

DOING BUSINESS IN THE UNITED STATES OF AMERICA

G A R V E Y S C H U B E R T B A R E R

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Introduction

Garvey Schubert Barer is pleased to provide *Doing Business in the United States of America* as an introductory guide for businesses and individuals from China who are interested in doing business in the United States.

China and the United States are increasingly interdependent trading partners, as the rapid growth in imports and exports between the two countries clearly shows. However, until now investment flows between the two countries have been decidedly in one direction. China has been the beneficiary of a massive amount of U.S. investment capital although there has been relatively little direct investment in the U.S. by Chinese companies. With China's accession to the WTO and the growing globalization of its economy, we should start to see a change in the historically one-sided nature of investment flows between the two countries.

The increasing global expansion and globalization of Chinese companies is one of today's most promising aspects of United States-China trade. Companies from China are exploring foreign export markets, with a view to taking a more direct role in market opportunities and the global development of their brands. Not content to rely on intermediaries, trading companies and importers, forward-thinking management of Chinese companies is looking to establish wholly owned subsidiaries or branches in the United States both to better understand and take advantage of the substantial growth opportunities presented by the U.S. consumer and business markets, and to gain control of their distribution channels in the United States.

The information in this booklet provides only an introduction to certain key aspects of doing business in the United States. Laws and regulations change over time, and readers are advised to consult with their legal counsel and/or other professionals before making plans to conduct business abroad. Early and careful planning ultimately avoids a variety of issues and reduces expense. Garvey Schubert Barer, with decades of experience in cross-border transactions and a long history of advising PRC companies on doing business in America, would be pleased to assist you in achieving your business goals in the United States.

CHAPTER 1

ESTABLISHING A NEW BUSINESS IN THE UNITED STATES

1. CHOICE OF ENTITY

A foreign investor may choose from a variety of forms of entities to do business in the United States. Such forms of entities include a corporation, a limited liability company (“LLC”), a partnership, and a sole proprietorship. In addition, a foreign investor may enter into a joint venture agreement with a U.S. business. A joint venture is generally a business entity formed by two or more non-affiliated persons, and can take the form of a corporation, an LLC, or a partnership.¹

Selection of the form of entity requires consideration of many different factors, such as limitation of liability and taxation. A single individual investor may choose to establish a “sole proprietorship,” or with one or more other individuals, a “partnership.” In either case, the individual actively involved will typically be responsible for all of the liabilities of the business.² Similarly, a foreign company may choose to establish a branch office of its business in the United States, but the foreign corporation will be subject to lawsuits and liabilities, as well as U.S. taxation.

Typically, foreign investors choose one of two forms of business structures available in the United States: (a) corporations or (b) limited liability companies. These legal forms allow the owners to limit or distribute the risks of the business, limit tax liability and filing obligations, provide for a more sophisticated form of management, make liquidating investments easier, and attract investment from other investors. The following provides a brief discussion of these two forms of business entities.

A. Corporations

(1) Major Characteristics of Corporations

The corporation is a legal entity separate from its owners (the shareholders). The main reasons for using a corporation to conduct business are to limit liabilities, and to provide a framework for attracting capital to the company by the sale of shares.

¹ There are also contractual joint ventures, but, for a number of reasons, these are typically not employed in a cross-border context unless each party also forms a separate entity through which each party will enter into such agreement.

² Limited liability partnerships allow a partnership structure, without the same exposure to the partners. Likewise, limited partnerships allow investment without the same risk of liability. But, as noted below, neither of these structures are typically employed in a cross-border context due to their tax consequences.

Generally, shareholders of a corporation are not personally liable for the debts of the corporation, and their liability is limited to their capital contribution in the corporation.³

In addition to the characteristic of limited liability, other major characteristics of a corporation include (a) centralized management, (b) relatively free transferability of ownership interests, and (c) perpetual existence.

Typically, the management power of a corporation is centralized in its Board of Directors. Directors are elected by the shareholders of the corporation. The Board then establishes corporate policy and has overall responsibility for the corporation's affairs. The Board appoints officers, who are expected to execute the Board's vision, and delegates to the officers the day-to-day operations of the corporation. However, directors are responsible for the actions of these officers. Certain major decisions involving change to the corporation can require shareholder approval, but otherwise only the Board of Directors need approve significant corporate actions, policies, or business decisions.

The ownership interest of a corporation is represented by shares of capital stock. Subject to limitations in shareholders' agreements and compliance with applicable local and federal securities laws, shareholders are free to transfer their shares.

A corporation enjoys perpetual existence unless otherwise specified in its articles of incorporation. A corporation continues to exist despite changes in its shareholders. For example, the insolvency or death of a shareholder does not dissolve a corporation.

(2) **Forming a Corporation**

The process of forming a new corporation in the United States is speedy and inexpensive. A number of follow-up actions must be completed after incorporation before a business can begin operations, but the actual incorporation process typically takes only a few days. The filing fee is usually several hundred dollars, but sometimes can be less. For example, in Oregon, the filing fee to incorporate is only \$50 per entity. Expedited service may be available in some states for a nominal fee. For instance,

³ Under certain circumstances, shareholders of a corporation may be held liable for the corporation's liabilities. When this happens, it is called "piercing the corporate veil." Courts have considered the following factors to decide whether to pierce the corporate veil: (a) failure to maintain corporate records, or comply with corporate formalities; (b) commingling of funds and assets; (c) failure to maintain the separate existence of the corporation, for example, by one corporation so controlling another that they are one and the same; and (d) failure to adequately capitalize the corporation, under circumstances so extreme that they amount to fraud or other improper dealings with creditors.

the Corporations Division of the Washington Secretary of State offers an expedited service for an additional fee of \$20 per entity.

(3) Purpose or Business Scope

In the past, a U.S. corporation's purposes had to be stated in specific details, and a corporation could not act beyond its stated purposes or powers, much like China requires today. Under current law, however, a corporation in the United States can typically be formed to "engage in any lawful business" unless a more limited purpose is set forth in its articles of incorporation. For instance, a local manufacturing company can engage in domestic or international trade without the need to incorporate another trading company. It is not necessary to list each specific intended purpose in the corporation's articles of incorporation at the time of formation. But it may be necessary to provide a general description of the corporation's business in certain annual filings.

(4) Capital Requirements

Unlike in China, there is generally no minimum capital requirement for forming a new corporation in the United States. Therefore, one can start a corporation with a nominal capital of, for example, \$1,000. Additional capital can be paid in later if necessary. The primary limit on this flexibility is that undercapitalization can trigger liability for shareholders (see footnote 3), so one should always seek to adequately capitalize a corporation for its contemplated business.

In the United States, the simplest and most typical initial capital stock of a corporation is one class of common stock. A corporation may also issue preferred stock. Preferred stock may have a variety of preferences over common stock with respect to such matters as payment of dividends or rights upon the liquidation of the company. Both common and preferred stock can be further classified into different classes and different series within classes, each with its own special voting and other rights. Generally, state corporate statutes provide that the number of shares, common and preferred, available for issuance must be stated in the articles of incorporation. These are called "authorized" shares. Usually, the Board of Directors sets the price for shares at the time the Board authorizes shares.

B. Limited Liability Companies

The concept of a Limited Liability Company in the United States is quite different from the concept of such an entity in China. An LLC in China is a regular corporation with 2-50 shareholders; an LLC in the United States is more like a hybrid between a partnership and a corporation. It is a registered legal entity

formed under a state statute that, like a corporation, limits the liability of its capital investors to their investment in the enterprise. At the same time, the tax laws governing LLCs permit the entity to be disregarded for tax purposes much like a partnership, allowing taxes to be paid only at the investor level. The applicable state statute is often called a Limited Liability Company Act. Today, every state has enacted legislation that authorizes the use of this form of entity.

Like a corporation, an LLC is a legal entity separate from the persons who own and manage it. Capital investors in an LLC are often called members. Some states require that an LLC has at least two members; other states allow one person (or entity) to own an LLC. Washington and Oregon both allow single member LLCs. Generally, there is no limit to the number of members.

The laws governing LLCs allow tremendous flexibility. For example, an LLC with two or more members may choose to be treated as a partnership or a corporation for tax purposes. If an LLC elects to be treated like a partnership, which most LLCs do, then the LLC pays no taxes at the corporate level. Instead, each member is allocated a share of the LLC's net income or loss, which the member then reports as an individual. This allocation occurs regardless of whether income is actually distributed to the member. Then, whenever money is actually distributed from the LLC, there are no taxes owing on those distributions. For more information about taxation of LLCs, see Chapter 3 of this booklet.

C. Registering a Foreign Corporation's Branch Office

As mentioned previously, a foreign corporation seeking to do business in the United States may elect not to form a new enterprise but merely register itself to operate through a branch office. This is a relatively simple process. In addition to a filing fee, the corporation will be required to submit an application to the appropriate state governmental authority, usually the Office of the Secretary of State. The application must commonly be accompanied by some proof that the corporation is in good standing in its home country.

As far as liability is concerned, the U.S. branch subjects the foreign corporation to possible claims and lawsuits in the United States. For this reason, foreign investors generally prefer to do business through a U.S. subsidiary rather than through a branch. The subsidiary helps insulate the foreign corporation from liability for the subsidiary's acts.

2. WHERE TO FORM

Unlike in China, where the Company Law governs operations of limited liability companies and joint stock limited companies throughout the country, the United States is a federation of 50 states, and each of the 50 states has its own corporate and limited liability company statute. Generally, these state statutes govern the incorporation, the structure of the Board of Directors, the shareholder power and rights, and matters relating

to the internal operations of a corporation. Although the state statutes are substantially similar from state to state, there are differences in the details, which may sometimes be significant. These differences may include such areas as taxation, shareholders' voting rights, the ability to sue directors, and the extent of the directors' fiduciary duty.

The decision concerning where to establish a business usually is determined by the business owner based on the expected principal place of business. However, for a company expecting to do business in more than one state, there may be several possible locations to consider. It is important to note that an entity formed in any one of the 50 states is permitted to do business in any of the other 50 states, subject to certain registration requirements in those states where the entity is deemed to be "doing business." Hence, in many instances, where to form is not of great importance to foreign investors.

Many large corporations elect to incorporate in Delaware because Delaware is perceived as favoring corporate management over shareholders. (Other large corporations, like Microsoft, later decided that incorporating in Delaware was not advantageous and reincorporated elsewhere – typically where their headquarters are located). Foreign investors sometimes favor New York and California because they are considered to be important commercial centers in the United States. More practical considerations may drive a foreign investor's decision on where to form – such as applicable state and local taxation policies and costs of doing business.

3. ADDITIONAL REGISTRATION AND REPORTING REQUIREMENTS

Once formed, but typically not before, a business must complete certain additional reporting and registration requirements. These vary depending on the applicable state and local laws and the type of business involved. A wide range of businesses, such as banks, beauty salons, and beer gardens, need special licenses to operate. The requirements also vary, depending on whether assets already in the United States will be acquired as part of the new business. For example, if a transaction will involve acquisition of sensitive technology, certain federal government approvals or licenses may be required. The applicable registration and reporting requirements should be investigated before forming an entity, to make sure that no separate license or approval is needed that, if not ultimately obtained, would alter a business' plans.

At a minimum, a business will typically be expected to obtain city and state business licenses, as well as registering with taxing authorities and the authorities governing employment relations in the relevant state. Sometimes states simplify this process through unified applications. In Washington State, for example, a company can start the process for any special business license, register with the Department of Revenue, register with the Department of Labor, obtain trade name registrations, and obtain general business licensure for the state and certain cities – all in one single "master business application." In the City of Portland, Oregon, any person or entity operating a business may pay a business license fee based on their net income. This fee replaces all general

business taxes imposed by the city and, hence, is both a license and taxation process in one step.

In addition, under federal law, U.S. businesses (even newly formed) are required to report foreign investments in their enterprises that result in a foreign party owning a 10% or more voting interest in the enterprise. These reports are for statistical purposes only and are made to the Department of Commerce. Its regulations provide that such information will be confidential and therefore is not shared with anyone else, except in a format that does not identify the individual investors or business enterprises. The scope and detail of these reports vary depending on the size of the investment and the U.S. business. At the simplest level, the U.S. business need only disclose its name and address, the cost of the investment, the quantity of any acreage involved, the total dollar value of the business' assets, gross operating revenues and income after U.S. taxes for the immediately preceding year (or estimated year, in the case of a new company), and the country of origin of the investor and the ultimate beneficial owner.

Similarly the U.S. Department of Treasury/Internal Revenue Service expects most businesses to obtain a federal employer tax identification number and has certain on-going reporting, filing and record-keeping requirements for portfolio investments, foreign currency transactions, and transnational transactions between related companies. The extent to which any of these requirements apply to any venture will depend on the nature of the business and the types of activities undertaken.

Additional federal reporting requirements exist for transfers of agricultural land, and various restrictions can apply to industries such as transportation, fishing, minerals, energy, and banking. Finally, a new enterprise in the United States should expect regulation of its flow of personnel and goods to and from the United States by the Department of Homeland Security. As will be discussed more in other chapters, this Department is keen on better monitoring activities in and out of the United States. We anticipate that its requirements on reporting activities will be amended from time to time during the next several years.

CHAPTER 2

U.S. CAPITAL MARKETS

Financing in the United States can take different forms. The most common are equity or debt offerings and commercial bank borrowings. Foreign issuers may choose to seek capital in public markets or private transactions. Public offerings are heavily regulated in the United States. The federal securities laws include the Securities Act of 1933 and the Securities Exchange Act of 1934.

All securities offerings in the United States must either be registered with the Securities and Exchange Commission (SEC) or completed in compliance with an exemption from the registration requirements of the Securities Act of 1933 and applicable state securities laws. Failure to comply with these requirements exposes the issuer and its officers and directors to potential liability.

Because of the cost and time required to complete a registered “public offering” of securities, most securities offerings are completed as “private placements” pursuant to an exemption from registration. Several exemptions are available, but it is essential that the issuer consult with U.S. legal counsel who specializes in securities matters before offering or selling securities in the United States. Regulation D and other commonly relied upon exemptions include several technical requirements, and failure to meet any of these requirements may result in loss of the exemptions.

In addition to satisfying the registration requirements, issuers planning to offer securities in the United States must also avoid liability under the disclosure and anti-fraud provisions of the federal and state securities laws. In general, these laws impose liability not only for misstatements of material facts in connection with a securities offering, but also for failure to disclose a material fact. This liability extends to the issuer and its officers and directors. Thus, when planning an offering in the United States, foreign issuers should consult with legal counsel concerning the disclosure plan for the offering.

Companies that complete a registered public offering of securities in the United States, or that list shares for trading in the United States, become subject to the reporting requirements of the federal securities laws. In 2002, the U.S. Congress enacted the Sarbanes-Oxley Act, which makes extensive reforms to corporate governance and disclosure requirements for public companies. Foreign issuers are also affected. Foreign issuers should consult professional advisors about the implications of these laws when considering a public offering or listing of shares.

In addition to the above federal laws, securities issuances in the United States are also governed by various administrative regulations and state securities laws (referred to as “blue sky” laws). Although states continue to seek greater uniformity in these blue sky laws from state to state, many inconsistencies exist and a foreign investor must be careful to comply with all applicable state and federal laws.

The New York Stock Exchange, the American Stock Exchange, and NASDAQ all have certain listing standards. These change from time to time, and the current standards can be confirmed by contacting the exchange or U.S. legal counsel.

CHAPTER 3

TAXATION

1. U.S. FEDERAL AND STATE TAXES

The U.S. tax rules are very complex. Therefore this summary is intended to provide only a basic overview. We have highlighted particular issues that are often important to companies and individuals from China.

A. Federal Tax Rates.

The U.S. tax system imposes income taxes on both corporations and individuals. In both cases, U.S. taxes are applied against taxable income, which comprises all gross income earned by the taxpayer less allowable deductions. For businesses the most common deductions are depreciation, interest, wages, state and local taxes, travel expenses, and meals and entertainment (which are 50% deductible).

(1) Corporate tax rates.

At the federal level, corporations with taxable income less than \$50,000 pay tax at a rate of 15%. The rate is 25% for income between \$50,000 and \$75,000, and 34% for income above \$75,000. Income above \$10 million is taxed at 35%. These income levels and tax rate brackets are not adjusted for inflation each year. Except for certain U.S. production income (discussed below), all corporate income is subject to these tax rates regardless of whether the income is classified as ordinary, passive or capital gain income.

There are two important points about corporate tax rates. First, although corporate tax rates are “graduated” (that is, they are designed to apply a lower rate for smaller amounts of income), the tax benefit associated with the lower rates is phased out once a corporation earns more than \$100,000 of income. The calculation is somewhat complex, but essentially the result is that a corporation with \$200,000 of taxable income will pay a special surtax on the amount over \$100,000. The sole purpose of the surtax is to take away the benefit of the 15% and 25% tax rates on the corporation’s first \$75,000 of income. As a result of this surtax system, a corporation will effectively be subject to a flat rate of 34% on every dollar of its income once it reaches \$325,000. Once a corporation reaches \$10 million, it is taxed at 35% on any amount over \$10 million. However, a surtax applies again once a corporation earns \$15 million of taxable income. The result: a corporation earning more than \$18,333,333 of taxable income will pay tax at a flat rate of 35% on all its income.

