

# SO, YOU WANT TO BRING YOUR BUSINESS TO AMERICA?

A Primer on Entity Choice, and Other Important  
Business Considerations

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**NIXON PEABODY**LLP  
ATTORNEYS AT LAW



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The Swedish-American Chamber of Commerce, Inc. in New York (SACC New York) is a private membership organization that was founded in 1906. As the first and leading Swedish-American Chamber, SACC New York provides a vast array of services aimed at promoting and advancing business relations between the U.S. and Sweden. By leveraging its unique network and Swedish-American business related experience, SACC New York is well-positioned to assist and facilitate in various business matters. We are here to help you stay informed and connected!

In addition to producing various publications such as the newsletter In New York, the Membership Directory and information booklets, SACC New York focuses on three areas of operation: Membership, Events, and Business Services.

### About Business Services

Business Services distinguishes the Chamber as a leader in knowledge sharing and consulting services to Swedish businesses interested in the U.S. market. Our consultants can assist with everything from business referrals to the most complex advisory services. Whether you want to open a new business, develop an existing business, find distributors or potential partners, or simply investigate foreign business practices, we are at your disposal!

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# So You Want to Enter the U.S. Market?

## Introduction

You have spent years building your business in Sweden based on well thought out and innovative products that are gaining in public acceptance and reputation. You have grown your marketplace as much as possible, and are looking for new and fertile markets in which to sell your product. Naturally, you would like to expand into a stable, as well as a strong business and economic marketplace. It is important to you that businesses in your new market have a clear understanding of the “rules of the game” and of the consequences of actions in conducting business. When taking into account all of these considerations, it becomes clear to you that selling your product directly into the U.S. marketplace is the answer to your growth strategy. Now that you have decided on what to do to increase sales and grow your business, how do you do it? What are some of the more important issues and considerations that you need to think about in order to successfully operate a business in the U.S.?

While there are a number of major considerations that must be analyzed before conducting business in the United States, your analysis should always be conducted in consultation with, and incorporating the expertise of one who has a considerable amount of experience in structuring, developing, and operating businesses in the United States. Such a person can be an experienced business lawyer, accountant, or business advisor. Ultimately, the expertise of all three will be needed in order to make correct decisions with respect to the structure and operation of a U.S. business enterprise.

At the outset, it is valuable to have a general working knowledge of how businesses are governed and regulated in the U.S. It is important to identify what governmental entities will likely have a significant impact on your ability to successfully and profitably conduct the business you are in. Are there permits, licenses, and/or approvals that must be obtained in order for you to conduct your business, to raise additional capital, or to sell your products, and what agencies or entities are responsible for issuing such licenses, permits, or approvals?

Unless you decide to simply export your product to the U.S. to a third-party distributor who will sell it to consumers, you will want to establish a business presence in the U.S. for your enterprise. Therefore, you will next want to consider the entity structure in the U.S. that will best serve your business plans and goals.

Since you have decided that the United States is the market of choice for your product, and that, therefore, it is important for you to have a legal presence in the U.S. that will take care of all of the marketing, permitting, distribution, and sales functions for your product (and no one else’s product) under your direct supervision and control, you will want to give consideration to which type of U.S. business entity is going to best serve your needs in the U.S.

Essentially, there are four business entities to consider for use in the U.S. They are the corporate form (“C” corporation or “S” corporation), the Limited Liability Company (“LLC”), the Partnership form (general or limited), and Joint Ventures. One can also do business in the U.S. as a sole proprietorship, but that is not recommended for reasons set forth below. Each of these entity structures has its own advantages and disadvantages depending upon such considerations as (1) whether additional capital is intended to be raised in the U.S., (2) whether the ownership of the entity will be expanded to include U.S. persons, (3) liability considerations for owners, and (4) the taxation of earnings and profits and the accounting for losses from U.S. operations.

