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International Business Transactions: The Five Basic Structures
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INTERNATIONAL BUSINESS TRANSACTIONS: THE FIVE BASIC STRUCTURES

THREE GENERAL OBSERVATIONS ABOUT INTERNATIONAL BUSINESS TRANSACTIONS

Observation One: Most nations (excluding the United States) are known as "civil code" jurisdictions. It is important to recognize that from a legal perspective, civil code jurisdictions operate differently in both form and substance than do common law countries such as the U.S. and the United Kingdom. Extensive civil and commercial codes (laws) in civil code countries monitor a wide variety of business-related transactions. For example, the existence of civil codes limits the ability of private parties to freely contract among themselves in all aspects of commercial transactions. Issues such as the termination of a distributor or agency relationship are detailed at length in the appropriate commercial code, and this generally makes for shorter contracts in civil code countries. Before signing a contract covering activities which will be carried out in a civil code country, determine which specific civil or commercial codes are applicable. Also, the specific country where a contract is executed may be significant if one of the parties is from a civil code jurisdiction.

Observation Two: In many parts of the world, government involvement is a significant factor in commercial transactions, even where contracts appear to be solely between private parties. Before executing documents such as agency agreements, establish whether the involvement or approval of a government authority is required. Do not rely on statements by the other party that there is "nothing to worry about". For example, in some countries royalty rates on a technology license must be approved in advance by the government even if the contracting parties have freely negotiated the rate. Failure to comply can make the contract unenforceable.

Observation Three: Do not make the mistake of assuming the American approach to contracts and business conduct will work in foreign markets. Be sensitive to restrictive local laws favoring nationals and their interests. In the area of dispute resolution, arbitration as opposed to the use of courts is normally preferred. This will often be the case whether the contract specifically provides for arbitration or not.

THE FIVE BASIC STRUCTURES IN INTERNATIONAL BUSINESS TRANSACTIONS

A U.S.-based company will normally choose from among five structures when planning its international business activities. You may find one option alone works, or perhaps a combination of two or more are needed in more complex transactions. Because major differences exist between how American laws and foreign jurisdictions treat the same transaction, it is critical to take special care when structuring international business deals.

I. Option 1: Direct Foreign Sales Without an Intermediary (A Buy/Sell Contract)

Legal counsel is often consulted when a U.S.-based company seeks advice on issues that may arise when negotiating a contract with a foreign buyer requesting that American-made products be shipped outside the United States. In Option 1, there are five key issues to keep in mind:

A. Make Sure Your Client Gets Paid

1. There are varying types of payment options. *Advice:* Always insist on payment by letter of credit or documentary credit; never sell on "open account". Which forms of documentary credit are most preferable? There are major differences between each.

   a. The irrevocable letter of credit (unconfirmed)
   b. The irrevocable letter of credit (confirmed)
   c. The stand-by letter of credit
   d. Assignment of proceeds of a letter of credit
   e. The back-to-back letter of credit
   f. The bid bond/performance guarantee
   g. The banker's guarantee

2. Even when a letter of credit or other documentary credit is offered, evaluate the creditworthiness of the named foreign bank's promise to pay a United States seller.

   a. The foreign issuing bank -- is it highly credible and rated? Check out its reputation for reliability.

   b. The correspondent bank (foreign or domestic) -- can you rely on it?

   c. Watch out for political circumstances (risk) that can affect payments by financial institutions (*i.e.*, Iranian Nationalization of Banks, questionable political stability in a specific country, the impact of the current economic crisis on international banks)

B. Definitions of Legal Terms in Contracts

In international contracts, you should be the party that will define all of the key terms or to make use of standardized terms that are part of accepted international conventions (*i.e.*, INCO Terms).

1. International contracts either define terms or stipulate which recognized definitions would apply. Never assume that the meaning of any term is obvious to non-U.S. parties and need not be defined. Pay particular attention to delivery terms, elements affecting the passage of title, force majeure and termination issues.

2. There are a number of international conventions and resource organizations that provide guidance from which you can select legal definitions. For example, the *International Rules for the Interpretation of Trade Terms* (INCO Terms) published by the International Chamber of Commerce are commonly incorporated into international contracts. INCO Terms are regularly updated, with the most recent version effective as of January 2011.