The second important point about corporate tax rates is that they are slightly lower for income from manufacturing and other U.S.-based

production activities (including engineering and construction services). This “U.S. production” income receives a tax rate reduction of between one and three percentage points. Thus, for a corporation subject to tax at 34%, the tax rate on U.S. production income will be a few percentage points less (between 31% and 33%).

Under the U.S. federal tax system, there are generally no tax holidays for corporations. Certain states and cities may offer reduced tax rates to attract investment.

(2) Individual tax rates.

For individuals, the federal tax system applies graduated tax rates. For a non-married individual, the tax rates in 2005 are as follows:

Income Level	Tax Rate
First \$7,300	10%
From \$7,301 to \$29,700	25%
From \$29,701 to \$71,950	28%
From \$71,951 to \$150,150	31%
From \$150,151 to \$326,450	33%
Over \$326,450	35%

Unlike the corporate tax rate system, the tax rates for individuals are not subject to any special surtax to take away the benefit of lower rates. Thus, a person who earns \$500,000 and pays tax at the highest rate (35%) on some of his income will still pay tax at the lower rates (10%, 25%, 28%, 31% and 33%) on a portion of his income. In contrast to corporate tax rates, the income levels for individual tax rate brackets are automatically adjusted for inflation each year.

For individuals, there are special low tax rates for certain kinds of income. For example, individuals pay tax of only 5% or 15% on certain capital gain income derived from capital assets held for at least one year. Also, individuals are eligible for a special 5% or 15% tax rate on certain dividends received from U.S. and foreign corporations.

B. State and Local Tax Rates.

Each of the 50 U.S. states has the power to impose its own taxes, subject to various limits under the U.S. Constitution and other laws. Cities, counties, and other local government jurisdictions also have taxing power.

At the state level, most states also apply their income tax to any individual or entity that is either resident in the state or carries out business in the state. In other words, for a state to tax a person or an entity, the state must first establish

“nexus,” which means a physical or business connection between the taxpayer and the state. A business that has an office, employees, or equipment located in a state will almost always be taxed by that state. The same is true of an individual who lives or consistently works in a state. However, states can also tax individuals and entities based on other connections, such as frequent visits to the state.

Most states apply some form of personal income tax, usually with graduated rates between 1% and 10%. A small number of states (including Alaska, Florida, Nevada South Dakota, Texas, Washington, and Wyoming) do not have an income tax for individuals. A few states (including Nevada, South Dakota, Texas, Washington and Wyoming) do not have a corporate income tax. The State of Washington has a unique “Business & Occupation Tax,” which applies a tax of about 0.5% to 1.5% against gross income. Whereas most states apply some form of sales tax, Oregon has none.

C. Example.

Assume a Chinese company incorporates a U.S. subsidiary in the State of Delaware. The subsidiary then registers to do business in California and New York. The subsidiary opens its main office in California and also opens an office in New York and hires two people in New York to assist with sales in that state. The company records most of its sales to California and New York customers, but a small amount of sales are made to other states. In calendar year 2004, the subsidiary has revenue of \$1,200,000 and deductible expenses of \$800,000.

The subsidiary’s taxable income will be \$400,000 (gross revenue of \$1,200,000 less deductible expenses of \$800,000). The subsidiary will need to file a U.S. federal income tax return and pay tax of \$136,000 (34% of \$400,000). In addition, the subsidiary will need to file tax returns in California and New York. Each state has its own rules for determining what tax shall be owed. Assume that the tax rate in California is 5% and the rate in New York is 6%. Assume also that under both California and New York tax rules, the annual taxable income is \$400,000, the same as the federal taxable income. For its California tax return, the subsidiary will need to calculate the percentage of the \$400,000 in income attributable to California. This percentage is based on a fraction that takes into account the subsidiary’s total property located in California, its payroll based in California, and its total sales made to California customers. New York applies a similar apportionment formula based on property, payroll and sales in New York. Assume that under these formulas 50% of the income is allocated to California, and 30% is allocated to New York. Another 20% of the income is allocated to states where the company does not have any office or other presence. The additional state tax would be \$10,000 for California (50% of \$400,000 multiplied by the 5% tax rate) and \$7,200 for New York (30% of \$400,000, multiplied by the 6% tax rate).

Notice several important things about the U.S. tax system. First, while the subsidiary is incorporated in Delaware, it pays no income tax there because it has no operations there. Under Delaware law, there is no income tax if an enterprise does not conduct business there. (The subsidiary will have to pay a Delaware franchise tax based on the number of shares of stock issued. This is a tax, in essence, for the right to be a registered Delaware corporation, rather than a form of income tax. Some states impose such a tax; others do not.)

Also, notice that some of the income escapes state tax entirely, because it is derived from sales to states where the subsidiary does not have nexus. Thus, in the U.S. system, often a business will record revenue from a state but will not have sufficient nexus with that state for the purpose of applying a state tax. For example, a business might solicit orders in a state through advertising, the Internet, or through an individual agent who does not have the power to sign contracts. Sales generated from such “solicitation” activities generally escape state income tax, provided the business otherwise does not have nexus with that state. Determining the states where a business has nexus takes a careful review of the business’ operations and the applicable law.

The example above is greatly simplified in determining state tax costs. Most states have tax laws based on the federal tax system, but differ on many issues including tax credits, depreciation, and the treatment of foreign-source income. Also, certain states (such as California) apply a so-called “unitary” approach in determining the total income subject to tax. Under this approach, a state will first determine which controlled enterprises are engaged in a common business (called a “unitary business”). A unitary business can include enterprises both inside and outside the United States. Next, the state will apply the apportionment formula to the total income from the unitary business. The apportionment formula will still be based on the property, payroll, and sales attributable to that state, but the unitary income base can be much larger. The unitary approach involves significantly more reporting and disclosure and may result in more tax cost. It can sometimes be avoided with careful planning.

2. TAX TREATMENT OF VARIOUS BUSINESS STRUCTURES

A. Simplest case – Chinese individual or company with investments in the United States.

Many individuals and companies in China are initially involved in the U.S. tax system through passive investments, such as investing in stock or a piece of real estate. For these investors, the tax rules are relatively simple. Non-U.S. parties who invest in U.S. securities or make loans to U.S. persons will generally face U.S. withholding tax on dividends and interest. The normal withholding tax rate is 30%, but this rate is reduced to 10% under the U.S.-China Tax Treaty. Assuming the person does not have a U.S. business, interest on most bank

deposits and certain registered debt (for example, debt securities offered to the public) is exempt from withholding tax.

Nonresidents who have no presence in the United States generally avoid tax on capital gains from the sale of U.S. securities and other capital property. However, an exception applies to U.S.-based real estate and intangible assets such as patents and trademarks. Any capital gains from real property located in the United States (or shares in companies principally owning real estate) or U.S.-based patents are automatically subject to tax at regular tax rates of up to 35%.

B. Chinese individual who visits the U.S.

As an initial step, many Chinese companies send individuals to the United States to take part in trade shows, meet with customers and investigate business opportunities. Also, many Chinese individuals visit the United States for personal business, travel, or study. An important tax issue is whether these visits cause the person to become subject to the U.S. personal income tax.

In most cases, any individual who spends 183 days or more in the United States during a calendar year will be classified as a “tax resident” and subject to U.S. personal income tax. There are some exceptions to this rule for students, government officials, and other special visa categories. An individual may also be subject to state income tax, depending on where the individual stays during this time and the residency definition in the applicable state.

In addition, the U.S. tax rules apply a rather complex residency test, which focuses on whether a person has spent 183 or more days in the United States over the last three years. Under this test, days spent in the United States in the preceding year are divided by three, and days in the second prior year are divided by six. Thus, it is possible for a person to spend less than 183 days in the United States in the current year, but still be treated as a U.S. tax resident due to the number of days spent in the United States in the prior two years. For frequent visitors to the United States, or individuals seeking to obtain a “green card”, careful tax planning on the issue of tax residency is essential.

If an individual becomes a U.S. tax resident, he or she is taxed on worldwide income. This person must report all of his or her income (no matter where it is earned in the world) and pay tax at the graduated tax rates described above. To avoid double taxation, the U.S. tax system offers a credit for foreign income taxes paid.

If the individual is not a U.S. tax resident, he or she will still be subject to U.S. tax on most forms of income derived from the United States. For example, a non-resident will generally have to pay tax on U.S. source wage income that is earned from services performed in the United States. (There are a few limited exceptions for Chinese students and teachers under the U.S.-China Tax Treaty.) Non-

residents must also pay U.S. tax on most forms of dividend, royalty and interest income from U.S. investments, generally through withholding, as discussed above. U.S.-source capital gains may be subject to tax, depending on the number of days the person has spent in the United States during the present year.

C. Operating through a U.S. branch.

As discussed in Chapter 1, some Chinese companies initially enter the United States market without setting up a separate corporation. Instead they set up a branch. A branch can be as small as one person working out of his or her home in the United States or as large as a permanent U.S. headquarters office with hundreds of employees and fixed assets. A branch may engage in virtually every type of business activity a U.S. business can, including purchasing, marketing, customer relationship building, and sales. The key tax issue is whether the branch must pay U.S. tax.

In most cases, branch activities will create a taxable presence in the United States. Thus, as a general rule, branches engaged in any part of the sales function – including direct sales, commission sales, or after-sale support -- will be subject to U.S. tax. Branches engaged in marketing and customer relationship building are often subject to U.S. tax. The U.S.-China Tax Treaty includes a list of very minor activities that a branch can conduct without creating a taxable presence. These activities include purchasing, storage, and display activities, and gathering information. In our experience, rarely can a branch of a foreign company avoid creating a taxable presence by engaging only in the non-taxable activities listed in a tax treaty. It is far more common for a branch to engage in an increasing number of activities as its business develops. As a result, the branch will normally become subject to U.S. tax due to sales activities or other business conduct.

A Chinese company with a U.S. branch must file a U.S. branch tax return and report its U.S. income. Since a branch is not a separate legal entity, it is the Chinese parent company that has the tax reporting obligation. Only the amount attributed to the branch is subject to U.S. tax (at corporate tax rates). In general, the tax calculations for branch returns are quite complex, because the foreign company has to allocate revenue and expense items to the branch. In certain cases, branches are subject to the “branch profits tax,” which acts as a second level of tax on branch earnings distributed to the foreign parent company. There are also complex rules regarding the treatment of interest paid by the branch to its foreign parent; such a payment is, in essence, payment by a legal entity to itself.

D. Operating through a U.S. subsidiary corporation.

The most common form of business entity is a corporation, and most Chinese enterprises setting up U.S. operations do so using this form. Using a subsidiary corporation rather than a branch offers many advantages. First, the U.S.

subsidiary will file its own tax return and report its own income. Thus, in general, the amount of disclosure of the parent's financial information is usually less with a corporation than with a branch. Second, U.S. corporate tax returns are often easier to prepare than branch tax returns. Third, a U.S. corporation is a separate legal entity and has limited liability. Therefore, any U.S. lawsuits (including disputes with U.S. tax authorities) will generally be brought against the U.S. subsidiary corporation. The foreign parent company may be a target of these actions, but as a separate legal entity it will have a much stronger argument to avoid the actions altogether. In contrast, if a foreign parent company operates in the U.S. through a branch, then any lawsuit or tax controversy will involve the foreign parent and may put the foreign parent at risk for liability.

U.S. subsidiary corporations pay U.S. tax at the corporate tax rates. U.S. subsidiary corporations also must withhold tax on dividends, interest, royalties, and other payments made to their foreign parent or other non-U.S. parties. The normal withholding rate is 30%, reduced to 10% under the U.S.-China Tax Treaty.

E. Other entities – LLCs and partnerships

A final set of alternatives is to operate in the United States through a limited liability company (LLC), a general partnership, or a limited partnership (LP). These entities offer different benefits and detriments. In most cases, an LLC or LP can be structured to offer an investor limited liability, like a corporation. A general partnership does not offer limited liability and therefore is often not recommended for foreign investors.

There is an important tax issue for all of these entities. In general, LLCs, LPs and general partnerships are not tax-paying entities. Instead, they act as “flow through” entities for tax purposes; income flows through the LLC, LP, or general partnership and is taxed directly to the member or partner. When the member/partner is a non-U.S. party, several complex U.S. tax issues must be considered. First, the non-U.S. member/partner will normally be treated as engaged in any trade or business that the LLC, LP, or general partnership is conducting in the United States. Consequently, if that entity is conducting a U.S. business, then the non-U.S. member/partner will also be treated as conducting this business and must file a U.S. tax return each year. Also, the LLC, LP, or general partnership will be required to withhold tax for the non-U.S. member/partners' share of the income and pay this tax to the tax authorities. This withholding obligation applies each year, even if the LLC, LP, or general partnership does not distribute any of its income to its members/partners. Although there are several exceptions to the foregoing requirements, we have generally found that foreign parties are not well-served by investing in the U.S. through a LLC, LP, or general partnership. Therefore, all these tax issues should be reviewed carefully before making such an investment.

3. OTHER TAX ISSUES

A. Other types of taxes.

Most businesses operating in the United States face a number of other taxes besides income tax. One important tax is withholding tax; a business does not pay the tax but is obligated to withhold the tax and pay it to the government. The most common types of withholding taxes are state sales taxes, payroll taxes, Social Security and Medicare taxes, and various other taxes on outbound payments of dividends, interest, and royalties. If these taxes are not withheld and remitted to the government, the business will be liable. In addition, U.S. tax authorities may be able to impose personal liability for these taxes against officers, board members and other individuals.

U.S. businesses may also have to pay state or local property taxes on real property or other tangible goods. Most states (and some cities) charge business registration and licensing fees (like Delaware's franchise tax). Businesses also pay state sales tax on purchases of tangible goods. At the federal level, businesses in certain industries (including trucking, fuel, liquor, beer and certain chemicals) must comply with special excise tax rules.

For individuals, the main taxes in addition to income tax are Social Security, Medicare, and other unemployment insurance taxes. These taxes are paid out of a person's paycheck, with the employer acting as withholding agent. The economic cost (about 15.3%) is normally shared 50:50 by the employee and employer. Individuals may also be required to pay sales or use tax on purchases. Finally, individuals are subject to estate and gift taxes, respectively, on the transfer of assets at death or during life as a gift to another person. Transfer taxes are very complex. An individual who becomes a citizen or resident of the United States should obtain guidance on gift and estate taxes prior to gaining citizenship or residency status.

B. Tax returns and information disclosure requirements.

The U.S. tax system requires an enormous amount of disclosure. Indeed, these disclosure requirements are often one of the biggest surprises to foreign investors. U.S. residents (including individuals and corporations) must report on their tax returns all their worldwide income, no matter where it is earned. A non-U.S. citizen who obtains a "green card" to work in the United States must file a tax return each year and report his or her U.S.-source wages along with interest, dividends, capital gains, wages, and other business income from overseas. Similarly, a non-U.S. citizen who becomes a U.S. tax resident under the 183-day test must file annual U.S. tax returns and report all worldwide income. There are significant penalties for failure to report income or file returns.

The U.S. tax system also requires estimated tax payments. Both companies and individuals must calculate their income tax on a quarterly basis and make estimated payments during the year. Any final amount due must be paid when the tax return is filed. There are automatic penalties if estimated payments are late or not made.

In addition to making estimated tax payments and filing annual tax returns, taxpayers with U.S. income also must comply with many information reporting obligations to a variety of U.S. agencies. These reporting requirements are used to monitor intercompany pricing for goods and services between related taxpayers. For example, a U.S. subsidiary corporation with a foreign parent must normally file with its annual tax return a special form listing all intercompany transactions between the subsidiary and the parent and the dollar amount of these transactions. The U.S. subsidiary must also report all outbound payments of dividends, interest, or royalties, and must withhold the proper tax on these payments. Finally, U.S. taxpayers (including individuals, branches and corporations) must file separate forms each year with the Treasury Department to disclose all foreign bank accounts if the aggregate total balance exceeds \$10,000.

C. The role of accountants, payroll agents, and tax lawyers in the U.S. system.

Tax planning can mean the difference between a profitable and unprofitable venture. Most businesses therefore rely on a variety of outside advisors to manage the complex requirements of the U.S. tax system. For example, most businesses operating in the U.S. hire a payroll service company to manage the task of paying employees. This task requires a careful calculation of withholding taxes and the remittance of these taxes to federal and state tax authorities.

Most businesses operating in the United States also hire an accountant (CPA) experienced in state and federal tax issues. In addition to audit services, an outside accountant may perform many tax-related roles. For example, an accountant will often help calculate a business' estimated tax payments. Accountants may either prepare the annual tax returns or review returns prepared by the business. Accountants also may calculate state and local tax costs and file necessary returns. Foreign businesses operating in the United States should hire accountants familiar with the unique tax rules applicable to businesses with overseas affiliates.

