptions, each party to a US lawsuit typically pays its own attorneys' fees and legal costs – regardless of which party prevails.
- It can be relatively inexpensive to initiate a lawsuit. Court filing fees are generally not very significant, and contingency fee arrangements are common in certain types of cases (i.e., the lawyer representing the party filing the lawsuit [the "plaintiff"] only recovers fees if the plaintiff recovers amounts from the other party [the "defendant"]).
- By contrast, defending a lawsuit in the US can require significant time and expense. The US legal system permits a greater amount of pre-trial discovery than many other jurisdictions. Each US litigant is permitted to demand a relatively wide array of documents and information from, and conduct interviews with, the other party and other potentially relevant individuals and entities.
- The prevalence of jury trials in the US – a right granted to all litigants by the US Constitution and the constitutions of all the states – introduces a measure of unpredictability to the outcome of litigation and the amount of potential damage awards.

- Due in part to the potential costs and unpredictability of outcomes, it is fairly rare for parties to a US commercial litigation to have the dispute resolved by a court. The vast majority of cases are settled through out-of-court agreements that may require the payment of compensation from one party to the other and typically preclude any further litigation of the disputed issues.
- Although a company transacting business in or with the US can never entirely eliminate the risk of litigation, it can mitigate some uncertainty and potential expense by entering into carefully written contracts with its customers, suppliers, contractors, distributors and other counterparties.
- It is customary to include in US commercial contracts a broad range of clauses intended to govern disputes between the contracting parties, such as the selection of venue for litigation, choice of state law governing the agreement, dispute escalation and arbitration, indemnification, and limitations on damages. Accordingly, careful drafting and review of commercial contracts by US counsel is an important part of managing US litigation risk.
- Additionally, given the higher risk of litigation in the US, it is important to obtain appropriate business insurance coverage using an insurance broker that is familiar with the US market and cross-border issues.

Key Links

Federal Judicial Center Overview of the US Legal System – www.fjc.gov/ijr/home.nsf/page/ie_briefingmat
US Federal Courts – www.uscourts.gov
American Bar Association – www.americanbar.org

Chapter Eight

EMERGING COMPANY FINANCING IN THE US

If you are considering raising capital from US angel investors or venture capitalists, it is important to be familiar with the basic legal terms of US startup company financings. These provide the framework for US investor expectations and consequently are relevant even where you are seeking to raise capital in your non-US parent company. The following is a summary of typical terms of venture capital financings in the US.

Financing Types: Debt vs. Equity

Debt and equity securities are the basic types of securities issued by companies to investors. Debt offers investors downside protection – in the event of the company's bankruptcy, debtholders have a higher-priority claim to the company's assets than do equityholders. Thus, debt investments involve less risk for investors, but the investor typically has little or no ability to participate in the company's upside potential and little control over the company.

> Equity investments, on the other hand, generally involve more risk for investors, along with the ability to participate in the company's upside potential and to exercise more control over the company.

Convertible Debt

Angel investors may seek to invest in debt securities of a growing company that are convertible into an equity interest in the company. This type of debt usually converts into shares of preferred stock upon the initial (or "Series A") venture capital-backed equity financing round. Convertible debt gives the angel investor the protections typically associated with debt securities, while also allowing the angel investor to participate in the company's growth.

Common Stock

Shares of a company's common stock represent a basic equity interest in the company. Common stockholders are on the bottom of the priority ladder in the company's ownership structure. In the event of the company's bankruptcy, common stockholders generally only have rights to the company's assets after debtholders and preferred stockholders have been paid in full. Holders of common stock exercise control over the company by electing a board of directors.

Venture capital investors generally do not invest in common stock, which often continues to be held by the company's founders and employees.

Preferred Stock

Shares of preferred stock represent an interest in a company that can be thought of as a hybrid of debt and equity. Like debtholders, holders of preferred stock may have downside protection in that they are generally entitled to fixed dividend payments, which must be paid out before dividends to common stockholders. Likewise, in the event of a liquidation, bankruptcy or dissolution of the company, holders of preferred stock may be entitled to a payment in priority to the common stockholders up to the amount of the preferred stock's "liquidation preference." The liquidation preference is often a multiple of the per-share purchase price paid for the preferred stock. While preferred stock that features a liquidation preference may have a higher claim on the company's assets than common stockholders, holders would still have a lower priority claim than debtholders, as the liquidation preference would only be payable to the extent sufficient company assets and funds remain available after satisfying the company's debt obligations. Often the terms of preferred stock stipulate that the liquidation preference is also payable in the event of a sale of the company (or a "liquidity event"), to the extent the proceeds of such event are sufficient, prior to any proceeds being shared with common stockholders.

Like other equityholders, holders of preferred stock may also participate in the potential upside of the company's growth, as shares of preferred stock may be convertible into shares of common stock that potentially appreciate in value. Shares of preferred stock may feature full voting rights on an as-converted basis, along with shares of the company's common stock, or may offer limited voting rights as described below. In venture capital financings, shares of preferred stock are often convertible into common stock upon a liquidity event or an initial public offering (IPO). Shares of "participating convertible" preferred stock allow the investor to receive BOTH the liquidation preference AND the value of the common stock into which the preferred is convertible upon such an event. However, the issuance of participating convertible preferred stock is not the market standard in venture financings.

> In venture capital financings, preferred stock is generally issued by a company to investors over time in a series of priced rounds or series (as "Series A," "Series B," etc.). The price of the preferred stock in each round is based upon an agreed-upon valuation of the company at the time of issuance. The issuance of additional series of preferred stock by a company may add complexity to a company's capitalization structure, as holders of each series may have different rights and economic interests.