What about the real value of your business? In this world, and particularly in the United States, the “value” of businesses is more often determined today by the amount and nature of the intellectual property that the entity owns, protects and controls than it is by the product being sold. Consequently, you will want to give consideration to the processes by which intellectual property (“IP”)—whether such property consists of patentable inventions, trademarks and trade names, or copyrightable material, or some combination of such assets—is protected in the U.S. We recommend that before entering the United States market, foreign business owners identify their intellectual property and ensure that it is (1) protected in its own jurisdiction and, as necessary, elsewhere in the world; and (2) is the subject of applications to the United States Patent and Trademark

Office seeking protection for the IP in the U.S. market, before they “open for business” in the United States.

Obviously, the prime motive for engaging in an enterprise (most of the time) is to earn a profit. Therefore, how earnings and profits are taxed and losses accounted for in the United States, as well as various methods by which U.S. earnings and profits can be repatriated to Sweden, are of prime importance to you. This means that a basic knowledge of the business taxation regime in the U.S. is critical. Additionally, a detailed understanding of how the United States–Swedish Tax Treaty operates is necessary in order to ensure that the structure of your business in the U.S. takes full advantage of its provisions. The Treaty provides for a number of methods by which U.S. earnings and profits can be repatriated to Sweden at very low tax costs in the United States. The structure of the entity used to carry on business in the United States will dictate whether any or all of those methods are available to you.

In most cases, the desire to raise additional capital from U.S. sources will be an important aspect of growing your business in the U.S. marketplace. Therefore, understanding how capital is raised in the U.S., the limitations and restrictions on the nature and character of potential investors who may be approached for additional capital, and what regulatory bodies or agencies will likely control and govern how capital is raised, are of critical importance.

It is likely that your new U.S. entity will employ one or more individuals to carry on the enterprise. The obligations placed on U.S. entities, and their owners, relating to employees are numerous and potentially burdensome, if not anticipated. They range from required insurance and tax payments to the federal government, as well as to the state where the entity is located, to conditions of employment to the regulation of various aspects of employment including wages, hours, overtime pay, discrimination, harassment, sick and other leave, health benefit laws regulating employer pensions, and profit sharing plans, and health and other benefit plans. Federal law, as well as the laws of some states, impose notice requirements prior to employment termination in certain instances.

Retaining a good accountant to set up tax reporting and payment processes, and a knowledgeable labor/ employment counsel is

a must to ensure against unpleasant dealings with the state and federal taxing authorities and their respective departments of labor. For example, initially it might seem easier to “retain” independent contractors or consultants to handle the business of the enterprise in the U.S., rather than employing individuals to do so. This is because the Internal Revenue Service (“IRS”) requires businesses to withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment taxes on wages paid to an employee, while independent contractors are responsible for their own taxes. This distinction can save a business time and money in administrative costs. However, the state and federal taxing authorities frown on this practice. The Internal Revenue Service has developed the so-called “20 Factor Test” to determine the degree of control exercised over the independent contractor by the Company. Too much control will result in the person being reclassified as an employee. A misstep here can be aggravating and expensive, however, since an improper classification will subject the business to liability to both federal and state taxing authorities for previously unpaid (withheld) taxes, interest, and penalties caused by the misclassification.

While there is no bright-line set of factors that classify a worker as an employee rather than an independent contractor, a critical issue in this determination is the degree of control and independence of the worker. The IRS has developed a list of some 20 factors to consider in determining whether a person is an employee or an independent contractor. These factors include evidence of control by the Employer over activities of the worker, independence that the worker has in completing the work assignment, existence of written agreements, how the worker is paid, what supplies the worker must provide, how work hours are established, among others.

Business owners should examine the nature and control of their independent contractor relationships from time to time to make sure workers are properly classified. The keys to determining the appropriate classification are to look at the entire relationship, consider the degree or extent of the right to direct and control, and finally, to document each of the factor used in coming up with the determination.

The National Labor Relations Act protects the right of employees to form, join, and assist labor organizations and to bargain collectively

over wages, hours, and terms and conditions of employment. It is prudent to be informed of the specific requirements of such laws prior to hiring local personnel. In most situations, it is also sound practice to adopt written employment policies in the form of an employment handbook to be distributed to employees at the time of hiring, being careful, however, to avoid any implication that an employment contract is created by such a handbook.