Tax attorneys typically have a different role in the U.S. tax system than accountants. Most tax attorneys do not prepare and file tax returns, although they often advise on specific items on the returns and disclosure issues. Tax attorneys typically provide advice for important events in a business' life, such as the start-up phase, acquisitions of assets, major litigation, mergers, restructuring, and liquidation. The tax attorney's role is to help with tax planning, provide advice during negotiations on the important tax consequences, and draft the implementing documents consistent with the client's goals. When a transaction

involves cross-border issues, it is important to use a tax attorney who has experience with the U.S. tax rules governing international transactions. Tax attorneys also often assist in handling controversies with state or federal tax officials. Communications with tax attorneys can be protected by attorney-client privilege.

CHAPTER 4

IMMIGRATION

Any tourist, student, or business leader who has dealt with U.S. immigration understands that a carefully planned trip can be ruined if equally careful attention is not paid to the visa application and immigration processes. They also know that many denials seem to be made with little or no consideration of the facts.

Although U.S. visa and immigration authorities will allow a person to attempt visa processing independently and some do succeed, many encounter problems which are sometimes irreparable. Particularly since the September 11, 2001 terrorist attacks, the United States has been increasingly tough on individuals seeking entry into the country. We strongly recommend seeking professional advice for this process.

Entering the United States from abroad involves at least two, and often three, separate and independent steps, each of which requires approval. Although tourists and business “visitors” can skip the first step, Chinese individuals planning to work in the United States must take that first step, which is to file a petition in the United States. U.S. Citizenship and Immigration Services (USCIS) is the government entity that considers these petitions. If USCIS approves, then the next step (or first step for a visitor) is applying for a visa from the Department of State (DOS) at an embassy or consulate. The final step is entry, which is determined by another government entity, the Bureau of Customs and Border Protection (CBP).

1. GETTING A VISA

Nearly everyone who wants to come to the United States must apply for a visa and be interviewed at the U.S. Embassy or one of the U.S. Consulates in China. All visa applications require payment of a non-refundable application fee in the RMB equivalent of US\$100 payable at designated branches of CITIC Bank. It is important to plan ahead, because it may take 30 days or longer before the interview is held and then, sometimes an equal or longer time for the completion of required security investigations. A visa will not be issued, if ever, until the process is complete.

Consular officers have only a few moments to interview each applicant and consider the application, so leaving a good initial impression is very important. The more obvious it is to the officers that the applicant understands the visa standards and has taken the process seriously, the greater the likelihood for success. Every applicant must complete all required forms and pay the required fees. Careful preparation requires time and effort. This is especially important for applicants who speak little or no English. If their paperwork is in order, they have less need to explain their circumstances at their interview and minimize the risk of misunderstanding.

Each application should be prepared individually. Some people choose to include a “letter of invitation” from a U.S. entity, inviting the person to the U.S. and describing the reason for the visit. Many applications that are denied use “form” letters of invitation that are vague and not specifically prepared for the individual or the particular visit. The

consular officer has a lot of discretion and, hence often operates subjectively to assess an applicant's honesty and legitimacy. The applicant's purpose for coming to the United States must be clear. Inconsistencies, even by mistake, can cause an application to be denied. A person who appears to be secretive or unwilling to openly discuss the purpose of the visit will often be denied a visa.

The length of stay requested should be consistent with the purpose of the trip. Denials sometimes occur because an applicant asks to stay in the United States for the maximum period allowed, rather than a period that would suffice for the planned activity.

2. TYPES OF VISAS

A. B-1 Status (Temporary Business Visitor)

B-1 status is for temporary business visitors. Employees of businesses located outside the United States may apply to enter the country in what is called "B-1" status to continue to perform work for the employer abroad. The business activity need not be temporary, but the basis for the visit must be.

B-1 status is for legitimate activities of a commercial or professional character. It does *not* allow employment by a U.S. entity. Acceptable activities for B-1 classification include negotiating contracts, consulting with business associates, and attending conventions, conferences, or seminars. Construction workers are not generally admissible in B-1 status, but certain people may be authorized to enter to supervise or train others engaged in building or construction work.

The person engaging in acceptable business activities must continue to be paid by the non-U.S. employer and should not have expenses paid by a U.S. business or individual, except limited payments for living and incidental expenses while in the United States. It *is* permissible, however, for a member of a board of directors of a U.S. corporation to enter the country to attend a board of directors meeting and to receive compensation for that purpose.

The American Consulate has the authority to issue a B-1 visa that can be used for multiple entries during its validity, which can be for up to one year. A visa can be used to seek entry into the United States while it is valid. Its validity has nothing to do with the period of stay in the United States that can be granted by the border inspector. CBP can grant an admission, if presented with a valid visa, for a period of up to one year, although six (6) months is more commonly the maximum granted. This distinction between the period of validity of a visa and the period a person is authorized to stay in the United States is important. If presented with a visa that will be valid for just one more day, the CBP officer has the authority to authorize an admission for up to one year. We encourage our clients to avoid this situation, and to always ask for a period of entry that is both realistic and reasonable to accomplish the task associated with the trip.

Generally, the duration of initial admission for B-1 visa holders can be no more than one year. A period of six months or less is typical. Extensions may be sought for additional six-month increments. Spouses and children who accompany B-1 business visitors may apply for B-2 visas.

B. L-1 Status (Intracompany Transfer)

A foreign entity with operations in the United States (such as a subsidiary, affiliate or joint venture) can apply to temporarily transfer key employees into the United States. This status is available to executives, managers, and certain technical staff who have worked for a foreign entity outside the United States for one continuous year within the three years preceding the filing of the petition. The “L-1” status can allow up to seven⁴ years of U.S. employment if the business, the job, and the individual meet minimum qualifications. This seven-year period is not granted all at once, but instead in shorter periods, with the length of the periods depending on how long the employer has successfully operated in the United States. And in many cases permanent resident status is an easy option for the future.

The foreign entity and its U.S. counterpart must be in a “qualifying relationship,” such as parent-subsidiary, affiliate, joint venture, or simply part of the foreign entity operating in the United States. The jobs that the individual did abroad and will do in the United States must meet government definitions as “executive capacity,” “managerial capacity,” or requiring “specialized knowledge.”

In most cases, L status is applied for from USCIS by mail. The filing fee is currently \$190, and a fraud detection and prevention fee of \$500 is also charged by the government. Decisions are usually reached within about 90 days. The government will review the filing within 15 calendar days if the petitioner pays a “premium processing fee” of \$1,000. If approved, the approval notice for the individual must be submitted as part of the second step (the visa application process with the Embassy or Consulate) for both the individual and any family members and, if visas are issued, the approval notice must also be presented to the CBP at the time the person seeks entry to the United States. L visas are normally valid for one visit during a three (3) month period of validity. L visa applications for multiple entry authorization over a 24 month period require an additional visa issuance fee in the RMB equivalent of US\$120. L visas for Chinese citizens can be valid for up to two years, even though USCIS can approve up to three years of time to be in the United States. Extensions of visas can be sought if travel is required.

The spouse and/or qualified children of a person approved for L-1 status may apply for L-2 status. One advantage for a spouse in L-2 status is that, with proper authorization, the spouse can work. Obtaining that work authorization requires

⁴ For “specialized knowledge” L-1 visa holders, the maximum stay allowed is five years.

submission of a form and a \$180 fee after being admitted to the United States in L-2 status.

C. H-1B Status (Specialty Occupations)

This status is available to foreign nationals who come to the United States to temporarily work in “specialty occupations.” These are jobs requiring the theoretical and practical application of highly specialized knowledge. That essentially means a bachelor’s degree, or an equivalent amount of education and/or work experience, is a minimum qualification for the job. Most people think of this status in terms of computer-related occupations and other professions for which college degrees are issued. But H-1B status can be used for a wide variety of jobs, so long as the government can be convinced of the job complexity.

An employer may offer an H-1B qualifying position to an H-1B qualified candidate even if a U.S. worker might also be available to perform the job. However, the maximum number of new H-1B approvals allowed each year is 65,000, so careful planning and filing well in advance is advised. H-1B holders can be admitted initially for up to three years, but that stay can be extended for another three years, for a total permitted stay of six years.

Filing fees for an initial H-1B visa include a \$190 filing fee, another \$750 or \$1,500 for a special training fee (depending on the number of employees at the U.S. employer), and a \$500 fraud detection and prevention fee. Assuming H-1B visas are available, the visa process takes time – up to 90 days or more. The process can be expedited by paying a “premium processing fee” (an extra \$1,000), which guarantees government review within 15 calendar days. But if the maximum annual number of visas already have been issued, an approved candidate must wait for his or her visa. An approval notice must be submitted as part of the second step (the visa application process with the Embassy or Consulate). If a visa is issued, the approval must also be presented at the time the person seeks entry to the U.S.

The spouse and qualified children of an approved H-1B visa may be granted an equal period of stay in H-4 status. Individuals in H-4 status are not authorized for employment.

D. EB-5 Employment Creation / Alien Entrepreneur (Permanent Resident)

An individual who can personally invest a substantial amount of money in a new or ongoing U.S. business may qualify for permanent resident status, which many people call “green card” status. The basic requirements for this kind of case, often called an “EB-5,” is that the person must personally invest at least the required amount of money and that the money be “at risk” of loss. Generally, this means that the person must have the money or assets for direct investment or as collateral for loans that are traceable directly to the individual and which were

acquired through lawful means. The investment may be made over as many as about two years. The amount of the required investment, either a minimum of \$500,000 or \$1 million, is determined by the unemployment rate in the geographic area in which the investment occurs.

Employment creation is an important part of the process. At least 10 new jobs must be created as a result of the investment. That requirement can be avoided only in cases in which the individual invests in a business that the government determines was failing. In those cases, the requirement is not to create 10 new jobs, but to prevent loss of the jobs that exist at the time of investment. The investor must take an active management role in the enterprise.

There is much at risk in a case like this, including that the investment is usually made or in the process of being made a long time before the U.S. government makes a decision related to the request for final permanent immigration status. The EB-5 process is an excellent mechanism to obtain a “green card”, but the most important consideration by the client should be on creating or maintaining a successful business - a “green card” should only be considered as an added benefit. Many business people who consider this process to get a “green card” may also qualify to get a “green card” using the less risky “multinational executive or manager” EB-1 process. That process is similar to the L-1 intracompany transfer process noted above.

The EB-5 status is divided in two separate processes. The first filing must be sent to USCIS by mail for it to consider the initial investment and plan. If approved, it results in granting of a two-year “conditional” permanent resident status. Then, at the end of the second year of that status, additional documentation must be sent to USCIS by mail. If that filing is approved, the individual will be granted permanent resident status. The spouse and/or qualified children of a person approved for EB-5 status can be granted that same status.

The government is often very, very slow in making decisions about cases like this. It can often take several months to a year or more for the initial decision, and then several months to several years for the final decision. The investor must be prepared to be involved in the process for several years.

3. CONCLUSION

This chapter covers only some of the issues a person should consider when planning a trip to the United States for pleasure, study, or work. Careful preparation and clear presentation of the information supplied to U.S. authorities can help reduce problems that occur in the complicated and time-consuming visa processes.

CHAPTER 5

SELLING GOODS TO THE UNITED STATES

The United States and China are important trading partners. Both countries belong to the World Trade Organization. In 2002, the entered value for imports to the United States totaled \$1.17 trillion, with goods from China representing 10.6 % of that total value.

The most common way for a Chinese business to enter the U.S. market is to start simply, with sales of goods to one or more parties in the United States. Sometimes the sales will be made by the Chinese business on its own, dealing directly with the buyer. Sometimes they will be made with the help of an agent. Sometimes these sales will be to a distributor or franchisee who, in turn, will handle all subsequent sales. There is no single, best approach and which one a Chinese business chooses will vary, depending on its experience, resources, needs, and objectives. Regardless of the approach chosen, Chinese businesses that sell goods in the United States are likely to encounter a variety of legal and regulatory matters.

1. SPOT CONTRACTS

Frequently, a Chinese seller will first begin business in the United States by selling its goods on its own, directly to a customer. This scenario typically occurs when there is a demand for the goods in the United States and the Chinese seller wants to respond to that demand. The Chinese seller receives an inquiry about its goods, the Chinese seller responds, the parties agree to terms, and the sale is made. This process gives the Chinese seller a chance to get to know its customers and, without a lot of up-front investment, learn how easy or difficult it is likely to be to sell its goods in the United States. Depending on how these initial sales go, the Chinese seller may want to later consider investing in longer- term sales arrangements.

These spot sales may be documented or oral. They may involve telephone solicitations, the Internet, or catalog or other mail orders. Or they may involve direct contact between two businesses via the telephone or written communications. Whatever the process, the agreement reached is generally governed by basic contract law.⁵

But even if “basic contract law” governs, an important issue is which country’s or state’s law will apply. The Chinese seller may prefer to set up the transaction so Chinese law applies. That way, the seller is familiar with the applicable law and avoids misunderstanding about the terms of its sale. If the transaction is not set up in that manner, or if the parties do not specify what law governs, then the laws of the jurisdiction where the purchaser resides or the United Nations Convention on the International Sale of Goods (often referred to “CISG”) may apply. Since both the United States and China are signatories to CISG, it applies automatically unless the parties opt out.

⁵ To the extent consumers are involved on the U.S. side of the transaction, special rules or laws may apply. Similarly telephone solicitations are subject to special rules, as are Internet sales transactions. Likewise, some states have special laws that may govern sales of particular types of goods. For example, if a sale is viewed as a sale of a product or equipment, which is sold or leased to enable the purchaser to start a business in Washington State, then it may be subject to the Washington Business Opportunity Fraud Act.

If the law where the U.S. purchaser resides is applicable, because the parties have opted out of CISG and expressly elected to have such law apply, typically state law will govern the sale. Many states have adopted a version of the Uniform Commercial Code (“UCC”), which generally applies to any contract for the sale of goods over \$500.

The UCC and CISG primarily serve to fill in gaps, when the parties have not completely set out the terms of their agreement. Businesses wishing to avoid uncertainty should therefore be as specific and thorough as possible in spelling out their understanding. Otherwise their intent will be determined from the terms of the agreement, their conduct, customs and practices in the industry, and applicable laws. Both the UCC and CISG allow the parties to agree on just about any terms they choose. But there are exceptions. For example, the UCC places restrictions on “unconscionable” and unlawful contracts and limits warranty disclaimers.

Certain rules under the UCC or CISG may be preferred in a particular transaction. For example, under the UCC an offer and acceptance may vary in terms and the parties may still have created a contract. Under CISG the offer and acceptance must essentially mirror one another. For a seller making frequent offers, CISG may be preferred, because it would reduce the risk that a counter proposal by the buyer would become binding without acceptance by the seller. Another difference is that the UCC requires a writing, although CISG does not. Although under the UCC this general rule has exceptions, the UCC may be preferred if a contracting seller or buyer wants to make sure that it is not bound by an unwritten agreement. The UCC also has slightly narrower rules about permitting the use of evidence outside the agreement itself to decide on a contract’s terms.

2. DEALERS AND DISTRIBUTORS

Once sales increase, a Chinese business often will look for someone in the United States to conduct market research, handle sales, and provide customer support. This local contact can take several forms. If the Chinese business wants to avoid conducting business in the United States and minimize market risks, it may choose to enter into a dealer, franchise or distribution arrangement. In essence, in these arrangements, the seller sells its goods to the United States buyer, with that buyer then working out the terms of a subsequent sale. Title to the goods transfers to the U.S. buyer before being resold to another buyer, creating two separate sales transactions.

The sales terms for such transactions between the Chinese seller and the U.S. seller may be included in separate purchase orders or in a distribution agreement. They may be oral or written and can involve telephone communications, e-mail correspondence, order forms, or negotiated contracts. They may be governed by the UCC or CISG. Whatever form the sales terms take, Chinese sellers conducting cross-border sales, when risk of inadvertent misunderstanding is high, can avoid misunderstandings by carefully and fully specifying in a written contract the sales terms.

A distribution agreement typically will include terms governing the way the two parties will work together to build sales of the Chinese business' goods in the United States. The distributor will have its own separate sales contracts with its customers.

The main advantage for a Chinese seller in this type of distribution arrangement is that the U.S. seller has to handle its own customer relationships, including credit decisions and risk and customer service issues. One disadvantage is that the Chinese seller has only limited contact with the ultimate customer and cannot control pricing and many other terms of the ultimate sales. Absent carefully drafted agreements that allow access to customer information but do not violate antitrust or privacy laws, the Chinese seller may have difficulty gathering market data, or analysis about customers' preferences and issues. Still, a distributorship arrangement is commonly used by Chinese sellers that want to reduce risk and believe that a local U.S. company will have greater knowledge of the market and can best handle local issues related to sales of their goods.

It is also fairly common for a Chinese business to form a subsidiary or to set up a joint venture with a local U.S. company and have that subsidiary or joint venture serve as the distributor. This arrangement gives the Chinese company some ability to influence the decisions made and policies adopted by the distributor in marketing, sales, and service. The arrangement also limits risks to the Chinese business. If the subsidiary or joint venture entity is formed and maintained properly, U.S. courts are not likely to look to the Chinese business to cover risks assumed by the distributor. (A manufacturer will still have risk under products liability law, a subject covered in Chapter 6, but will not have the same exposure for other liabilities and issues assumed by the U.S. entity.)