3. Remember to specifically define which language will be used to interpret a contract if two or more parties use a different language in their normal business negotiations or dealings.

C. <u>Three Basic Types of Arbitration in International Contracts</u>

There are three basic types of arbitration: *institutional*, *administered* and *ad hoc*. Consider the following when you undertake to draft a dispute resolution provision in an international contract.

1. Is arbitration required by local law in a commercial dispute?

2. Have you selected specific rules to govern the dispute (*i.e.*, ICC, UNCITRAL, etc.)?

3. Does arbitration make sense for the American seller?

4. Is the arbitration award enforceable in a foreign jurisdiction?

5. Where will arbitration take place and who will pay the costs at the conclusion? Who and how can a party initiate arbitration?

6. How many arbitrators will be used? How will they be selected?

7. Will one of the over 130 different international arbitration forums around the world be used? Examples:

    a. International Chamber of Commerce

b. American Arbitration Association
c. London Court of Arbitration
d. The International Centre for Dispute Resolution (ICDR)
e. The Singapore International Arbitration Centre (SIAC)
f. The Hong Kong International Arbitration Centre (HKIAC)

8. The *United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards*, 9 USC §206 (the New York Convention), is an important aid in the enforcement of arbitration awards. To be applicable, the nations of both parties to a contract must be signatories to the Convention. The U.S. is a party to the New York Convention. You should refer to this specifically in your contract if applicable.

D. <u>The United States Antiboycott Statutes</u>

The U.S. Commerce and Treasury Departments each have a set of regulations dealing with antiboycott situations. Penalties for failure to report or comply are harsh and may include both corporate and individual criminal sanctions.

E. <u>The UN Convention on Contracts for the International Sale of Goods</u>

Adopted by many nations around the world, the effective date for U.S.-based companies was January 1, 1988. *Remember*: You must specifically opt out of the Convention in writing or you will be bound by its provisions.

F. <u>Transfer Risk</u>

Consider the "transfer" risk (*i.e.*, will a foreign government permit the use of its foreign currency reserves to satisfy private trade obligations of companies operating within its borders). Factors to consider are:

1. Political stability of the foreign government (*i.e.*, Pakistan, Afghanistan).

2. Permanence and reliability of foreign financial institutions.

3. Economic prospects for the foreign country, both short term and long term (compare the differences among the countries of former Eastern Europe since the disintegration of the USSR).

4. Comparative attitudes toward the importance of international credit reputation of specific countries (*i.e.*, Nigeria).

5. Does any practical recourse exist under the foreign country's laws when problems for a foreign company arise?

6. Balance of trade issues and how they affect foreign investment.

7. Freedom of exchange (hard currency vs. inconvertible money). For example, during the 1990s transactions occurring in the countries that comprised the former Soviet Union involved at least some element of countertrade, but this is no longer the case. This is a factor because of an ongoing shortage of "hard currency" available to pay for needed products or technology in the West.

8. The People's Republic of China still has an inconvertible currency (the renminbi), and this affects contracts and payment terms.

G. <u>Documentation Required</u>

Closely monitor the full and accurate completion of all export documentation and the specific requirements of a customer's order so as to avoid any defenses to payment asserted by a foreign customer at a later date.

1. Is an import license needed?

2. Is an export license required from the U.S. government? Since 1991, the requirements for a valid export license under U.S. law has been liberalized to facilitate easier exporting, particularly to the People's Republic of China and other former communist-controlled economies. Restrictions still exist in certain key areas, such as India in the nuclear area.

3. Is permission to issue foreign exchange needed from a foreign government?

4. Does the foreign country allocate foreign exchange as to payment of foreign obligations? What priority for payment would you have if your transaction went through?

5. Has all export/import documentation been fully and properly completed? *Best advice*: Avoid becoming involved in a "double invoicing" request from your foreign customer. This can result in criminal and civil penalties both in the foreign country and the United States.

