Corporate and Securities

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Entering the US Market—Challenges, Opportunities and Potential Pitfalls for Foreign Companies

Despite a sluggish recovery of the US economy until relatively recently and continuing pressure to outsource certain operations to other countries, new foreign direct investment in the United States increased from $39.9 billion in 2003 to $115 billion in 2004.[1] Moreover, the amount reinvested by foreign companies with US subsidiaries in their US operations increased from $12 billion in 2003 to $62.6 billion in 2004.[2] In the Greater Washington, DC, region alone, there are over 600 foreign-owned companies.[3] The US market remains a significant opportunity for a large number of foreign companies.

When considering entry into the US market, the issue is rarely whether the market is relevant; rather, it is whether the potential benefits of entry outweigh the perceived costs and risks. To make an informed decision, a company must understand the risks associated with entering the US market (e.g., market, execution and legal risks) and how to address them. This article focuses on some of the legal risks and potential pitfalls, but also highlights several key cultural factors affecting market and execution risk.

The overriding legal risk associated with entering the US market is the fact that litigation—and threatening litigation—is a part of (and a cost of) doing business in the United States. According to the Insurance Information Institute, the cost of the US civil liability (or tort) system in 2003 was $246 billion.[4] This litigiousness increases the cost of doing business in the United States by, among other things, increasing the need for insurance and the price of the premiums paid to insurance companies. However, it is often difficult to quantify the amount of money a company should budget for this risk because it is contingent on some unpredictable factors—whether litigation will, in fact, arise; the amount of damages, if it does; and the legal fees incurred in defending the litigation. Furthermore, unlike some countries where the losing party in litigation must pay the legal fees for both sides, in the United States, each party typically pays the cost of its own lawyers. Moreover, many plaintiffs' lawyers in particular will represent a client on a contingent fee arrangement, which means that the client only has to pay its own lawyer a percentage of the actual money received. By understanding this dynamic of doing business in the United States, a foreign company can take steps to protect itself by mitigating the risk of litigation.

In general, the legal issues that arise when a foreign company enters the US market can be categorized into the following: (1) establishing a presence, (2) hiring workers, and (3) selling products or services. There is no one-size-fits-all answer, but lessons can be learned from some of the common mistakes companies make.

Establishing a Presence

The fundamental choice in establishing a presence is whether to form a new entity (or acquire an existing entity) for US operations or enter the market by establishing a branch office of the foreign company. It is important to note that under some circumstances, a foreign company that sells products in the US market may be subject to regulation or litigation in the United States even if it has not established a presence in the country. Entering the US market through an entity—whether newly established or through an acquisition—is often thought to be advantageous because it can limit the liability of the parent company under the doctrine of limited liability.[5]

If a foreign company decides to establish a new entity, the first step is to choose which type to create—generally, either a corporation or a limited liability company.[6] Entities are established under state law, not federal law, except in rare cases of specialized industries. Delaware is often preferred as a state of incorporation because of its efficient service, low taxes for non-resident corporations, comprehensive body of corporate law and the quality of its courts. A corporation or limited liability company may incorporate in Delaware even if it is not located in Delaware, and will then need to file to do business in the other state(s) where it physically operates.

Both a corporation and a limited liability company can provide limited liability for the parent company, are fairly flexible in terms of governance, and can be formed quickly and relatively inexpensively. A corporation will pay an entity-level tax on its net income and may need to withhold taxes from dividends paid to a foreign parent company (although these withholding taxes may be reduced or exempted by treaty). A corporation will file its own tax returns and thus, the parent company will not have to file with the US tax authorities unless it has other US taxable income. A limited liability company—assuming it has a single owner—will usually be treated as a branch office of the parent company for US tax purposes. Therefore, its net income will be subject to US tax, and distributions to its parent company will be subject to withholding, in the same manner as a corporation. Tax returns will be filed by the foreign parent company rather than by the limited liability company.

If the new entity is not going to remain a wholly owned subsidiary of the parent company, there may be additional reasons to establish a corporation. For example, if the new entity plans to seek equity financing in the United States, many US investors prefer corporations (especially those formed under Delaware law regardless of where the company will be physically located). Also, corporations may be preferable if the entity plans to issue equity compensation (particularly stock options) to employees in the United States.

Regardless of which type of entity is established, the US company should be adequately capitalized and function like a separate entity from the parent company in order to protect the parent company from liability in the United States. For example, the US entity, not the parent company, should enter into contracts in the United States. It is also important to recognize that federal and state securities laws require each issuance or sale of a security to be either registered or exempt from registration. In practical terms, the issuance or sale will rarely be registered unless the US company is a public company, which means that any time a corporation or limited liability company issues an interest in the company (or any time an existing equity holder wants to transfer its equity interest), there must be an exemption from registration under federal and state securities laws. The securities laws are just one example of the bigger issue: a company must understand both applicable state laws as well as federal laws—a potential legal pitfall that is common when doing business in the US market.

Hiring and Terminating Workers

When deciding to hire workers for US operations, a company must always recognize the difference between employees and independent contractors. Although the distinction varies by applicable state law, in general, employees are hired by the company and are paid a salary and receive a variety of benefits (commonly including vacation days and health insurance), while independent contractors receive no benefits. Companies are obligated to withhold taxes for employees, but not for independent contractors. Although senior executives may have a contract with the company, most employees do not. Depending on the laws of the state in which they work, employees are often employed "at will," which means that in theory, a company can terminate their employment at any time for any or no reason (other than a discriminatory or otherwise unlawful reason). This "at will" arrangement should be expressly set out in any offer letter. Independent contractors have a contractual relationship with a company whereby the contract contains all the material terms of the relationship.