3. AGENTS, SALES REPRESENTATIVES AND MANUFACTURER'S REPRESENTATIVES

When a Chinese seller wants more direct control over relationships with its customers, it may adopt a strategy of hiring an agent, sales representative, or manufacturer's representative to help with sales and identify sales opportunities. In these arrangements, the Chinese seller is the party making the sale to a customer (whether a wholesale or retail customer). The agent merely helps and for that help receives a commission. The agent never takes title to the goods.

The terms of such an arrangement are typically set out in an agency or representative agreement. This agreement will generally describe things like what the agent must do to receive a commission, when the commission will be paid, what territory the agent is expected to cover, and when and how either party can cancel the arrangement.

An advantage of this arrangement is that the Chinese seller can set the price and terms of the transaction with the customer. The Chinese seller also knows who its customers are and directly handles customer service issues.

A disadvantage of this arrangement is that the Chinese seller assumes all the credit risk for these transactions. Although agents are typically expected to help with collection

issues, the Chinese seller will bear the loss if the customer does not pay. Also, the Chinese seller can sometimes face risk of liability for the conduct of its agents. An agent is viewed under the law as acting for the principal, the Chinese seller, at least within the scope of the agent's authority. If the agent's conduct turns out to be unlawful, it is possible that the Chinese company will be held accountable or, at least, subject to claims for that conduct. There are ways to limit this risk; for example, by defining the authority of the agent in clear terms and imposing on the agent an obligation to indemnify the Chinese seller if the seller faces such claims. Still, with the benefit of more control comes the risk of more responsibility.

If the agency approach is chosen, the Chinese seller must make sure that the terms of its sales transactions with customers are clear, much as they would be if the seller were conducting the sale without the agent. These terms will be established by the contract formed between the seller and the customer. As discussed above, such a contract can be oral or written and can involve telephone communications, e-mail correspondence, order forms, or negotiated contracts. It may be governed by the UCC or CISG. Whatever form the contract takes, Chinese sellers wishing to avoid misunderstanding should carefully and fully include in a written contract the terms of its sales.

4. CUSTOMS LAW

In selling goods in the United States., a Chinese seller company must consider a variety of legal issues. One that must be addressed every time is Customs compliance.

A. Basic Customs System

With very few exceptions, all goods imported into the United States must be declared with the Bureau of Customs and Border Protection of the Department of Homeland Security (formerly the U.S. Customs Service), which is a federal agency. The goods are subject to duties under the Harmonized Tariff Schedule of the United States ("HTSUS"). Duties vary with the type of merchandise, its value, its origin, and other factors. Penalties for violating Customs laws or procedures can be substantial.

Despite very high duties (sometimes higher than the corporate tax rate), few importers give Customs law questions the same attention they spend on tax planning or other issues. This is a mistake. Duties and fines imposed for Customs laws violations add an extra cost to the item imported and correspondingly reduce the item's competitive worth in the U.S. marketplace.

The duty payable at the time of entry is a function of four distinct factors:

(1) Classification.

Classification means how the imported goods are described in HTSUS. The classification determines the duty rate and whether the product is eligible for

a duty preference program. Most countries, including China, have a similar classification schedule.

The merchandise classification system is like a pyramid, beginning at the Section level, such as vegetable, textiles, vehicles, and so forth, then proceeding to the Chapter level, with articles such as tin items, aircraft, furniture, and so on. Within each Chapter, Headings are further organized by level of processing or by function or use. Subheadings further define products into various categories.

This classification system is subject to nationally and internationally promulgated rules of interpretation. The vast majority of rulings issued by Customs deal with classification questions. Many rulings are on the World Wide Web at <http://rulings.cbp.gov/>.

The classification determined by Customs can have a significant effect on the rate of duty applied. One area in which classification is particularly significant is the treatment of merchandise as finished or unassembled. Certain items may fall under different tariff rates, may be under a quota, or may be subject to dumping duties, depending on whether the item is a component or completed article.

(2) **Valuation.**

Valuation under Customs laws can be very complex. The methods used in determining the value of imported goods for Customs purposes are set forth in Section 402 of the Tariff Act of 1930, as amended by the Trade Agreements Act of 1979. U.S. Customs law is derived from the valuation code of the General Agreement on Tariffs and Trade (“GATT”). Both the GATT code and the U.S. implementation focus on the use of “transaction value” as the basis for Customs valuation.

(3) **Country of Origin.**

Certain goods, such as those from Canada, Mexico, Israel, some third world countries, and certain other countries may be eligible for reduced duties. Most countries, including China, qualify for normal duties as a “most favored nation.” Goods from countries not considered “most favored nations” are subject to increased duties. The country of origin also affects such things as a product’s marking requirements and application of dumping or quota rules.

Determining a product’s country of origin may be easy, in some cases, but in others, it may be complex. For example, when parts of a product are manufactured in different countries and then assembled in yet another country, it can be difficult to know which the country of origin is for

Customs purposes. The traditional rule used in Customs focuses on whether the processes in a particular country constitute a “substantial transformation,” changing an existing product into a “new and different product.” However, because this standard has proved unworkable in the modern trade environment, an international movement has begun that looks to the valuation of the work done in a particular country to determine whether that country becomes a country of origin. This issue is subject to WTO negotiations and the rules may change again in the near future.

(4) Status of Entry.

Merchandise imported into the United States is not subject to duty until it is officially “entered” for consumption. There are a number of methods to delay or avoid the entry for consumption and thus either avoid or substantially reduce duty. Merchandise entered into a Customs bonded warehouse, a foreign trade zone, or for special purposes may be entered free of duty or with duty deferred.

B. Penalties.

Failure to comply with Customs laws, including merely negligent failures, can result in penalties, including liquidated damages, seizures, or civil penalties. Liquidated damages typically result when merchandise is recalled by Customs (under a Notice of Redelivery), the merchandise is not redelivered within the required time, and the delay is not discussed or resolved with Customs. The damages are typically equal to the value of the goods not delivered and are assessed against the bond filed at the time the goods were imported. Liquidated damages are often assessed for such things as failing to properly mark the country of origin, pirated copyright merchandise, counterfeit merchandise, quotas, or enforcement by Customs of the laws of other federal agencies (such as the Food and Drug Administration).

Customs can seize goods introduced into the United States contrary to law. Seizures are normally handled administratively with the filing of a petition for remission. Typically, remission requires removal of the problem that caused the seizure, if possible, or exportation of the goods if the problem cannot be corrected. Typically, storage and related costs must be paid. Again, Customs has published guidelines for remission of seizure, which must be followed carefully.

Most civil penalties are assessed under Section 592 of the Tariff Act of 1930, as amended. This section was amended and additional penalty provisions added by the Customs Modernization Act, described below. These provisions allow Customs to assess penalties for the fraudulent, grossly negligent, or negligent entry or introduction of goods into the United States by means of any document, written or oral statement, or act that is material and false or any omission that is material. The maximum penalties that can be imposed depend upon the degree of culpability. In addition, the penalties can be reduced markedly by making a voluntary disclosure.

If you discover a problem with a Customs entry, it is far better to disclose it than to wait for Customs to find out about it.

C. Customs Modernization Act Changes

The Customs Modernization Act has implemented a number of changes. It introduced the concept of “reasonable care” into the making of Customs declarations and thus shifted the burden of compliance onto the importer. Legal responsibility for correctly classifying and valuing goods is now entirely upon the importer instead of Customs as it was before. The importer must do more than simply rely on a Customs broker to enter goods. The importer must be able to demonstrate the establishment of in-house training, formal compliance review on a regular basis, and written procedures of how the importer complies with its legal duty of reasonable care.

Imported goods flow more quickly now. Rather than waiting at the border for Customs to clear the shipment and make the classification and valuation, imported goods are entered typically without Customs inspection. Customs, under the concept of “informed compliance,” examines documents on a post-entry basis to ensure compliance with Customs requirements. Therefore Customs is now relying on extensive audits after entry and requiring the importer to check with experts before entry rather than holding up entry. Greater security requirements have caused an increase of inspections for security purposes, even as inspections for regulatory compliance have been reduced.

In sum, Customs law is in a period of great change. With increased security concerns, the U.S. government is seeking to control its borders more carefully and to devote resources to this effort. Given the potential penalties involved for violating Customs rules, a Chinese business importing goods into the United States needs to understand its obligations and resolve any Customs issues before, rather than after, importing the goods.

5. ANTIDUMPING LAW

Another area of law that must be considered by a Chinese seller wanting to sell goods in the United States is the country’s Antidumping laws. “Dumping” is an unfair trade practice. It occurs when a foreign business sells goods in the United States at a price lower than the price it charges for a comparable product in its domestic market or in a third country, or when it sells its goods at a price below the cost of production and the imports cause material injury or threat of material injury to a U.S. industry. Sometimes a seller will do this intentionally to expand market share and reduce competition. But dumping also can occur inadvertently due to a seller’s lack of awareness of the way the law determines what “dumping” is and what it is not.

This is especially true for businesses in China because the U.S. Commerce Department (the “DOC”), the agency that initially conducts antidumping investigations, has determined that China is a non-market economy country. This means that the DOC

views the government, not the market, as setting prices and costs. Because China is considered a non-market economy country, the DOC does not use actual prices and costs in China to determine whether a Chinese company is dumping. Instead, it compares Chinese export prices for the United States to a “normal” value -- a calculated cost. The cost is calculated using factors of production, that is, how much raw materials, electricity and labor a Chinese seller uses to make a specific unit of goods. The factors of production are then multiplied by “surrogate” values gathered from public, published prices in a third country. Usually these values come from India or Indonesia, in the case of China, because they are viewed as having “comparable economies.” The resulting figure is then compared to U.S. prices, to determine whether dumping has occurred. Because prices are based on “surrogate” values, dumping calculations are often distorted and high dumping margins are more likely to be found.

Antidumping laws are strictly enforced in the United States. Chinese businesses have been subject to various antidumping investigations. Any business faced with a dumping investigation must be prepared to respond promptly and accurately if they want to have any chance of avoiding high dumping duties. If the DOC finds that dumping has occurred and the U.S. International Trade Commission (“ITC”) finds that the imports have caused material injury or threat of material injury to a U.S. industry, the DOC will issue an antidumping order, imposing additional duties on goods subject to that order. Antidumping orders can stay in place for 5 to 30 years. The United States has issued antidumping orders for everything from agricultural products, such as frozen crawfish tail meat, garlic, honey, apple juice concentrate and mushrooms, to consumer products, such as candles, pencils, windshields, bedroom furniture and brake rotors, originating in China. In the last several years the vast majority of the active antidumping cases in the United States involved goods from China, and 89% of the antidumping bonds required at the time of Customs entry were for goods of Chinese origin. The rates of antidumping duty covering Chinese goods range from 0% to 376.67%. Antidumping duty on garlic is 376.67% and antidumping duty on crawfish tail meat is as high as 201.63%.

Defending oneself in an antidumping investigation can be costly and time-consuming. Moreover, because the U.S. government will typically require some continued monitoring of a dumping business’ activities, the burden and expense may continue for many years. Some general planning and understanding of U.S. antidumping laws can help avoid these problems from the outset.

Although the United State considers China to be a non-market economy country, that classification confers a related benefit on China. U.S. courts have held that the countervailing duty law does not apply to non-market economy countries such as China. Countervailing duty law is aimed at offsetting government subsidies. As of April 2005, however, when this book went to press, there is a strong movement in the U.S. Congress to make the countervailing duty law applicable to China and other non-market economy countries. Hence, this benefit may or may not continue.

CHAPTER 6

PRODUCTS LIABILITY

Chinese manufacturers, distributors and exporters of products destined for the United States face a growing number of lawsuits in U.S. courts stemming from personal injuries their products may cause in the United States. The damages that an American court may assess can amount to millions of dollars, and the grounds on which liability may be imposed are typically broader and more encompassing than in China. Therefore, Chinese businesses need to become familiar with American product liability law and the defenses available to counter the substantial risks created by such law.

The number of product liability lawsuits against Chinese business and their American affiliates appears to be rising.⁶ Cases have been brought against Chinese related interests (for example, Beijing Native Produce Import & Export Corp.; Norinco;⁷ China National Corporation; Fireworks Factory; Zodiac Enterprises, Ltd.; China Products Northwest, Inc.; DNP International, Inc.;⁸ China International; and Aero-Technology Import and Export Corporation) involving fireworks, guns, motorcycle helmets, chains, tires, chemicals, automobile parts, clothing, forklift trucks and parts, and even car jacks.

American product liability laws permit claimants to proceed with their lawsuits under a far greater number of circumstances and situations, and to recover higher damage awards, than Chinese law. Understanding American law can help a Chinese business reduce and insure against risk, as well as shift responsibility to others involved with product distribution.

Set out below are the basic legal principles that generally govern product liability lawsuits, the rules of jurisdiction that may apply, the reach of U.S. law, the targets of such suits, and the ability of injured parties to pursue collection of judgments against Chinese businesses or their affiliates. To minimize the risk of litigation, Chinese manufacturers need to adhere to all applicable regulatory and industry standards, test and carefully design their products, document their compliance with all applicable laws and regulations, and label and otherwise adequately warn about their products. Chinese businesses must become completely familiar with advances in the art and science of the product, quality control procedures, and design alternatives evaluated on a risk-benefit basis.

1. VERY SUBSTANTIAL JURY VERDICTS

The United States has witnessed a substantial increase in the number of product liability

⁶ The growth of exports from China to the United States will likely result in a further increase in the number of lawsuits between Chinese and American business that arise from contract disputes such as non-payment, breach of warranty (goods not conforming to the agreement), or delivery disputes (products delivered late or in short supply). These types of lawsuits are addressed elsewhere in this booklet. This chapter focuses primarily on the liability of Chinese businesses whose products cause personal bodily injuries, rather than solely economic loss, in the United States.

⁷ Garvey Schubert Barer represented Norinco in a complex product liability case involving motorcycle helmet design issues.

⁸ Garvey Schubert Barer represented DNP in connection with product contamination issues.

lawsuits. Even in the 1980s and 1990s, courts in the United States annually processed more than 90 million civil cases.⁹ Of those, a small percent (about 3% in 1992), were products liability cases, but the sheer number was still huge (over 2 million cases). Recent data on product liability filings in federal courts reveals that it is highly likely a great number of cases will continue to be brought in U.S. courts. For the years 1999, 2000, and 2001, respectively, 19,664, 15,980 and 12,775 cases identified as product liability suits were commenced in United States District Courts (the federal trial courts).¹⁰

Median jury verdicts for product liability cases were the highest among all personal injury cases. The median jury verdict in product liability cases was \$260,000¹¹ for the 1975-1993 time period. Although plaintiffs only prevailed in 41% of product liability cases in 1992 (compared with 74% for toxic substance cases (like asbestos) and 60% for auto accident suits), when plaintiffs won, they won large damage awards. Consequently, the management of risk associated with product liability litigation should receive a very high priority from Chinese businesses.

2. EVOLUTION OF BASIC PRODUCT LIABILITY LAW IN THE UNITED STATES

Product liability law in the United States has undergone a steady evolution from a fault-based system to one primarily associated with charging a product manufacturer with a very strict duty to pay injured parties for injuries associated with the manufacture, distribution and sale of defective products regardless of fault. During most of the 20th century, persons injured by dangerous products had to establish that the manufacturer or seller was at fault for the accident and that such fault was a cause of their injuries. This fault-based liability system, typically referred to as negligence law, originated in English common law and prevented many injured parties (the plaintiff) from recovering damages against manufacturers and sellers (the defendant) because the plaintiff could not prove that the defendant had failed to exercise reasonable care under the circumstances. The plaintiff had to show that the defendant did not comply with the then existing standard of care for the design, manufacture, or warning about the risks inherent in the use of the product.

Courts in the United States¹² became increasingly concerned with the plight of persons

⁹ Kauder, *1 Caseload Trends* (August 1995). This article contains the data referenced in this section.

¹⁰ Table S-10 of the 2000 and Table C-2 of 2001, *Judicial Business of the United States Courts 2000 and 2001*. We expect a far greater number of cases were filed in state courts, but we do not have current data on this subject. In addition, discrepancies in these numbers may exist because of the different time periods used in the reports, which would alter any conclusion about a decline in such cases.

¹¹ We are unable to provide the actual median value of all product liability cases, since about 90% of all cases settle, and the parties typically do not publish and often keep the settlement amount confidential. Even where the settlement amount becomes public knowledge, we have not found any collection of such data. Insurance companies probably keep such information for each company's loss histories.

¹² Under the United States federal system, each state can develop its own law in areas such as product liability. In each of the states, common law rulings by the courts supplement the state's statutory law to some extent. In addition, the extent to which the state's previous existing common law remains applicable to product liability claims on issues such as damages can differ depending upon the state. Until the United States Congress adopts uniform standards for product liability cases, we would expect the states to continue expanding each state's laws and common law principles, resulting in differences in verdicts and settlements depending upon where a case

severely injured by products, since most companies had the ability to insure against the risks associated with the sale of their products and, therefore, could spread such risks among all consumers (customers) of their products. Early in the 1900s, American courts began to apply legal concepts, such as absolute or strict liability, to cases involving injuries caused by tainted food, but they did not extend the reach of those concepts to ordinary product claims. Courts reasoned that the public health hazard of tainted food was so great that it was appropriate for food sellers and processors (such as restaurants and slaughter houses) to bear full responsibility for the damage caused by a person eating their food products, regardless of whether the defendant had exercised all possible care in the manufacture or handling of such products.