Finally, it will probably be necessary for you, and/or other employees of your business in Sweden, to travel to and, perhaps, spend time in the U.S. in order to ensure that the U.S. enterprise operates consistently with the global strategy you have developed. A solid understanding of the laws and regulations governing the entry into the U.S. of non-U.S. citizens, the activities that they may engage in while in the U.S., and how long they may stay, will be necessary. These laws and regulations are implemented through the U.S. Citizenship and Immigration Services (“USCIS”). It will also be critical for you to engage the services of counsel who has real expertise in this area, as the laws and regulations can be very complex and their administration follows strict protocols. For information in this area, you should consult the SACC/Nixon Peabody pamphlet entitled “Immigration Issues: Planning to Work in the U.S.”

The considerations and possibilities raised for you by each of these questions can be varied and complex. The purpose of this pamphlet is to provide the basic information to consider, and the basic questions to ask in order to begin to inform your thinking as you consider bringing your business to the United States. As stated before, the constant rule of thumb should always be to engage the assistance of an experienced counsel as you begin to consider what will obviously be an important and major step forward for the business you have built.

## Business Regulation in the U.S.

How a business is regulated and by whom will often have a significant impact on the ability of a business to operate profitably. In the United States, businesses are regulated at three separate levels: the federal government; the governments of the various 50 states in which a business is formed, has employees, or property (nexus) or makes sales; and the local government where a business is physically

located. Additionally, many business activities, such as raising capital, and commercial activities that implicate more than one state, are regulated by more than one layer of government.

The federal government will play a significant role in taxation of income and gain, as well as any activity crossing state lines (interstate commerce), the manufacture and quality of certain products (Federal Drug Administration or Federal Trade Commission), anti-trust matters (Department of Justice and Federal Trade Commission), and the raising of capital across state lines and/or from a broad segment of the public (Securities and Exchange Commission). Additionally, the federal government will regulate the activities of so-called “public companies,” primarily through the provisions of the Sarbanes/Oxley Act. The federal government will also regulate how employees are paid, treated, dismissed and disciplined by regulating the payment of wages, prohibiting discrimination in the workplace, regulating unionization activities, and determining the classification of individuals as either employees or independent contractors.

One layer below the federal government are the 50 state governments, which ostensibly have jurisdiction over individuals and businesses either located, or who engage in business within their borders. States will regulate the formation, operation, and governance of business entities; the raising of capital from its citizens; the need for certain business activities to be licensed; and, in line with the federal government, various aspects of employment in the workplace. States require businesses to carry unemployment compensation insurance and workers’ compensation insurance, as well as establish aspects of the payment of wages and the hours worked by employees. Additionally, the states in coordination with the federal government also regulate the raising of capital from its citizens. States exclusively regulate the buying and selling of real estate located within their borders.

Local town and city governments will be intimately involved with the physical location of a company within their borders and will regulate such things as zoning and land use, construction, and expansion.

Many considerations can go into deciding what state should be chosen as the state of formation. Such considerations may include what state’s laws are the most advantageous to the chosen form of

business enterprise, state tax implications, and investor familiarity. For example, the laws of California and New York are very favorable to employees, whereas the laws of New Hampshire, Delaware and Nevada are considered to be very business friendly. Delaware is a common state of formation for many United States corporations and limited liability companies, including a majority of the entities formed by foreign owners. This is because the Delaware business statutes are well-drafted and widely understood; in general, the statutes and case law of Delaware favor management and the operating efficiencies of the business enterprise; the Delaware Chancery Court system is highly skilled in the adjudication of business disputes. The bench is occupied by business savvy judges, and, investors generally know and understand Delaware business law. While Delaware is a popular forum for entity formation, one should research the various state laws when making a decision, as there may be reasons centered on location, a particularly friendly regulatory environment for the specific enterprise or ease of raising capital that could balance in favor of choosing one state over another as the place to form the entity.