II. <u>Option 2: Using Agents and Distributors Overseas</u>

United States companies regularly appoint agents and distributors overseas to represent their interests. There are numerous potential pitfalls to consider *before* taking the step to appoint an agent or distributor outside the U.S. The most critical risk is termination of the foreign agent or distributor by an American company, which can be very costly due to foreign laws designed to protect agents and sometimes distributors. This is true even if the reason for termination was poor performance.

A. General Rule

Most civil law countries have specific statutes favoring the interests of their local agents and distributors who deal with foreign companies. Do not assume that all of the specific terms and conditions in a contract freely entered into between an American company and the foreign agent or distributor will be enforceable. The laws of each country must be separately examined. Local laws normally take precedence over contractual obligations negotiated by the parties. Do not use a standard agent or distributor contract uniformly overseas.

B. The *U.S. Foreign Corrupt Practices Act* (FCPA)

Originally passed in 1977, this law was amended in 1998 and should be carefully read and understood. Since 2009, the U.S. Justice Department aggressively stepped up its enforcement efforts of the FCPA. *(See Part IV of this outline for a more detail description of the FCPA.)*

C. Foreign Labor Statutes

Carefully examine foreign labor statutes because they may grant favorable treatment to agents and distributors over the interests of a foreign company. It is often difficult to draw a distinction between one's employees and agents. Generally, high costs resulting from terminating foreign agents and distributors are not uncommon.

D. Antitrust and Anticompliance Laws

Some foreign antitrust laws restrict the ability to grant an agent or distributor an exclusive geographic territory and limit its ability to sell outside a specific geographic region. For example, the *European Union Competition Statutes* limit the ability to contract with representatives in the EU.

E. Factors to Consider When Evaluating the Appointment of a Possible Representative or Distributor

1. Initially determine whether the appointment is for a "representative" or a "distributor". Check local statutes to determine how each is treated. Normally local laws are more protective of the interests of representatives (agents) than distributors.

2. What specific products are covered by the relationship? Consider providing a limited grant at first to your agent to check out the agent's capability for the project.

3. Are the rights granted to your foreign agent exclusive or non-exclusive? What is the territory? Is it more than a single country? Is this a good idea?

4. Do United States export control regulations affect the appointment of a foreign agent?

5. Clearly define what rights your agent or distributor may have to use your trademarks, servicemarks, or copyrighted materials in advertising or in connection with sales activities.

6. You must specify any commission payment arrangements with your agent. Should you include performance goals in the contract even if they are not necessarily enforceable under local laws?

7. What about service obligations and warranty follow-up? Are there minimum standards your agent or representative must provide? Are they enforceable?

8. Before signing your foreign representative, determine how local laws are structured in the event you later desire to terminate your agent or distributor. Calculate your maximum exposure in advance.

III. Option 3: The International Licensing and Transfer of Technology

Licensing of technology is a common type of international business transaction. There are certain points about international licensing contracts that are unique and need to be understood by legal counsel.

A. Local statutes dealing with foreign license agreements can influence how parties can deal with each other.

1. Is foreign government approval required?

2. Are the sizes of royalties restricted by government statutes?

3. Is there a compulsory licensing requirement?

4. Are there problems with local currency controls which will limit your ability to receive royalty payments?

5. How will local taxes affect royalties?

B. <u>Four Points to Consider When Drafting a License Agreement</u>

1. Term of agreement: Should it be limited?

2. Exclusivity vs. non-exclusivity: Is there an advantage to a non-exclusive arrangement?

3. Arbitration of disputes: Is arbitration the best dispute resolution mechanism or the only one available?

4. Patents, copyrights, trademarks and trade secrets: Does the treatment of each differ according to the laws of each foreign country?

C. <u>Foreign Antitrust Statutes and the Applicability to a License Agreement</u>

Outside the United States, the greatest potential for antitrust problems exists in the European Union. Japanese antitrust laws are not a major concern. Elsewhere, antitrust laws are not normally a factor.

1. <u>Tax Implications of Licensing</u>

a. Check if there is a bilateral tax treaty between the United States and the other country which limits the mandatory American or foreign withholding rate on royalties paid to license.

b. Consider the use of a third country with a tax treaty through which to run the license if the licensee's country has no tax treaty with the United States.