During the mid-1900s, American courts began expanding the use of strict liability principles to so-called “inherently dangerous” products (such as explosives), because courts believed that manufacturers should exercise a very high degree of care in making and selling such inherently dangerous products. The courts held defendants liable for injuries caused by such products if the courts found the products were defective in manufacture or design. In some states, this liability became absolute for certain dangerous products.

Courts in the United States began focusing on the adequacy of warnings given by product sellers about the nature of the risks associated with product use, including warnings for products designed for use by children. Gradually, the courts began expanding these various categories of strict liability until, by the 1960s and 1970s, in virtually all states, any product that caused injury would expose a manufacturer or other product seller to liability, regardless of fault, if the product were found to be “unreasonably dangerous.”

Under these strict liability principles, a product seller (including a seller or manufacturer of a component or the entire product) can be held “strictly liable” if the defendant is one of the parties in the chain of the delivery of the product that caused the injury. The plaintiff has to prove that (a) the product was defective,¹³ (b) the defective product caused the injury, and (c) the plaintiff suffered damages resulting from the injury. The plaintiff generally does not have to demonstrate that the manufacturer was at fault, although some recent changes in statutory law have reintroduced fault concepts. Instead, a defendant can be held liable for injuries if the product is found defective, even if the defendant had done everything possible to make the product safe.

The courts and legislatures define “defect” in various ways. Defects can exist in both the construction and design of the product or in any lack or adequacy of the product seller’s warning. Courts have declared products to be unreasonably dangerous, and thus defective, if the product is dangerous to an extent beyond that which would be

gets filed. The size of jury verdicts also varies substantially by and within states. This results from differences in substantive law, abilities of trial counsel, specific case facts, economic perceptions and experiences of juries, and demographic factors such as the composition of the jury, the wealth of the region and the current economic climate.

¹³ The concept of “defective products” has expanded over time as discussed more fully below. A product can be “defective” if it is found “unreasonably dangerous” for its intended purpose.

contemplated by ordinary consumers who purchase the product with ordinary knowledge common to the community.

American law requires product sellers to warn of dangers about which the manufacturer should know, and tell how to avoid them. Medicines now come with labels on dosage and side effects of the product. Cigarettes in the United States contain warnings about the severe health hazards associated with their use. Not only must the warnings be present, they also must adequately and sufficiently describe the most basic risks of using the product, and be conspicuous. If the warnings are on a label that no one can reasonably expect to notice or read (because the print is too small or not understandable to an average American consumer), a court may rule such warning is inadequate and rule the product is defective as a result.

Liability for product defects can also arise from how products are marketed. If a product seller advertises its products in a certain manner, consumers will claim they relied upon such marketing in using those products in that manner. If representations or advertisements are made, they must be accurate.

A party injured by a defective product usually can recover compensatory damages consisting of the party's medical costs and expenses, lost wages, property losses, and similar out-of-pocket damages. In some states, a plaintiff can recover an unlimited amount of money for pain and suffering; in other states, limits are placed on such damages. If a party is unable to work or might require medical treatment in the future, juries can award damages based on the prospective value of such losses. Plaintiffs use economists to estimate the amount of losses that an injured party will suffer. Defendants counter this testimony by trying to disprove the extent of injury and the amount claimed. Finally, state law on the amount of and whether a jury can award punitive damages vary by state. Punitive damages are imposed to punish a product seller when it grossly fails to produce safe products.¹⁴ Only some states allow a plaintiff to seek punitive damages.

3. THE REACH OF U.S. COURTS IS EXTENSIVE

Courts in the United States frequently deal with cases brought against businesses abroad that have manufactured or sold a product made outside the United States which caused an injury to a person in the United States. For a U.S. court to exercise its authority or jurisdiction over such a defendant in a product liability action, the plaintiff must show that the defendant has a connection to the defective product. To successfully challenge the court's jurisdiction, the defendant must establish the lack of such a connection. Even if the defendant delivered its product in China, this may not serve as an adequate defense to jurisdiction, as long as the seller or manufacturer connected with the defective product

¹⁴ In a limited number of cases, juries have awarded catastrophic punitive damages. Although the claims did not arise from product liability, a jury awarded \$5 billion in punitive damages against EXXON Corporation as a result of the grounding of an oil tanker off the coast of Alaska. A federal Court of Appeals recently reversed that decision.

had reason to know that the product was entering the stream of commerce and could cause damage in the state where the lawsuit is started.¹⁵

However, a plaintiff must comply with conventions, treaties and applicable Chinese law for serving its lawsuit on the China-based defendant, if it wants to bring that business into a U. S. court.¹⁶ The Hague Convention on the Service Abroad of Judicial and Extrajudicial Documents, which has been adopted by both China and the United States, provides that a China-based defendant can be served through a translated copy of the summons and complaint sent to the Bureau of International Judicial Assistance of the Ministry of Justice in Beijing. The Ministry of Justice then delivers the legal documents to the defendant manufacturer or supplier. Although service of these papers is relatively simple, this does not mean that jurisdiction is automatic.

Assuming that plaintiff follows the proper rules for commencing the lawsuit, the defendant must appear in the court, in the United States, in the state in which suit was filed, within the time period provided in the notice, through counsel licensed or otherwise admitted to practice in that court. The defendant can challenge whether the plaintiff adhered to the proper means of commencing the lawsuit, whether the notice of the lawsuit complied with legal requirements and whether jurisdiction existed.¹⁷ If the defendant fails to appear to defend itself, the plaintiff can secure a judgment against the defendant by default.¹⁸ The plaintiff can then proceed to enforce the default judgment to collect the amount awarded. If a China-based defendant has assets in the United States, the plaintiff can seek a court order requiring a sale of the defendant's property to satisfy the judgment.

4. THE EFFECT OF INTRA-CORPORATE RELATIONSHIPS AMONG CHINESE PARENT CORPORATIONS AND AMERICAN SUBSIDIARIES

Many Chinese businesses have created United States-based subsidiaries for legitimate tax, customs and business reasons. Those entities can be sued for injuries caused by products

¹⁵ Of course, as a practical matter, if a large exporter in China has purchased a defective product from a small regional or local manufacturer that has limited assets, we would be surprised if that manufacturer were sued in the United States. Plaintiffs would try to sue the exporter. American law might place ultimate responsibility for a loss on the exporter, if the court concludes that the Chinese manufacturer cannot be brought in to answer for the damage to the plaintiff. Moreover, we understand that Chinese businesses frequently provide for arbitration in China of disputes that arise from their business dealings *in* China. Thus, a Chinese exporter may have to pursue its claims in China for defective products made by the local manufacturer. This can, at times, result in a party with less responsibility for causing an injury ultimately paying all or most of the damages paid to a plaintiff in the United States.

¹⁶ We do not attempt to provide a comprehensive discussion of these points but only highlight a couple of the key principles.

¹⁷ Jurisdiction refers to the authority of a court. A court has to have "jurisdiction" or authority to act in a case before the court's rulings will be valid. The court must have jurisdiction over the person, including the corporate entity sued, and jurisdiction over the subject matter of a case.

¹⁸ A default judgment is entered when a defendant, over which the court has personal jurisdiction, fails to appear in court to defend itself. It has the same force and effect as any judgment.

made by China-based manufacturers.¹⁹ Numerous issues arise from these relationships including:

- Is the presence of a subsidiary in the United States an adequate ground for jurisdiction over the Chinese parent corporation?
- Does the joinder of a subsidiary require the parent corporation to produce evidence in the United States, including personnel, even if the parent is not a party?
- Does a judgment against a subsidiary serve as a judgment against the parent corporation?
- Can the parent corporation's assets be seized to collect a judgment against the subsidiary?

There are no simple answers to these questions. Although a subsidiary's presence in the United States generally does not create jurisdiction against the parent, if the parent made the defective product, it could be subject to U.S. jurisdiction for that reason alone, regardless of whether it has a subsidiary. Where the parent has no connection with the subsidiary's manufacturing activity, the plaintiff should not be able to obtain jurisdiction against the parent simply because it owns a U. S. subsidiary. Sometimes, however, an officer of the subsidiary is also an officer of the parent and service on this officer would be considered service on the parent. To defend itself in that situation, the parent would have to retain counsel in the United States to try to convince the court that the parent has no responsibility for the defective product involved in the case.

Unless a judgment is imposed against both the parent and its subsidiary, U.S. courts generally do not permit seizure of the parent's assets to satisfy a judgment against a subsidiary. Once the parent delivers cash or assets, including merchandise, to the subsidiary, a plaintiff can seize those assets to satisfy a judgment against the U.S. subsidiary, even if the parent does not receive payment for those goods from the subsidiary. Therefore, provided a subsidiary has operated properly under U.S. law, a judgment against a subsidiary is not usually a judgment against a parent.

However, U.S. law provides for the "piercing" of a corporation's veil²⁰ when the corporate form has not been maintained or has been abused. If a subsidiary has been adequately capitalized and run as a separate entity, courts will generally not permit a

¹⁹ Risk management of product-related claims will arise from agreements with joint venture partners, American-based agents and sales representatives, joint marketing agreements and other business arrangements. For example, companies can contractually agree on which entity will bear liability for a product claim through indemnity and contribution agreements and contracts obligating a party to acquire insurance. These subjects, although highly relevant to risk management of product liability claims, are too broad to be covered thoroughly in this chapter.

²⁰ The "veil" refers to the usual protection afforded corporations. In most cases, a creditor cannot attach the assets of shareholders, including a parent corporation, to satisfy a claim against a subsidiary. If, however, the proper corporate legal requirements are not followed or the parent corporation so controls the subsidiary that they are alter egos of one another, a court could permit the creditor to pierce the veil of the parent and allow collection to proceed against the parent corporation, as well as the subsidiary.

plaintiff to pierce the veil of the subsidiary to seize the assets of the parent to satisfy the plaintiff's judgment. However, each case turns on its facts and the particular state's law governing such matters.

5. CONCLUSION

This chapter cannot explain the extensive risk management problems of product liability law in the United States, and it only touches on some of the more important and common issues. U.S. product liability law has evolved and will change in this century as products become increasingly sophisticated and the risks of unforeseeable injuries grow. Claimants will seek to expand the scope of responsibility of manufacturers as a result. If a Chinese business wants to reduce risks of selling into the U.S. market, it should become familiar with those risks and their causes. Only then can those risks be efficiently and economically managed.

Every Chinese business contemplating exporting products to the United States should seek legal advice as part of its risk assessment and risk management process. The business should work with legal counsel to minimize its risk of being pulled into lawsuits and/or preparing for them. The business should have adequate insurance. It should ensure that its agreements (sales, representation, distribution, marketing and joint venture contracts) comply with applicable U.S. law and allocate liability to others, as appropriate. The business should have a records and retrieval system that permits it to show that its products were manufactured and designed properly. Additionally, the business should have a key manager able to monitor and supervise any litigation internally.

Lastly, the business should work with its U.S. counsel to cover claims and deal with insurers when a claim arises. If a business is faced with more than one claim, then management of those claims must be coordinated. Giving different and inconsistent statements of the facts (even if they can later be explained) can jeopardize a defendant's defense from one case to the next. With teamwork, product liability litigation is much more manageable and will keep such claims from undermining the success of a Chinese business' venture in the United States.

CHAPTER 7

LABOR AND EMPLOYMENT

1. WHY FOREIGN BUSINESS INVESTORS SHOULD PAY ATTENTION TO EMPLOYMENT LAW

Employers are highly regulated in the United States. There are numerous laws and rules dictating how employers should treat applicants, employees and former employees. Employment laws are often complex and can overlap, resulting in different and sometimes contradictory standards.

Given all these laws and rules, it is relatively easy for a foreign business to inadvertently violate them. Some violations result only in fines, but many violations lead to extremely expensive lawsuits. For example, the average jury verdict for an employment law violation in one U.S. city is more than \$400,000 (even excluding all verdicts over a million dollars), and employment suits are filed almost every week. In states such as California and New York, the average verdicts and number of cases are even higher.

Most American employees have a good understanding about their employment rights. It is not unusual for employees to consult attorneys after an involuntary termination or if they feel treated unfairly by management. In addition, there are many government agencies that inspect an employer's practices, documents, and records to check on compliance with employment laws.

Because the costs of non-compliance can be high, Chinese businesses starting U.S. operations should, prior to hiring any U.S. employees, carefully plan the employment policies and practices to be implemented.

2. BASIC OVERVIEW OF U.S. EMPLOYMENT LAWS AND REGULATIONS

U.S. employment laws cover almost every aspect of the employment relationship, from hiring to firing and beyond. For example: there are rules regarding recruiting, hiring, pay, leaves of absence, safety, taxes, immigration, whistle blowing, background checks, testing, record retention, disclosing employee information, workplace posters, employee illnesses, injuries, terminations, and references to prospective employers.

U.S. employment rules derive from different sources. First, there are laws passed by U.S. Congress, which are usually supplemented by regulations issued by U.S. government agencies. These laws apply across in every state. Second, there are laws passed by each state legislature, which are sometimes supplemented by state agency regulations. These laws apply within that state only. Within a state, counties and cities often pass their own employment laws. Finally, U.S. federal and state courts independent of the statutes have created additional employment rights.

To understand its obligations under any employment law, an employer must know what the actual law provides, how the law is affected by regulations (if any), and how the

courts have interpreted the law and relevant regulations. Without help from legal counsel, this task can be difficult.

Some employers are subject to multiple sets of employment laws and rules. Because any geographic area may have different employment laws, regulations and cases, employers need to tailor policies and practices to the local workplace rules. The courts usually apply the most protective employment rule when there are multiple and overlapping federal and local laws governing the same issue. For that reason, employers often do the same thing – pick the strictest standard from applicable law, so they can demonstrate their best efforts to comply.

Employee rights may be increased by employers intentionally or inadvertently entering into employment contracts. In many U.S. states, under certain circumstances employer statements, verbal or written, can become contracts binding the employer to obligations it would not otherwise have. Often, until a lawsuit is filed, the employer is completely unaware that the employee believes there is an employment contract.

3. PRACTICAL GUIDANCE FOR BUSINESSES STARTING OPERATIONS IN THE UNITED STATES

The volume and complexity of U.S. employment law can seem overwhelming to foreign businesses starting U.S. operations. However, we have developed simple and practical guidelines to assist businesses in developing compliant personnel management systems in a cost-effective manner.

The first step toward compliance is setting up basic personnel systems. To illustrate how these systems can be broken down into manageable steps, the following is a partial employment checklist for new businesses:

Step One

Employment Type: Determine, based upon local and federal law, whether the persons you plan to hire are independent contractors or employees. A common mistake by new employers is to misclassify employees as independent contractors. The test for true independent contractors is narrower than most employers would expect.

Step Two For Independent Contractors:

- **Contracts:** Draft contracts that protect the employer. For example, deal with insurance issues and include wording that tracks the local and federal tests for independent contractor status.
- **Policies:** Draft internal policies designed to avoid a situation in which a manager inadvertently converts a contractor into an employee.

Step Two For Employees:

- **Tax:** Set up system to ensure tax and social security withholdings are properly calculated and issued. Also, mark your calendar with all IRS reporting obligations.
- **Safety:** Check local and federal safety rules to ensure the work location complies with the most protective standards. When required by the rules, set up safety committees and trainings on required safety procedures. Draft safety policies and install required safety posters. Consider, with input from legal counsel, whether to use federal or local governments' complementary consultation services to maximize initial compliance.
- **Immigration:** Set up a system to verify new employees' eligibility to work in the United States. Establish record-keeping processes to comply with government retention and disclosure rules.
- **Workers' Compensation:** Obtain industrial insurance coverage information from the local labor and industry department. Draft policies regarding employee injury reporting and procedures. Draft forms for employee injury reporting.
- **Unemployment Insurance:** Obtain from the local employment security department information about all required unemployment insurance coverage. Information regarding this insurance is usually sent to you with confirmation of your local business license.
- **Wage and Hour:** Determine whether your employees must be paid a higher wage (called overtime) for work performed beyond a certain number of hours in a day or week or whether they are exempted from the federal and local overtime or minimum wage obligations. One of the most common employer mistakes in this area is misclassifying employees as exempt because the exemptions are much narrower than commonly believed. If employees are not exempt from the minimum wage, then ensure the proposed pay is at or above the applicable minimum wage rate. If employees are not exempt from overtime, then set up a time recording system and draft related policies to ensure proper determination of overtime wages. Set up rest and meal period policies and practices. Set up pay periods and rate-of-pay calculation systems that comply with applicable law. Draft wage and hour policies such as hours worked provisions.
- **Contracts:** Determine whether there is a true need for any employment contract. Employers often enter into unnecessary employment contracts – except for business protection agreements (to protect against disclosure of the employer's business information). Employee contracts should be the exception, not the rule. Draft policies to minimize risk of inadvertent contractual claims. Draft offer letters for non-contractual employees.
- **Handbook:** Draft employment policies and rules. These can be in handbook or some other format depending on your workplace needs. We have model handbooks

that can be easily adapted to your workplace. Certain key provisions should be considered for every handbook, such as a properly drafted disclaimer and complaint procedures that satisfy the case law on affirmative defenses.