## Choosing the Right Business Entity

### General Considerations

An important consideration for any business venture planning to conduct business in the United States is the type of entity to use. In most instances, the formation of a United States subsidiary is preferable to operation of a branch. This is true for both reducing general liabilities and to minimize tax problems. The North American Free Trade Agreement (“NAFTA”) further enhances the utility of an American subsidiary. From a business viewpoint, a subsidiary tends to demonstrate to customers and others greater American presence as well as an image from which the customer can see a greater commitment to the American market and to ongoing service to American customers. Several Swedish companies, which once had a small presence in the U.S., have gained over a relatively short time period to be commonly thought of as indigenous to the U.S. market or as a multinational. The use of subsidiaries assisted those companies in their U.S. expansion efforts.

Choice of entity has a broad range of implications for a business, including ease of formation, tax considerations, limitation on liability, ability to raise and attract capital, transferability of ownership, and management. The choice of which business entity to select is often dependent on the nature of the business venture. For example, whether the new U.S. entity will need to raise significant amounts of additional capital from unknown, outside U.S. and non-U.S. sources and whether a broad based solicitation of investors or a solicitation from a limited pool of potential investors will be needed, will dictate what form of entity to use as well as the structure of the entity. The principal business entities available in the United States consist of (1) corporations, (2) limited liability companies, (3) partnerships, and (4) other entities such as joint ventures and sole proprietorships. Before choosing which entity is the most appropriate for a particular venture, it is important to understand the basic elements of each entity.

As will be discussed in more detail below, any U.S. business entity will be subject to both federal as well as, in many cases, state and local income taxes. For example, a U.S. subsidiary of a foreign corporation is subject to U.S. federal income tax on its worldwide income at the same rates as other U.S. corporations (currently 35%).

The United States may, in effect, tax the income of a U.S. corporation twice. First, the income is taxed to the corporation when earned by the corporation (“corporate-level tax”); second, the income is taxed to the shareholder when the income is paid out as a dividend from the corporation (“shareholder-level tax”). However, as will be discussed below, with proper prior planning, the provisions of the Sweden-U.S. tax treaty can be utilized to moderate, or even eliminate certain withholding requirements and shareholder-level taxes. While the corporate form is preferred if the enterprise intends to raise additional capital from U.S. sources, if that consideration is less important than reducing income taxes, a single-tax entity, such as an LLC or partnership may be preferable.

As explained in more detail in the Taxation Section, so long as the Swedish parent is deemed to have a permanent establishment in the U.S., it will be subject to U.S. federal income taxation. The solution is to establish a U.S. subsidiary to carry on the enterprise in the U.S. The most effective means of assuring that the U.S. subsidiary

will not be considered a permanent establishment of its parent is to have it serve as an intermediate distributor for the parent in its dealings with American customers. This structure would permit the subsidiary to be engaged in contract negotiations in its own name. If such a structure is not used, there is some degree of danger that the parent will be unable to convincingly and factually provide that the subsidiary's role does not involve contract negotiations on behalf of the parent company. If the American subsidiary acts in the name of the Swedish parent and thus negotiates and concludes agreements with American companies on the Swedish parent's behalf, a problem could arise.

In the preferred structure, the Swedish parent would sell its products to its American subsidiary; the American subsidiary, in turn, could freely negotiate and conclude agreements with prospective American customers or joint venture partners in its own name. It will be necessary that the American subsidiary earn reasonable profits on the transactions.

An alternative structure could involve the subsidiary as an agent on a commission basis. In this structure, the parent would negotiate and conclude the agreements and render the invoices. For its negotiating role, the subsidiary would have to be paid at least normal commissions.

From our viewpoint, the subsidiary as distributor is preferable to the subsidiary as commission agent. The commission agent type of arrangement leaves open the possibility that the Swedish parent will be seen to have a "permanent establishment," which, in addition to exposing the Swedish parent to U.S. federal income taxation, also results in an inability to access many of the benefits afforded by the Sweden–U.S. income tax treaty.

## What are the differences between U.S. business entities?

### *Corporations*

Corporations are separate legal entities that are created, exist, and are governed by and under state statutory law. As such, the structure and internal operations of a corporation, as well as the relationship

between the entity and its owners are governed by statute of the state of incorporation. Corporations are divided into S-corporations (named for Subchapter "S" of the Internal Revenue Code) and C-corporations (named for Subchapter "C" of the Internal Revenue Code). The most important elements of corporations can be grouped into three broad categories: ownership and structuring, liability, and taxation.