Typically, it is much easier to hire and fire employees in the United States than in other countries (e.g., Germany), though severance pay may be required and there is a significant risk of litigation in the United States when a company fires an employee. Moreover, a relatively low percentage of employees of private companies in the United States are members of labor unions and are typically covered by collective labor agreements that restrict an employer's right to terminate members.

There are contractual arrangements that can be entered into with employees (usually at the time of hiring or in connection with an option grant or severance payment) to protect the company upon termination of the employee. For example, a company can enter into a non-solicitation agreement with an employee, preventing the employee from soliciting the company's customers and/or employees. Additionally, some states enforce non-competition agreements, which a company can use to prevent a former employee from competing against the company in a particular region for a fixed amount of time.

One of the most difficult decisions an international company faces once it decides to enter the US market is the extent to which it wants to hire locally or send employees from the company's "home" country—which can raise tax, immigration and cultural issues. Many times, immigration

issues can be addressed by obtaining an L-1 visa, which generally allows a manager (L-1A visa) or employee with specialized knowledge (L-1B visa) to be transferred temporarily from the parent company to the US subsidiary. If opening a new office, other provisions will apply. The cultural issues are more challenging because the natural inclination is to relocate employees from the home country and parent company. Successfully penetrating the US market, however, frequently requires executives with experience and contacts within the United States.

Selling Products or Services

The litigious society of the United States is governed by a legal system that provides flexibility to negotiate the obligations and liabilities between parties in contracts. Unlike countries with a civil law tradition, in the United States, there are not many codified default provisions that apply, absent a contract. Accordingly, written contracts are paramount in the United States and tend to be much longer and more detailed than in many other countries. It is critical to develop standard contracts that address common risks and issues that can be used to sell the company's products or services in the United States. These contracts will not only contain the business points (such as pricing and payment terms and a description of the products or services sold), but also important legal provisions, such as representations and warranties, indemnification, dispute resolution mechanisms and termination. Even the legal "boilerplate" or "fine print" typically found at the end of a contract or reverse side of an order form can significantly affect a company by, for example, preventing the company from assigning the contract to another party or by selecting a jurisdiction for resolving disputes that is not convenient.

If a foreign company is selling in the US market through a US subsidiary, the US subsidiary needs to have the right to make such sales. In most cases, a contract will exist between the parent company and the US subsidiary. Moreover, this arrangement will raise a variety of tax issues, including transfer pricing and sales tax issues, which will need to be addressed.

Another relevant consideration is protecting the company's intellectual property. This can be accomplished through a variety of legal mechanisms, including patent, copyright, trademark and trade secrets protection. One or more license agreements from the parent company to the US subsidiary are generally required. In order to maintain trade secrets protection, it is important that a company obtain written confidentiality or non-disclosure agreements from employees and independent contractors with access to the trade secrets. Written confidentiality or non-disclosure agreements should also be obtained from other parties before providing them with any confidential information.

There are some additional considerations with regard to patent protection. First, intellectual property that may not have been patentable in the country where the parent company is located nevertheless may be patentable in the United States—where business method patents and patents for "anything under the sun that is made by man" can be issued and where intellectual property already disclosed can be protected if the patent is filed within one year from the date of first disclosure. Second, beyond confidentiality or non-disclosure agreements, a company should obtain intellectual property assignment agreements from employees and independent contractors who create or modify intellectual property for the organization. In addition, a US patent often enjoys higher recognition than patents from some jurisdictions with shorter histories of patent protection.

In sum, the US market provides significant opportunities for foreign companies. Although the costs, risks and potential pitfalls should not be underestimated—including the cost of preparing for, defending and prosecuting litigation—the legal risks can be managed and mitigated through informed planning. In the end, the decision as to whether to enter the US market should be based on the strength of the business opportunity, not the fear of legal pitfalls and costs, even though those risks and costs should be part of a thorough overall analysis.

Mr. Gregory Ewald is a partner in the Corporate and Securities Departments of WilmerHale and has established a special program for international companies entering or expanding their operations in the US market. This article does not represent legal advice as to any particular set of facts, nor does it create an attorney-client relationship or represent any undertaking to keep the recipient advised as to all relevant legal developments. The views expressed herein are solely those of Mr. Ewald and do not necessarily represent those of the firm.

1. See Organization for International Investment, press release of March 16, 2005, http://www.ofii.org/newsroom/press.cfm.
2. Id.
3. See Greater Washington Board of Trade's Greater Washington Initiative, http://www.greaterwashington.org/business/international.
4. See the Insurance Information Institute, http://www.iii.org/media/facts/statsbyissue/litigiousness.
5. Acquiring a company or entering into a joint venture each presents a variety of issues which are beyond the scope of this article. Please note, however, that the term "joint venture," as used in the United States, is not a particular type of company but rather a contractual relationship that may, but need not, form a new entity (e.g., a corporation, limited liability company or limited partnership).
6. In short, a limited liability company is like a partnership, but each partner's liability is limited to its interest in the partnership. The governance structure of a limited liability is very flexible. For example, a limited liability company can be managed by its members (i.e., owners), managers, a board or any combination of the foregoing.

IF YOU HAVE ANY QUESTIONS OR NEED ADDITIONAL INFORMATION, PLEASE CONTACT:

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