- **Forms:** Prepare standard human resources forms such as leave requests and notices.
- **Performance Management:** Design and draft forms for a standard performance management system to minimize disparate treatment claims.
- **Hiring System:** Set up a basic hiring system designed to comply with the non-discrimination laws. For example, develop an interview checklist about what the interviewer should do and what the interviewer should avoid, an application form that complies with applicable laws, and an orientation checklist.
- **Training:** Plan initial manager training on basic employment matters. Plan initial diversity training for all employees.

4. CONCLUSION

Set up personnel systems that comply with applicable law at the earliest possible stage of establishing a U.S. business. It is more cost effective to implement best practices and forms, than trying to convert personnel systems as issues arise.

CHAPTER 8

CONSUMER PROTECTION

Businesses that operate in the United States are subject to a number of different laws that attempt to protect consumers from “unfair business practices.” These laws are set forth by the U.S. federal government, by one or more state governments, and by local authorities. The laws are not entirely consistent with each other, and many are duplicative. Some consumer protection laws include regulations governing the sale of various goods or services (for example, the sale of appliances, textile products, and furs); others regulate the means by which certain businesses can operate or require disclosures in connection with certain transactions. Some laws are administered by federal or state agencies. Some, but not all, allow an injured consumer to file a lawsuit directly, recover money damages, and force a company to do business in a certain way.

A wide variety of business practices can be subject to these laws, and the laws and their regulations will differ from state to state. Below is a brief overview of a few types of important consumer protection laws that can relate to the sale of goods in the United States.

1. THE MAGNUSON-MOSS ACT

The Magnuson-Moss Act is a federal law that governs the terms of warranties for consumer goods. While this law does not require a manufacturer to provide a warranty for a product, it sets forth several requirements if a written warranty is provided to consumers. Any Chinese business manufacturing consumer goods that ultimately will be sold in the United States must understand and follow the requirements of this law. The Federal Trade Commission has also set forth administrative rules that warrantors must meet.

Among other things, the Magnuson-Moss Act requires that (a) written warranties specify whether they are full or limited warranties (if the product is sold for more than a certain amount), (b) the warranties must be in a clear document that is easy to read, and (c) the warranties are available where products are sold so consumers can review them. The law also limits the degree to which a warranty can be disclaimed or modified, prohibits certain type of tie-in requirements; and prohibits deceptive warranties. The law also encourages consumer lawsuits by providing for recovery of attorneys’ fees and costs.

The law should be considered in conjunction with the Uniform Commercial Code (“UCC”). This law, in effect in all states and discussed in more detail in Chapter 5, covers, among other things, warranties. Each state has enacted its own version of the UCC. Most portions of the UCC are identical from state to state, but many states have slightly different laws dealing with the enforcement of limitations and disclaimers in consumer warranties. In other words, some warranty provisions might be enforceable in one state, but not in another. Careful drafting of a warranty is therefore required.

2. THE FEDERAL TRADE COMMISSION ACT

This federal law generally prohibits “unfair or deceptive practices” in business affairs. Under this broad language, the Federal Trade Commission (FTC) regulates many different areas of business practices, including “Truth in Advertising;” various scams, frauds, and schemes; enforcement of trade laws, rules, and guides; and fraudulent marketing schemes and practices. The FTC has an International Division that seeks to promote consumer confidence in the international marketplace by negotiating bilateral consumer protection agreements and assisting in international litigation.

3. STATE “LITTLE FTC” ACTS

Many states in the United States have their own laws that parallel or duplicate the Federal Trade Commission Act. These laws can be more important to businesses because they can provide broader remedies, including the right for consumers to sue directly and the right for consumers to recover so-called exemplary or punitive damages (money used to punish a wrongdoer, as opposed to money used to compensate for harm suffered). Generally speaking, the large awards being handed down in U.S. courts that the media reports are from these types of punitive or exemplary damages. The state laws generally prohibit unfair or deceptive practices, but states frequently have different regulatory frameworks to explain which practices are acceptable and which are not. Often a state agency is given some form of regulatory and enforcement authority over deceptive practices, but the activity level of each such agency varies from one jurisdiction to another.

4. FEDERAL AND STATE ANTITRUST LAWS

Various federal and state laws prohibit monopolization, restraint of trade, certain types of mergers and acquisitions, and certain types of price discrimination and exclusive dealing arrangements. The general purpose of these laws is to foster and encourage competition in a free marketplace. Different federal agencies, including the FTC and the Department of Justice, have jurisdiction over certain types of activities that might violate the federal antitrust laws. Private individuals or businesses may also bring civil claims for violation of the antitrust laws; such violations can lead to awards that include treble (triple) damages. (See Chapter 10 for further discussion of antitrust laws.)

5. RICO

RICO is the Racketeering Influenced and Corrupt Organizations Act. This federal law was designed to attack criminals who infiltrated or used legitimate businesses in their illegitimate activities. However, RICO’s potential breadth is vast; it can lead to potential liability in any matter where criminal fraud can be alleged and proven. If two or more federal crimes can be proven (including mail fraud or wire fraud), and if those crimes are linked in a pattern that affects a third-party enterprise, there is potential for a RICO claim. Such claims can include both criminal and civil liability.

RICO is significant in part because of the broad remedies it provides. Damages claims are trebled (tripled) for a RICO violation. An award of attorneys’ fees for the winning

claimant is allowed. Because the law was designed to punish criminals, there are also forfeiture provisions.

CHAPTER 9

REAL ESTATE

1. INTRODUCTION

In the United States, real estate or real property generally includes land and buildings. U.S. real property law is mostly a combination of ancient rules derived from English common law and modern statutes. The law is complicated and varies from state to state. Foreign investors wishing to conduct businesses in the United States are advised to consult their counsel well in advance, whether the foreign investors are real estate developers or other types of enterprises engaged in a business which will acquire or lease real estate.

Foreign investors conducting business in the United States can either acquire U.S. real property or lease property for their U.S. operations. Although alien ownership of U.S. real property is regulated by both federal and state governments, control over alien land ownership is primarily vested in the states. Therefore, laws governing land ownership in the United States have not developed in a uniform fashion.

Regulation of alien land ownership finds its genesis in the feudal laws of medieval England, under which the King was the owner of all land and alien land ownership was prohibited. This same common law approach was adopted by the colonies in North America, but soon proved to be problematic. After the United States gained independence, the states began a gradual movement toward the removal of common law restrictions on alien land ownership, though not breaking completely with the common law heritage. Over the years, the United States has significantly eased restrictions on foreign ownership of U.S. real property, but retains reporting requirements for foreign investors.

2. FEDERAL REGULATION OF ALIEN LAND OWNERSHIP

Federal regulation of alien land ownership takes various forms. This section briefly describes the key federal laws and regulations governing alien land ownership.

A. Controlling Exploitation of Federally Owned Lands

Federal laws and regulations in this area are designed to protect natural resources of the United States. They generally restrict alien exploitation of natural resources on public lands to aliens who intend to become U.S. citizens, and affect different types of lands, including lands containing mineral deposits and off-shore oil tracts.

B. The International Investment and Trade in Services Survey Act

Generally, the U.S. government requires foreign investors to report ownership in U.S. business enterprises, and that requirement includes ownership of real

property, either directly or through a holding company. Under the International Investment Survey Act, failure to report may trigger both civil and criminal penalties. The civil penalty for failure to report ranges from \$2,500 to \$25,000. Whoever willfully fails to report will be fined up to \$10,000 and, if an individual, may be imprisoned for up to one year, or both. Any officer, director, employee, or agent of any corporation who knowingly participates in such violation may be punished by a like fine, imprisonment, or both.

C. The Agricultural Foreign Investment Disclosure Act

This Act imposes certain reporting requirements for acquisitions or transfers of agricultural land interests by foreign persons. Under the Act, any foreign person who acquires or transfers any interest in agricultural land, with certain limited exceptions, must submit a report to the Secretary of Agriculture not later than 90 days after the date of such acquisition or transfer. The report must include such information as the legal name and address of such foreign person, his or her citizenship if an individual, the purchase price paid for the property, and other information the Secretary may require. Failure to report will subject the foreign person to civil penalties.

D. The Foreign Investment in Real Property Tax Act

Prior to the enactment of this Act, foreign investors were required to pay tax on gains from the disposition of real property only if they were engaged in a trade or business in the United States and the gains were effectively connected with such trade or business. Under this Act, gains from the disposition of real property by a foreign investor are subject to federal taxation as if the foreign investor were engaged in a trade or business in the United States, and as if such gains were effectively connected with such trade or business.

3. STATE REGULATION OF ALIEN LAND OWNERSHIP

The rights of aliens, including foreign investors, with respect to real property are primarily a matter of state regulation, and depend upon the constitutional and statutory provisions of the state in which the property is situated. Some states have statutory or constitutional provisions granting aliens the same rights as citizens. Some states have enacted statutes restricting the rights of aliens ineligible for citizenship from acquiring real property. The tendency of most state legislation, however, has been to enable aliens to purchase and own real estate.

4. ACQUIRING REAL PROPERTY

A foreign investor may acquire U.S. real property for development or investment, or as a location for its U.S. operations. Purchasing real property requires assistance of skilled U.S. advisers, including attorneys. Such a transaction may have many traps for the unwary. Due diligence is absolutely necessary. Careful consideration must be given to

such issues as whether the property is free of encumbrances or other title defects, and whether environmental or zoning regulation limits the use of the property. Local tax authorities also impose annual real estate taxes, with such taxes adjusted based on the value of the property. In addition, disposition of real property may be subject to tax on capital gains. Negotiating a real property transaction requires the allocation of legal and economic risks, and assistance of skilled U.S. legal counsel is highly recommended.

5. LEASING REAL PROPERTY

A foreign investor may lease property for its U.S. operations. The parties to the lease are free to negotiate almost any terms, including the duration of the lease, rent, maintenance and repair obligations, early termination and penalties, financing arrangements, assignment and subleases, and remedies. Assistance of skilled U.S. counsel is essential to avoid surprises, especially since most lease agreements tend to favor the landlord.

6. INSURANCE

Foreign investors that own or lease property should be aware that insurance against risks in connection with owning or using the property is available. Generally, a foreign investor should consider purchasing three kinds of insurances: (a) title insurance, (b) property insurance, and (c) liability insurance. A foreign investor may purchase title insurance from a title insurance company. Title insurance protects the foreign investor as a purchaser or as a tenant against the risk that its ownership or leasehold rights are subject to third-party security interests or other title defects. Property insurance is intended to protect against damage to property caused by such events as fire or flooding. Liability insurance helps protect the foreign investor against claims that arise on account of the property and which may be asserted against the investor.

CHAPTER 10

ANTITRUST

U.S. antitrust law applies to conduct anywhere in the world that affects U.S. markets or U.S. customers. For example, several Japanese companies were seriously punished for agreeing about the price of fax paper sold to U.S. customers, even though the agreement occurred at a meeting in Japan. Often companies from abroad do not realize that their conduct outside U.S. borders is subject to U.S. law and inadvertently take actions that are antitrust violations. The consequences of such violations can be severe. Individuals responsible for the conduct, or the company involved, can be subject to criminal prosecution. In addition, customers, competitors, and others harmed by the conduct may recover damages against the offending party for triple their actual damages, plus their attorneys' fees.

Preventing antitrust violations is far more cost effective than addressing antitrust violations after they occur. Once a foreign enterprise begins to do business in the United States, even through others such as independent distributors, it should make sure it understands, and institutes policies to avoid violations of, U.S. antitrust laws.

Federal laws governing antitrust matters are stated simply, but they have become quite complex to understand and apply through regulation, government policy, and case law. The following description provides a basic, practical outline of key points, but seeking legal counsel before adopting policies is advised.

1. ANTI-COMPETITION AGREEMENTS

The most important U.S. antitrust law prohibits agreements that unreasonably restrain competition. Agreements among competitors are particularly dangerous. The key word is "agreement." Independent, unilateral conduct by a business does not violate the U.S. antitrust laws. Independent, unilateral conduct means that a business acts alone and without consultation or coordination with its competitors, without reaching any mutual understanding with its competitors, and without any gentlemen's agreement, quid pro quo, or reciprocal obligation with a competitor.

An illegal antitrust "agreement" includes implied or tacit understandings even though they are never written down or expressly agreed to, and even though the understanding would not be a legally enforceable contract. U.S. courts have defined an "agreement" under the antitrust laws as a "conscious commitment to a common scheme to achieve an unlawful objective," and as "a unity of purpose or a common design and understanding, or a meeting of minds in an unlawful arrangement." Under U.S. antitrust law, a court or jury is often allowed to infer that there was an agreement based upon "little more than uniform behavior among competitors, preceded by conversations implying that later uniformity might prove desirable, or accompanied by other conduct that in context suggests that each competitor failed to make an independent decision."

Not all agreements among competitors violate the antitrust laws. However the following types of agreements are called "per se violations," which means that they automatically

violate the antitrust laws and the defendant is not allowed to explain the reasons or benefits of the agreement:

- Agreement among competitors to fix the prices they charge their customers;
- Agreement among competitors to allocate customers or divide markets;
- Agreement among competitors not to compete for particular customers or types of cargo or not to compete for business from a competitor's established customers;
- Agreement among competitors not to compete in certain geographic areas or in certain lines of business;
- Agreement among competitors to limit the capacity they offer in the trade;
- Agreement among competitors that all of them will refuse to do business with a particular customer or type of customer or with a particular supplier or type of supplier (sometimes called a "boycott"); and
- Agreement between a manufacturer and a retailer to fix the price the retailer charges its customers.

2. ANTI-MONOPOLY LAWS

U.S. antitrust laws prohibit using improper practices to obtain a monopoly or to attempt to obtain a monopoly. It is not illegal to be a monopolist; it is only illegal to obtain or keep a monopoly through unlawful conduct. In general, conduct that does not have a legitimate business justification is unlawful conduct, which can be a basis for a monopoly claim under the antitrust laws. Unlike agreements in restraint of trade, where an agreement with another person is required before it violates the law, unilateral action that does not have a legitimate business justification can constitute illegal monopolizing or attempting to monopolize.

What constitutes a legitimate justification is often unclear. But conduct that improves service to customers or increases efficiency will likely be found lawful, even if it also has the effect of making it difficult for other businesses to compete. If, however, the only reason for the conduct is to harm a competitor, a court will likely conclude that the conduct could be the basis for a charge of illegal monopolizing.

CHAPTER 11

INTELLECTUAL PROPERTY

Intellectual Property is often one of a business' most valuable assets. Yet, despite its importance, uncertainty often exists about what it is and how to protect it. This chapter provides a brief overview of intellectual property and how it is protected in the United States.

At the outset, three points should be noted. First, the "property" in intellectual property is not generally a thing that can be seen or touched, but the mental or creative effort that results or is embodied in the thing seen or touched. For example, intellectual property in a book is not the book itself; it is the way the ideas are expressed. Second, the "rights" in intellectual property rights, like most other types of property, refer to the right to control how, when and by whom the property is used. Third, in many instances "intellectual property" is not automatically protected. As discussed below, the owner must take steps to protect it.

1. TYPES OF INTELLECTUAL PROPERTY

Intellectual property generally refers to creations of the mind. This includes inventions, literary and artistic works, symbols, names, designs used in commerce, and information. It also includes such things as a person's name and likeness, product shapes, geographic designations, and the integrity of works of art. The most well-known forms of intellectual property include copyright, trade secrets, confidential information, patents, and trademarks, servicemarks, and trade dress.

A. Copyright.

Copyright is essentially an ownership interest held by the author (or employer in the case of a "work for hire") in an *original* work fixed in any tangible medium of expression (such as on paper or video). For most works created on or after January 1, 1978, a work is protected from the moment of its creation and the protection usually lasts for the author's life plus 70 years.

Copyrights are governed by the federal Copyright Act, and, in some cases, state law. In addition, the United States is a signatory to various international conventions governing copyright, including the Berne Union for the Protection of Literary and Artistic Property (Berne Convention) and the Universal Copyright Convention. For more information about copyright, applicable law, application information, and FAQs, see: www.copyright.gov.

Many countries recognize neighboring rights and "moral rights" as part of the bundle of rights covered by copyright. For the most part, the United States is an exception to this rule. At least at the federal level²¹, only limited protection is

²¹ The rights are also protected under state moral rights laws and art preservation statutes in California and New York and, depending on the facts, may be covered by other state and federal laws. For example, if a work is

given to these rights. Specifically, the Visual Artists Rights Act (17 U.S.C. § 106A) grants authors of visual works the right of attribution, and the right to prevent intentional distortion, mutilation, or other modification of a work if that distortion is likely to harm the author's reputation. These rights are not transferable and end with the life of the author.

B. Trade Secrets and Confidential Information.

A trade secret is information, including a formula, pattern, compilation, program, device, method, technique, or process, that (1) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by, other persons who can obtain economic value from disclosure and use; and (2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy. Trade secrets include business plans, customer and supplier lists, contract terms, price lists, and other commercial information.