2. <u>"Grantbacks" of Technology</u>

After-acquired technologies and improvements are of major concern to both licensees and licensers. Who owns them? Define this carefully in your license agreement.

3. <u>Secrecy Obligations</u>

a. Determine if you can reasonably expect any protection of your trade secrets or proprietary information in the event of termination.

b. Do local courts provide for any kind of injunctive relief?

4. United States Export Control Laws

Check into whether U.S. export control laws will in any way limit your ability to transfer technology.

IV. Option 4: The International Joint Venture or Strategic Alliance

Joint ventures are a common structure when doing business around the world. In the past decade, a more complex form of the joint venture -- the "strategic alliance" -- has come into use. Assume a United States client wants to enter into a joint venture or some kind of alliance with foreign business partners. Remember that in some countries, joint ventures with a local partner are the only realistic method of doing business, and local laws almost always favor national companies over foreign partners. For example, in the People's Republic of China, joint ventures with foreign companies that have high technology products and are willing to contribute the technology to the venture are encouraged by local laws and government officials over wholly-owned activities.

A. The Impact of Antitrust on the Joint Venture

1. Consider the application of United States antitrust laws to overseas activities. Do not forget that U.S. antitrust laws can have extraterritorial applications.

2. Foreign antitrust laws (*i.e.*, those of the European Union and Japan) should be examined for applicability.

3. China has existing regulations governing proposed joint ventures and acquisitions. These regulations can be used to block transactions which Chinese authorities oppose.

B. Tax Implications

1. Structuring any joint venture depends upon the tax jurisdictions involved and where the joint venture activities will be carried out.

2. Tax planning must be done in advance of the joint venture negotiations if problems are to be evaded in structuring.

C. The "Control" Issue

A common challenge is how to maintain control in a joint venture where local laws limit the amount of equity participation by the foreign (American) partner. Techniques to get around these laws vary from country to country.

D. The Impact of the *U.S. Export Trading Company Act of 1982* (ETCA)

1. This statute clarifies the applicability of American antitrust laws to joint ventures. (See Title III and Title IV.)

2. Title III (Antitrust Certification) is the most significant part of the ETCA. Title III offers a potential advantage to U.S. partners in a joint venture which is carried out overseas by allowing pre-approval of activities (certification) by the U.S. government.

E. Trade Secret Proprietary Information

1. Be certain to execute secrecy agreements during negotiations and make them a part of the joint venture agreement. Recognize, however, that enforcing trade secret agreements or non-disclosed agreements outside the U.S. court system can be very difficult.

2. What happens to technology developed during the course of the joint venture? Who owns it? This is the "grantback" problem.

F. Termination

1. Provide in advance for a formula for damages in the event of a premature termination of the joint venture.

2. How are technology and trade secret rights affected by termination? Who owns them?

V. **Option 5: The Wholly-Owned Foreign Subsidiary**

United States companies wanting to do business overseas often insist upon total control over their operations. As a result, they elect to set up a wholly-owned subsidiary. Many U.S. companies (except the largest) find the costs of operating foreign wholly-owned subsidiaries can be prohibitive. Where costs are not a limiting factor, below are a number of the areas to think about before moving in this direction.

A. Tax Implications

1. You will need to coordinate your operational activities from a tax standpoint.

2. Intercompany pricing becomes a problem. Check this out before setting up a subsidiary.

B. Foreign Laws

1. Some countries discourage (directly and indirectly) wholly-owned subsidiaries from operating without a local partner.

2. Beware of product liability or other problems flowing back to the parent in the United States (*i.e.*, the Union Carbide chemical disaster in Bhopal, India).

3. Stricter laws as to hiring foreign nationals can be a problem for wholly-owned subsidiaries. This is particularly true at the time of the termination of an employee.

C. The *U.S. Foreign Corrupt Practices Act* (FCPA)

A wholly-owned United States subsidiary may subject an American parent to liability which may not occur when using a foreign agent or distributor or having a joint venture partner.

D. Intellectual Property

A major advantage of the wholly-owned subsidiary is tighter internal and external control over your company's intellectual property.