The following are some additional terms that are typical for preferred stock venture financings:

- **Voting rights**. Preferred stockholders may have the right to vote alongside the holders of common stock in director elections (particularly if the preferred stock is convertible into common stock), or elect a fixed number of directors to the company's board. In addition, preferred stock investors may negotiate for specific negative consent rights over certain corporate actions, such as the issuance of debt above a specified threshold or the entry into contracts that are material to the company.
- **Antidilution protections**. Preferred stockholders often have preemptive rights on the additional issuance of preferred stock, which give existing preferred stock investors the option to participate in future financing rounds on a pro rata basis. Preferred stock may also feature price protection such that the shares' conversion price is subject to adjustment based on the price of later financing rounds.
- **Redemption rights**. Either the company or investors may have the option to redeem shares of preferred stock after a specific period of time. A redemption right in favor of an investor (i.e., a "put" right) may make it more difficult to raise future rounds of capital.

Venture Financing Documents

Below is a brief description of some of the various contracts and other documents that are typically entered into by companies and investors in connection with a venture financing. Model forms of these documents can be found at the website of the National Venture Capital Association (www.nvca.org). These model forms are only starting points and companies should engage US legal counsel to negotiate the terms of a venture financing in a way that is tailored to the needs of the company and its founders.

Preferred Stock Purchase Agreement

Investors typically purchase shares of preferred stock by entering into a stock purchase agreement with the company. Although in some transactions these agreements feature a lag time between the signing of the purchase agreement and the closing of the financing, purchase agreements in venture financings are often signed at the time of the closing of the financing. They generally include representations and warranties made by the company regarding the validity of the shares being issued and the company's business. Purchase agreements in venture financings also commonly stipulate that all disputes arising in connection with the investor's purchase of preferred stock be settled through arbitration rather than litigation.

A purchase agreement may be thought of as an agreement that governs the sale of the company's securities to investors at the moment of the closing of a financing. Following the closing, the relationship between the company and its investors going forward will be governed by the documents described below.

Certificate of Incorporation

A company's certificate of incorporation, or charter, establishes the company's legal existence and, along with the company's bylaws, sets forth the rights of the company's stockholders. The certificate of incorporation may be amended in connection with a venture financing in order to account for the creation of a new class of preferred stock. Many of the dividend, liquidation preference, voting and negative consent rights of preferred stock are included in a company's certificate of incorporation.

Voting Agreement

If investors will have the ability to appoint directors to the company's board, the company and the investors will typically enter into a voting agreement, which governs how specific board seats will be filled. Voting agreements may also include "drag-along" rights requiring each investor to vote to approve a sale or sell its shares in connection with a sale of the company if enough stockholders approve the transaction.

Right of First Refusal and Co-Sale Agreement

A right of first refusal and co-sale agreement (or "ROFR agreement") prevents a founder or significant common stockholder from selling shares to a third party without the company and the investors having the option to either purchase the shares themselves or participate in the sale alongside the founder or stockholder. ROFR agreements typically provide for some exceptions to these restrictions, such as transfers of stock to family members or for estate planning purposes.

Investor Rights Agreement

An investor rights agreement can cover an array of subjects and include various covenants the company agrees to undertake after the closing of a financing. Investor rights agreements typically provide investors with the right to receive certain information about the company, such as financial statements. Investor rights agreements also often provide investors with preemptive rights, or the right to purchase securities in future equity financings conducted by the company. Additionally, investor rights agreements typically provide investors with registration rights, which allow investors to cause the company to publicly register shares of the company's common stock with the SEC in connection with or following an IPO of the company.

Securities Law Considerations

Companies that are considering issuing securities in a financing in the US will need to take into account various securities laws and regulations at both the US federal and state level. Under the (federal) Securities Act of 1933, a company that offers or sells its securities must register the securities with the SEC or find an exemption from the registration requirements. Some of these exemptions are set forth in Regulation D, which includes an exemption for certain issuances of securities to "accredited investors." Accredited investors are defined to include certain businesses or high-net-worth individuals with assets or income above certain thresholds. The SEC's guide for small business on raising capital and complying with US federal securities laws is available at http://www.sec.gov/info/smallbus/qasbsec.htm.

Companies that are considering financing in the US should consult with US legal counsel to ensure that their financing qualifies for an exemption from the registration requirements of applicable securities laws.

“Crowdfunding”

“Crowdfunding” – or the use of the Internet and social media to raise capital in exchange for equity, typically through small contributions from a large number of people – presents companies with an intriguing new way to raise capital. Currently, crowdfunding in exchange for equity in a company is not permitted under existing US securities laws. In 2012, however, the US Congress passed the Jumpstart Our Business Startups Act (JOBS Act), which encourages the funding of small businesses by easing various federal regulations. The JOBS Act included provisions to make equity crowdfunding legal if conducted through an SEC-registered broker/funding portal, if investors meet certain requirements and if the company meets certain disclosure obligations. As of the date of publication of this resource, the SEC has yet to adopt formal rules and regulations pursuant to the JOBS Act that will establish specific legal requirements for equity crowdfunding, and its use remains illegal until the SEC establishes such rules.

Key Links

National Venture Capital Association – www.nvca.org
US Securities and Exchange Commission Guide for Small Businesses on Raising Capital – http://www.sec.gov/info/smallbus/qasbsec.htm

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