Related to trade secrets is confidential information. This is information that may not meet the requirements of a trade secret but may nevertheless have value. Although court cases have offered some protection for such information in the context of certain types of relationships, this type of information is often protected by contract.

Trade secret and confidential information is governed by contract, common law and state statute. Forty states have adopted the Uniform Trade Secrets Act. In addition, certain types of information are subject to federal protection under the Economic Espionage Act of 1996 (18 U.S.C. §1831, §1832), and state and federal statutes governing specific types of information, (for example, health and financial information). Other legal regimes dealing with trade secret and confidential information include UNIDROIT and the GATT Trade Agreement. For more information about trade secrets, applicable law, and FAQs, see: www.uspto.gov/main/trademarks.htm.

C. Patents.

Patents and trademarks fall into a particular subset of intellectual property known as industrial property. A patent is a monopoly on an invention (useful process; machine, manufacture, or composition of matter; or new useful improvement thereof) granted by the U.S. government in return for disclosure. The monopoly for most patents lasts for 20 years from the date the application is made to the U. S. Patent and Trademark Office (www.uspto.gov). There are three types of patents: design, utility, and plant. A utility patent is granted for a new and useful invention. A design patent covers new and non-obvious ornamental design for an article of manufacture; it does not cover structural or functional features. Plant

misattributed or modified without the author's permission, the author may have a claim under the Copyright Act for infringement (derivative work), the Lanham Act (false designation), state publicity rights or defamation.

patents cover new varieties of a-sexually reproduced plants. To qualify for a utility or design patent, the invention must be new, useful, and non-obvious.

Patents are governed by federal law, with its roots in the U.S. Constitution. In addition, the United States is a signatory to various international treaties governing patents, including Paris Convention for the Protection of Industrial Property and the Patent Cooperation Treaty. For more information about patents, applicable law, application information and FAQs, see: www.uspto.gov/web/offices/pac/doc/general/faq.htm.

D. Trademarks, Servicemarks and Trade Dress.

A trademark can be words, images, designs, shapes, colors, or other signs that identify goods as offered by a specific person or business. A servicemark is the same as a trademark except that it identifies and distinguishes the source of a service rather than a product. In the United States, trademark and servicemark ownership is established by priority of use for the particular goods, associated with goodwill and name recognition. Protection is not afforded to all words or symbols, such as generic or descriptive terms, in many instances.

Trademarks are governed by federal trademark and unfair competition laws, as well as state law. For more information about trademarks, applicable law, application information, and FAQs, see: www.uspto.gov/main/trademarks.htm.

Related to trademark is trade dress. Trade dress refers to the visual appearance of a product or its packaging. This can include the three-dimensional shape, graphic design, color, or even smell of a product and/or its packaging. To qualify for protection as trade dress the features must be capable of functioning as a source indicator (like a trademark) and must be non-functional. To be non-functional, the feature cannot affect the product's cost or quality.

E. Lanham Act and Personality Rights.

In addition to the above categories of intellectual property rights, there are federal and state laws protecting certain more general categories of intellectual property. For example, at the federal level, the Lanham Act is an unfair competition law that creates property rights in words, terms, names and symbols used in connection with commerce. In addition, state law provides protection for personality rights, that is, the right to privacy and the right to keep one's image and likeness from being exploited without permission. These rights are treated as "chattel" in the United States and therefore may be conveyed by testamentary disposition and protected after death. For more on unfair competition and the right of publicity, as well as FAQs, see: www.law.cornell.edu/topics/unfair_competition.html and www.law.cornell.edu/topics/publicity.html.

2. PROCEDURE FOR PROTECTING INTELLECTUAL PROPERTY

By protecting its intellectual property right a business can achieve two goals: narrow competition by distinguishing its products and services from others and avoid violating the rights of others to their intellectual property. In addition, protecting intellectual property is necessary in virtually any business transaction. The other parties to these transactions want to know that business has rights to what it sells, whether a product or service. In the process of protecting its intellectual property a business necessarily assesses its intellectual property rights. It better understands whether and to what extent it has exclusive rights in an intellectual property asset and, hence, where to invest its resources.

In general, there are two ways to protect intellectual property: (a) regulating access and use and (b) registration, as a prerequisite to enforcement activities.

A. Limiting Access and Use.

To obtain the legal protections available for trade secret and confidential information, the owner must take steps to limit access to and use of that information. This means establishing internal rules for the handling of information. It also means establishing rules regarding external use via a business' contracts. For example, in business discussions, it is common for the parties to enter into non-disclosure agreements regulating the use and access to each other's information. Non-disclosure provisions are also common in employment agreements.

Contracts are another useful tool for protecting know-how and other types of information and assets such as copyrights, trademarks, and patents, as well as information or assets not otherwise protected by law. Freedom to contract is an almost sacred principle of law in the United States. Parties are for the most part free to enter into agreements that extend protections beyond that covered by law (subject to such limitations as misuse, preemption, anti-trust, and similar concerns). For example, parties may contractually prohibit reverse-engineering of software, limit the use of otherwise non-protected lists or collections of data, limit photography of exhibits, or prohibit the use of an idea for a product that would not be protected under copyright or patent law.

B. Registration.

Copyrights, trademarks, and patents all provide for federal registration. However, only patents require government action to establish rights; copyrights and trademark rights are created without such action or registration. But there are advantages to registration for both. For example, registering a copyright is required before someone can bring an infringement action, obtain certain damages or seek certain remedies set by law, or seize or block infringing works through U.S. Customs. Likewise, trademark registration is required before its owner can pursue an action for infringement in federal court under the Trademark Act. In

addition, trademark registration puts potential infringers on notice, makes registration abroad easier, and gives the registrant the benefit of a legal presumption of ownership of the mark and the exclusive right to use the mark nationwide on or in connection with the goods and/or services listed in the registration.

The rules regarding the proper applicant for registration of a copyright, trademark or patent vary, depending on the type of intellectual property involved. For example, for copyright the applicant may be the author, his/her employer in the case of a work made for hire, or the author's assignee. The applicant is not required to be a citizen of the United States and the work is not required to be first published in the United States. Copyright protection is available as long as on the date of first publication, "one or more of the authors is a national or domiciliary of the United States, or is a national, domiciliary, or sovereign authority of a treaty party." For trademarks the applicant must be the owner of the mark. So it must be the person or entity that controls the nature and quality of the goods or service identified by the mark.

Only the inventor (or his/her legal representative if the inventor is dead) may apply for a patent, with certain exceptions. The applicant does not need to be a citizen of the United States, but the applicant must sign an oath or declaration and no patent can be obtained if an application was filed in a foreign country more than 12 months before filing in the United States. An applicant may file either a provisional or non-provisional application. A non-provisional application consists of: (a) a written specification (description and claims) and an oath or declaration, (b) a drawing in those cases in which a drawing is necessary, and (c) filing, search, and examination fees. A provisional application offers a lower cost first patent filing in the United States. It does not require claims or an oath or declaration. A provisional application provides the means to establish an early effective filing date in a patent application and permits the term "Patent Pending" to be used in connection with the invention. Provisional applications may not be filed for design inventions. The applicant has up to 12 months after a provisional application to file a non-provisional application for a patent.

All materials submitted in connection with a copyright registration (including source code), trademark registration, and patent application are available to the public. The rules governing copyright permit trade secret information to be excised from the materials submitted to protect against disclosure, and the rules also allow for filing of less than all the source code. See www.copyright.gov/circs/circ07d.html for specific rules relating to the deposit and public access. Patent applications are generally published after the expiration of an 18-month period following the earliest effective filing date or priority date claimed by an application. After publication any member of the public may access the patent file.

C. Notice.

Notice advises the world that the owner is claiming rights in a work, trademark or invention. Notice is provided by way of marks next to any reference to the work, trademark or invention.

A copyright mark on copyrighted material or a trademark symbol on a trademark are not required. However, including these items informs the public that the work is protected and prevents innocent infringements. If a notice is used for copyrights, the correct form is (a) the symbol © (the letter C in a circle), the word "Copyright," or the abbreviation "Copr."; (b) the year of first publication of the work; and (c) the name of the owner of copyright in the work. This notice puts the world on notice as to the copyright owner and the year of first publication. The notice should be placed in such a way as to give reasonable notice of the claim of copyright. For trademarks, a trademark owner may use the "TM" (trademark) or "SM" (service mark) designation before registration to alert the public to the claim of ownership. After registration, the owner may only use the federal registration symbol "®" and only on or in connection with the goods and/or services listed in the federal trademark registration.

The rules for patent differ from those for copyright and trademark. A patentee who makes or sells patented articles is required to mark the articles with the word "Patent" and the number of the patent. The penalty for failure to mark: the patentee may not recover damages from an infringer unless the infringer was duly notified of the infringement and continued to infringe after the notice.

3. RIGHTS GRANTED

In the United States the laws governing intellectual property provide an owner with two types of rights: (a) the exclusive right to exploit the intellectual property or (b) the right to prohibit others from exploiting the intellectual property. Copyright falls into the first group; trademark, patent, trade secret, and unfair competition laws into the second. This distinction affects an owner's remedies, as well as the scope of what the owner can protect. For example, with copyrights an owner is the only one who can use the copyrighted material, but the owner cannot prevent someone from using the ideas in that material to create something new. In contrast, a trademark owner does not obtain rights to a trademark through the trademark law. Rather, the law merely recognizes that right and grants the owner a right to prevent others from using the same or a confusingly similar trademark in connection with similar goods and services. Similarly, if a business owns a patent, then it can prevent someone else (other than the government) from using that patented technology, even if that other person independently created the product or was unaware of the patent. In sum, a business must understand what type of intellectual property it owns to assess its options for asserting and protecting its rights.

4. COMMON ISSUES

Set out below is a brief list of considerations in dealing with intellectual property:

- Get it in Writing – It is too easy to lose rights in intellectual property without proof; a Chinese company should make sure it has written proof of its rights.
- Record – Documents relating to the sale of intellectual property rights should be filed with the Copyright Office or the United States Patent and Trademark office, as applicable, as should exclusive licenses. Recording is also critical if the intellectual property is pledged as security for a loan or the performance of an obligation.
- Think Before Pursuing a Breach or Infringement – Litigation in the United States is very expensive, can take a long time, and may raise issues that the owner of the intellectual property may not want made public. Suing for infringement or breach will inevitably involve a challenge to the validity of the owner's intellectual property rights. If a challenge is successful, the owner's rights may be declared invalid or narrowed. With licenses or similar agreements, the wiser course is to make the agreement self-enforcing and to limit the scope of the issues that may be subject to litigation.
- Clarify Ownership – The issue of ownership of intellectual property is present in virtually all business transactions. It is important to think about ownership of intellectual property whenever a transaction is contemplated.
- Consider Termination – At the beginning of a business transaction, the parties rarely want to focus on the consequences of termination or breach. This issue is one of the most important in any agreement, particularly for a licensee. The abrupt termination of a licensee's rights can be disastrous. At the outset, consider the consequences of termination and address the issue.
- Preserve Confidentiality – Often parties need to disclose information to evaluate a potential business transaction. To reduce risk, these disclosures should be limited. Chinese companies should also consider signing a confidentiality agreement before such discussions, up front, well before a deal is struck. It should address what happens if the transaction is not concluded. A later agreement can address the deal, if it works out.
- Use and Select Trademarks Carefully – Because trademark rights do not require registration in the United States, a Chinese company considering use of a trademark or service mark in the United States should first run a broader search to assess whether it is already owned by someone else. Doing this will ensure that the mark is available for use, avoiding costly changes later and potential litigation. It also will provide some protection against a claim of willful infringement. There are companies that perform these types of searches.
- Control Licenses – Make sure a license for a trademark covers the key terms needed to protect it. For example, it must permit the owner to monitor the quality of the goods/services sold under the trademark and the manner in which the mark is used, or the owner may be viewed as having abandoned the trademark.

CHAPTER 12

ENVIRONMENTAL PROTECTION

Over the past two decades, the federal and state governments in the United States have sought to carefully regulate environmental contamination. Liability under such laws has therefore been a regular concern for any business operating in the United States. Under the federal Comprehensive Environmental Response, Compensation, and Liability Act, popularly known as “Superfund,” current and former “owners” and “operators” of a “facility” (which includes real property and just about anything else, including equipment, tanks, and buildings), among others, may be liable for an actual or threatened “release” of “hazardous substances” from the facility. Many states have their own versions of Superfund, but they are often different from Superfund. For example, while petroleum products are not “hazardous substances” under Superfund, they are under many states’ laws.

The environmental risk should be carefully examined when a business is considering a lease or purchase of real estate. The business should consult with legal advisors who are knowledgeable about environmental law in any state in which the business plans on owning property or doing business at any physical facility.

Liability under Superfund is strict. It exists even if the person handled the hazardous substances carefully or if the person did not even know there was a release.

Liability is also joint and several. That means each liable person is responsible for all of the costs to clean up the contamination, even if others are also liable. If some of those people have no money, the other liable parties must pay. The law expects the parties found liable to work out among themselves who is really responsible and, hence, if money is available, who must reimburse the others found jointly liable.

There are very few defenses to liability under Superfund, but some may exist and are therefore worth considering. First, a person is not liable for contamination at a person’s facility if that contamination was caused solely by an act of another. Superfund (and many states’ laws) also protect owners or operators of properties from liability for contamination caused solely by their neighbors. To take advantage of the exemption, one must take reasonable steps to prevent the spread of contamination, must not do anything to exacerbate the contamination, must cooperate with cleanup efforts, and must act carefully.

Second, an “innocent purchaser” is not liable for contamination. To qualify as an innocent purchaser, a person must prove the following:

- The purchaser acquired property after the disposal or placement of hazardous substances on the property;
- When the purchaser acquired the property, the purchaser did not know and had no reason to know that any hazardous substance that was the subject of release or threatened release was disposed of on the property;
- The purchaser exercised due care with respect to the hazardous substance;

- The purchaser took precautions against foreseeable acts or omissions by the guilty third party and against the foreseeable consequences of those acts or omissions; and
- The purchaser made “all appropriate inquiry” into past uses and owners of the property.

Third, a “bona fide prospective purchaser” of contaminated property after January 11, 2002, is exempt from liability. To qualify as a bona fide prospective purchaser, a person must prove the following:

- Hazardous substances were only disposed of at the facility before the person acquired it;
- The person made “all appropriate inquiry” into the previous ownership and uses of the facility in accordance with generally accepted good commercial and customary standards and practices;
- The person provided all legally required notices concerning the discovery or release of hazardous substances at the facility;
- The person took reasonable steps to:
 - stop any continuing release;
 - prevent any threatened future release; and
 - prevent or limit human, environmental, or natural resource exposure to any previously released hazardous substance;
- The person cooperated with, and gave access to, persons authorized to clean up the contamination and restore the environment;
- The person complied with all land use restrictions and did not impede the effectiveness or integrity of any institutional control;
- The person complied with all requests for information from the Environmental Protection Agency; and
- The person has no potential liability due to a familial, contractual, corporate or financial relationship to someone else who is potentially liable.

A bona fide prospective purchaser’s title to property may, however, be subject to a “windfall lien” on the property if the Environmental Protection Agency spent money to clean up the property and failed to recover the cleanup costs from liable parties. The lien will only attach if the cleanup increases the fair market value of the property, and is limited to the amount of the increase in that value.

Both the innocent purchaser and bona fide purchase defense require a person who acquires a facility to conduct “all appropriate inquiry” concerning the history of the facility and its surrounding properties. Superfund now identifies the several steps a purchaser must make to satisfy this requirement. These steps, which must be taken before completing a purchase, require (at a minimum) the help of a trained environmental consultant.

Liable parties can agree to allocate the cleanup costs among themselves before or after they discover contamination that must be cleaned up. A party who cleans up contamination may also be able to sue and ask a court to allocate financial responsibility for the cleanup.

To take advantage of potential exemptions from liability, and to support efforts to allocate responsibility for environmental cleanup to others, the owner or operator of a facility must investigate the condition of a property or facility before acquiring it. This investigation will typically require the help of an environmental consultant and possibly an environmental lawyer. Buyers and sellers, and owners and operators, should also try to agree on a way to divide responsibility for known and unknown environmental conditions on a property. This is less expensive than asking a court to divide that responsibility. Finally, the owner or operator of a facility facing an environmental claim should make sure the other party to a transaction has the financial strength to shoulder its share of the cleanup burden, if liable. If the other party cannot pay its cleanup obligations, the party to a transaction with financial wherewithal but without full responsibility may be forced to bear the entire cost.

CHAPTER 13

LITIGATION AND DISPUTE RESOLUTION

Doing business is not always easy. Disputes often occur between companies, or between a company and its customers. Sometimes these disputes cannot be resolved by the parties and become lawsuits. In the United States, courts have well-established procedures for handling litigation, the highlights of which are outlined below.

1. START OF A LAWSUIT

The United States has both state and federal courts. The state courts are those set up and administered by each of the 50 states (Washington, Oregon, New York, etc.). Each state has a set of trial courts, where cases start and are first decided. Each state also has appellate courts, where the party who lost at the trial level can, under some circumstances, ask a higher court to review the lower court result.

The federal courts have a similar structure. These are courts set up and run by the national government. The federal trial courts are called District Courts, and there is at least one in each state. There are also federal appellate courts, called Circuit Courts of Appeals. Like the state courts, the losing party at the District Court level can sometimes seek review of the lower court result at the Circuit Court level.

In both the federal and state systems, a case starts with the filing of an initial pleading called a complaint. A complaint contains the outline of the facts upon which the plaintiff (the person starting the lawsuit) bases the claim and the legal theories under which the plaintiff seeks relief. A complaint does not need to state all the facts, only enough to put the defendant (the person sued) on notice of the nature of the claims being asserted. The defendant then responds to the complaint with an equally terse pleading called an answer. This pleading begins by admitting or denying the allegations in the complaint. It also may assert technical legal barriers to the plaintiff's claims (such as the suit is barred by a statute or other legal requirement). A defendant may also assert claims against the plaintiff. These are called counterclaims. If they arise out of the same facts included in the complaint, they must be asserted in the answer or they will be considered waived.

A number of factors influence which court will preside over a particular dispute. One important factor is the nature of the dispute. Many disputes involve ordinary business or consumer matters. Examples include breach of contract claims or claims based on a defectively made product. These disputes are decided using a particular state's law, rather than federal nationwide legislation. Under most circumstances they will start and ultimately be resolved in state courts. However, if the dispute involves enough money, and if the parties come from different states or countries, the case can be heard in a federal District Court in two ways. First, the plaintiff can start the case there by filing a federal court complaint. Second, even if the case starts out in a state court, the defendant can move it to federal court at the beginning of the case.

The federal court system will also generally preside over cases that involve nationwide laws passed by the U.S. Congress (for example, federal copyright, patent or other

intellectual property laws) or cases brought under the U.S. Constitution. These cases are said to involve “federal questions.” They may be filed in District Court regardless of the amount at stake, and – even if they start in a state court – they can be (and usually are) removed to District Court.

2. LOCATION OF CASE.

Where a case will be heard in the United States depends largely on facts about the parties and how the case arose. Two principles are involved.

The first of these is so-called personal jurisdiction. Put simply, for a court – federal or state – to have the power to hear a case, the defendant must have some minimal connection with the state in which the court sits. The defendant need not have an office or do regular and ordinary business there for personal jurisdiction to exist. However, there must be sufficient ties (for example, shipping products into the state or soliciting business from state residents) so that it is fair for a defendant to expect that, if things go wrong, the defendant might be sued in that state for matters arising out of the connecting activity.

Merely having personal jurisdiction over a defendant will not, however, assure that a court will keep the case. Under some circumstances, a defendant may convince the court that the case would be better and more efficiently handled in another forum. Courts decide such matters based on a number of factors. These include where most of the witnesses reside, what jurisdiction’s law will govern, the hardship on the plaintiff in having to litigate far from home. In most cases the plaintiff’s choice of forum will prevail, but a motion to change venue can often be worth pursuing. Winning such a motion can raise the costs of litigation for a plaintiff to the point where the plaintiff may find it uneconomical to pursue the case. Also, if the court where the case started is perceived as for some reason unfriendly to the defendant, having the case go elsewhere can be seen as an important strategic move. Finally, procedural differences can affect the outcome of the case sometimes, so that one court is much better for a defendant than another.

3. EARLY DISMISSAL OF CASE

Litigation anywhere is expensive, and – from the defendant’s point of view – has no particular benefit. So one of the first questions most defendants ask is: Is there some legal basis to end the case early in the process? The answer to this question can sometimes be “yes.” Both federal and state courts have established procedures for requesting such early dismissals. Such requests are in written form, called a “motion.” In it, the defendant argues that even accepting the facts asserted in the complaint the law simply does not allow such a claim. Each case, of course, is different and has to be analyzed on its own facts and applicable law. However, there are at least two benefits to making such motions where there is some reasonable basis to do so. First, the motion may well win; that will be the end of the case, except for a possible appeal. Second, the plaintiff is obligated to respond to the motion, and the response must include both the plaintiff’s position on the applicable law and a legal rationale for why the plaintiff should

be allowed to continue the case. In other words, an early motion to dismiss forces the other side to reveal more about its case. This information can assist later in the defense of the case, even if the motion to dismiss the case at the beginning fails.

4. GATHERING FACTS

Assuming an early motion to dismiss is not successful, the case enters a new phase, in which the parties seek out the facts the plaintiff needs to prove its claims at trial and the defendant needs to resist the claims. This stage is called “discovery”, and it is the one stage that causes most foreign parties the greatest concern. U.S.-style discovery is wide-ranging and allows factual inquiries that are much more broadly based than in most other countries. This has the advantage of allowing the parties access to information that might be unavailable in other systems, information that can often be crucial to proving a claim or a defense. On the other hand, the process is without question expensive and, if not monitored, intrusive. Examples of discovery tools available in most U.S. courts include:

- Requiring each party or other person to provide relevant documents;
- Requiring a party to provide another party with written answers to written questions;
- Requiring a witness (whether employed by a party or not) to submit to questioning by the lawyers for the parties, under oath and in advance of the actual trial; and
- Requiring a party to admit or deny the truth of certain statements propounded to the party.

Each of these tools has its uses, and the decision on whether and how to use them depends on the circumstances of each case. However, most cases will involve at least three and often all of them.

5. TRIAL AND AFTERWARDS

Relatively few cases go all the way through trial. For one thing, most cases settle. For another, some cases are dismissed after the discovery phase because it becomes clear no support exists for the asserted claims. Similar to the early testing of claims discussed above, a request for dismissal on this basis is presented by a motion, called a “summary judgment” motion. The moving party must show that the important facts are not in dispute and, given those facts, there is no claim under the controlling law. Motions for summary judgment are in many respects defining moments in cases. If even partially successful, they can force a plaintiff into settlement. If unsuccessful, they can cause a defendant who was reluctant to pay any money to reconsider that position and perhaps settle the case.

If settlement does not occur, then the case is tried, either with or without a jury. A jury can be involved only if one party or the other asks for one earlier in the case, and the claims are ones for which a jury is appropriate. In general, cases involving money damages can (and often do) involve juries. On the other hand, cases are decided by a

judge alone when the only relief requested is a court order to do (or not to do) something (so-called injunctive relief).

At the end of the trial, a decision is rendered, either by judge or a jury if there is one, and a judgment entered that reflects who won and who lost. If the case goes no further, a variety of mechanisms can be used to enforce the judgment. For example, if the plaintiff wins and is awarded a sum of money, court rules and statutes provide tools to uncover and seize the defendant's assets to pay the plaintiff the sum owed. If the defendant wins, the plaintiff's case is over, at least at the trial court level. No matter who wins, a case will continue only if the losing side appeals.

An appeal does not generally focus on challenging the facts proved at trial. Instead, the appealing party (the appellant) asks the appellate court to consider whether or not the trial court applied the correct law either before or during the trial. Not every case is appealed and by no means are all appeals successful. However, if a party and the party's counsel believe strongly that an error of law was made, an appeal can be the correct course of action.

6. RESOLVING DISPUTES OUTSIDE THE COURT

One does not always need to use the public court system to resolve a dispute. There are two alternate ways in which private parties can handle disputes they are unable to resolve on their own.

First, the parties may seek the assistance of a mediator. A mediator is a person trained in helping parties settle disputes. The mediator does not decide the case, but instead seeks to help the parties reach agreement. Hence, this process cannot result in a decision unless both parties agree. Mediation is often fruitful even before a dispute turns into formal court litigation, and we recommend considering it at the outset. However, early mediation is unfortunately often unsuccessful, for a number of reasons. One is that not all the relevant facts are available because there has been no discovery. Another is that the parties and their attorneys may have strong and differing views about what the law requires. If a judge has not yet given guidance on these legal differences, then the parties may not be able to resolve their dispute. Some of the litigation process may therefore be necessary before mediation can be successful. But at some point almost all cases go through mediation. Indeed, most courts require it.

The second way for parties to resolve disputes without litigation is to have the dispute arbitrated before one or more arbitrators. An arbitrator is essentially a private judge. Often he or she is a lawyer or an expert in the subject of the dispute. To use arbitration, the parties to a dispute must all agree to it. Sometimes this agreement has already occurred, which happens when an earlier contract between the parties contains an arbitration provision. Indeed, if a contract has such a provision, courts will refuse to hear the case and will compel arbitration of the dispute. In any event, the arbitration process is often not so different from that of litigation in the courts, except in one important respect - no jury. Whether this is an advantage depends on the case, the parties involved, and a number of other factors. Some of these can be reasonably anticipated in advance, at the

beginning of a contractual relationship. That is the time, not later when they are at odds, that the parties should decide whether particular disputes are best handled in the courts or in arbitration.

7. CONCLUSION

Litigation in the United States can be complex and expensive. It is, however, more manageable than is often believed. More important, the prospect and management of litigation are part of the price of doing business in one of the world's largest markets. Understanding the U.S. litigation process and the choices to be made in it are important steps in such management.

CHAPTER 14

REGULATORY COMPLIANCE

As evident from the other Chapters of this guide, one of the most challenging aspects of doing business in the United States for Chinese companies is the tremendous variety of federal, state and local laws and regulations impacting those businesses and their competitiveness. There are practical and cost-effective steps, however, that can be taken to deal with regulatory compliance issues as a whole. Chinese companies should consider addressing regulatory issues in a systematic manner.

1. INITIATE A COMPREHENSIVE SURVEY OF THE REGULATIONS THAT MOST IMPACT THE BUSINESS AND CREATE A REGULATORY COMPLIANCE “CHECKLIST”

Using English-speaking staff and qualified outside attorneys and consultants, a Chinese business should start by identifying the federal, state and local laws and regulations that have the greatest potential to affect its operations and profits in the United States. This helps the business to understand which legal requirements create the greatest risk to its short and long term success and to allocate resources accordingly. Based on this assessment, the Chinese business and its advisors can develop a written “checklist” of all those government permits, approvals and other filings that are required, along with applicable time deadlines. Most Chinese companies have extensive past experience with regulations, permits and filings in their particular area of business, such as regulations governing textile manufacturing, maritime transportation, or telecommunications. But many times there are other regulations to which a Chinese business enterprise is subject that are not as obvious. Based on GSB’s past experience, the following are some of the key areas that any Chinese business should consider:

- Financial transactions – The U.S. federal government prohibits or severely restricts transactions involving certain governments, companies or persons, such as transactions with North Korea, Cuba or Iran.
- Health or safety reporting/compliance obligations – Federal and state regulatory authorities require reporting of certain business activities and transactions that could impact public health or safety.
- Environmental permits and standards – Federal, state and local governments require a variety of permits and reports as well as compliance with complex environmental rules arising from particular activities of the company.
- Entity maintenance obligations – States require a variety of filings to maintain corporations and other types of entities in good standing where they are formed or conduct business.
- Corporate governance/business ethics/internal financial controls – More and more, federal and state governments (as well as private accounting auditors)

increasingly insist that businesses abide by rules regarding unfair competition, business ethics and proper accounting.

- Import/export rules and terrorism protections – Restrictions on exports to China can have a major impact on Chinese companies operating in the U.S.; also some of the post-9/11 anti-terrorism rules are being strictly enforced against foreign businesses whose product sales and financial transactions are subject to these rules.

One area mentioned above, corporate governance, is a major new focus of federal and state regulatory officials. Although there is no precise set of statutory or regulatory rules that ensure compliance with American business ethics, many business entities in the United States are being forced by their private customers, government customers or financial auditors to establish a business ethics compliance program. After business failures on the scale of Enron or Parmalat, business counterparts want assurances that an enterprise is not likely to face some unexpected financial turmoil due to ethical misconduct or failures in management oversight.

Chinese companies may not be initially impacted by this recent trend because of the limited nature of their businesses in the United States. Still, it is important for Chinese business enterprises to be aware of the impact of the Sarbanes-Oxley (SOX) rules. (*See Chapter 2 on U.S. Capital Markets*). Although SOX rules generally apply only to companies regulated by the United States Securities and Exchange Commission, many private enterprises in the United States are beginning to undertake SOX compliance voluntarily. They do so to remain competitive and show that they are stable and well-run businesses. Moreover, these compliance programs are not limited to ensuring that a business enterprise has sound financial and accounting practices; they also include identification of management's role in maintaining regulatory compliance throughout the whole range of a corporation's business activities and compliance obligations.

Although it may take some time and effort to develop a comprehensive regulatory compliance checklist and although such a document can be lengthy, it is well worth the effort. It can help a Chinese business enterprise in at least two ways: It can provide a permanent guidepost to company management dealing with regulatory issues. It can also demonstrate to federal or state regulatory officials that the business takes regulatory compliance seriously. This second function is especially important should the enterprise ever become subject to enforcement actions by U.S. authorities. Enforcement officials are increasingly focused on whether there are "internal controls" such as this checklist in determining whether and how to deal with domestic and foreign companies facing allegations of regulatory noncompliance. They can influence how much continuing monitoring, oversight and reporting to which a company is subject, as well as the extent and nature of potential "punishment" (e.g. fines or prison sentences) a business enterprise and its principals may face.

2. ESTABLISHING A COST-EFFECTIVE REGULATORY COMPLIANCE PROGRAM

Once a Chinese business enterprise has completed its survey and created a regulatory checklist, the challenge is to establish a permanent program to ensure compliance at an acceptable cost. Large American businesses have recently established entire regulatory compliance departments and compliance officers to ensure compliance, but this approach may not be possible or feasible for a Chinese business. Depending on the size of the business and its activities in the United States and abroad, it may be more prudent for a Chinese business to assign specific English-speaking company officers to regulatory compliance duties, and to provide these officers with the authority and resources necessary to meaningfully assure compliance. Practically, this means that the company compliance officers must know: (a) how to understand and use the regulatory checklist; (b) which governmental officials and private advisors should be contacted with specific questions; and (c) which senior management officials have the responsibility and authority to direct actions in support of regulatory compliance.

As the next step, executives responsible for regulatory compliance obligations should create a “contact list” for each of the specific areas covered on the regulatory checklist discussed above. The regulatory compliance checklist and contact list could be made available to all executives, managers and staff, perhaps through posting on any in-house “intranet” or through other digital storage and retrieval means.

From past experience working with Chinese enterprises, the following are some of the most common problems and suggested solutions associated with establishing a cost-effective regulatory compliance program:

- Dealing with Management/Staff Turnover – In light of visa requirements and other business considerations, Chinese enterprises often transfer management and staff, including the officials who could be assigned to regulatory compliance. The regulatory checklist and contact list can be especially valuable if there are changes in the company personnel assigned to regulatory tasks. Providing time for regulatory training of new personnel, however, is also important. Lack of continuity in regulatory compliance is a serious problem, and the solution lies in creating written guidance and in-depth regulatory transition/training.
- Coordinating “Two Systems” – Because of the significant differences in business law and practices between China and the U.S., there are sometimes situations in which actions permitted in one country are prohibited in the other. Management should identify the particular areas where these legal and regulatory differences are the greatest, and ensure that there are no Chinese management directives that are issued to businesses operating in the U.S. without some prior “screening” for regulatory compliance.
- Selecting and Coordinating Outside Expertise – There are large numbers of outside legal counsel and regulatory experts who claim to be able to save companies on regulatory compliance, but selecting and coordinating among these advisors is always difficult. When selecting a new advisor on regulatory issues, a Chinese business should consider that advisor’s past experience with foreign

companies operating in the U.S. In addition, evaluating the cost and methods for any new advisor to coordinate with others involved is important to be efficient and consistent in a business enterprise's regulatory compliance strategies.

3. SUMMARY AND CONCLUSION

Chinese enterprises operating in the United States are coming under increased regulatory scrutiny as their competitors attempt to use regulatory compliance as means of obtaining competitive advantage. Federal and state regulatory officials are being contacted by American competitors who often make unfounded accusations and allegations about Chinese companies. Under these circumstances, it would seem appropriate for Chinese companies operating in the U.S. to establish a regulatory compliance program to maintain their competitive position and be prepared for any regulatory investigations that may arise in the future.

ABOUT GARVEY SCHUBERT BARER

Garvey Schubert Barer ("GSB") is a full-service business law firm with more than 120 lawyers serving clients in the United States and abroad, with particular focus on the Pacific Rim. From our five strategic locations, Beijing, China; Seattle, Washington; Portland, Oregon; New York, New York; and Washington, D.C., we serve as outside counsel to established market leaders and newly launched enterprises. Since its inception in 1966, GSB has served clients across virtually all industry sectors, including: technology, trade, transportation, maritime/admiralty, real estate, communications and media, entertainment, manufacturing, and healthcare. The firm provides cost-effective, practical solutions to Fortune 500 companies and a broad range of privately held companies, investment firms, financial institutions, not-for-profit organizations and individuals.

GSB's International Practice Group has represented Chinese companies since negotiating the reopening of the U.S.-China shipping relations in the 1970s. Today, from our Beijing office, we are even better positioned to assist Chinese enterprises on all aspects of doing business in the United States, from setting up operations, raising capital and forming strategic alliances, to dealing with issues of taxation, immigration, trade and customs regulation, employment, product liability, real estate, intellectual property, antitrust, and commercial litigation.

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