### *Ownership and Structuring*

Formation of corporations is quick and inexpensive, and is completed by filing "Certificate of Incorporation" or "Articles of Incorporation" with the Secretary of State's office in the chosen state of incorporation. The articles will set forth principally the name and address of the entity, its initial capitalization, its business purpose, and may identify its initial board of directors. The management of a corporation is centralized in a board of directors, elected by the shareholders. Officers are selected by the board to carry out the day-to-day business of the corporation. Ownership of a corporation is freely transferable, and existence of a corporation is perpetual. A U.S. business corporation may be formed with the Swedish parent as the sole shareholder. Profits of a corporation may be distributed to stockholders in the form of dividends, or periodic per-share cash distributions. All shareholders in a given class must be treated equally as to voting rights, distributions, dividends, and liquidation.

Ownership issues must be considered when deciding between the use of a C-corporation or an S-corporation. A C-corporation possesses a great deal of flexibility in deciding who can be a shareholder, in structuring rights of various shareholders, including with respect to valuation, preferences, and protections, and in having the ability to issue more than one class of stock. A C-corporation may have any number of classes of common and preferred shareholders, with each class having different rights and privileges from the others.

Additionally, there are no restrictions on who can be a shareholder in a C-corporation, nor on whether the shareholder is a U.S. citizen or a citizen of another country. Shareholders may be individuals, companies, or trusts. Additionally, there are no restrictions as to the

number or characteristics of classes of share ownership that may be utilized. As a result, C-corporations offer much more flexibility in attracting capital than do S-corporations.

Conversely, S-corporations have less flexibility of ownership than C-corporations. S-corporations are limited to no more than 100 stockholders, all of whom must be in one of the following categories: (1) U.S. citizens or legal residents; (2) U.S. estates; (3) certain eligible trusts; or, (4) certain tax-exempt entities. An S-corporation is also only permitted one class of stock, which can be a deterrent for some investors. The restriction as to the nationality of shareholders above will generally make S-corporations an inappropriate entity for non-U.S. investors and ownership. For these reasons an S-corporation is generally not a viable vehicle for doing business in the U.S. by non-U.S. business owners or companies. Therefore, this presentation will focus on the C-corporation.

The governance of corporations is set forth in the business corporation statute of the state of formation. The corporate statutes of the 50 states are similar in many ways in that substantially all are now premised on the Model Business Corporations Act (“MBCA”), as amended from time to time. However, the MBCA is only a suggested form of the law that may be adopted in whole or in part by the states, in their individual discretion. Therefore, each state’s statute has its own unique characteristics. As a result, the statute applicable to the entity must always be consulted before moving forward. The statute will specify the minimum number of directors required, what officers a corporation must have, the duties of directors and officers to the corporation and its owners, when a corporation’s shareholders or directors must meet, what each body is entitled to determine, the nature and timing of notices, and the rights and obligations of dissenting shareholders, to name a few. Matters of governance not specified by the corporate statute will be set forth in the by-laws adopted by the board of directors. A corporation’s by-laws create internal rules for how the corporation will function and establish corporate formalities. In addition, the business corporation law of the state of formation will specify other corporate formalities that must be followed, such as the holding of annual shareholder meetings.

## *Liability*

A corporation has a legal identity separate and distinct from that of its creators and shareholders. Under the law, it is a “person.” As such, a corporation is able to acquire debt, enter into contracts, sue, and be sued.

As a result, exactly what and whose assets might be exposed to those having claims against the corporation becomes an issue of paramount importance to investor/owners. One of the major advantages enjoyed by corporations is the shield against personal liability enjoyed by shareholders/investors. As long as the corporate formalities and requirements are observed and the corporation is adequately capitalized, shareholders, directors, and officers will generally be able to manage the operations of the company without the threat of personal liability for the acts and obligations of the corporation. This shield from personal liability is often referred to as the “corporate veil.”

To maintain this shield of liability, the corporation must be careful to avoid being classified as the “alter-ego” of its shareholders, or a “mere corporate shell.” In either case, state courts will allow a third-party claimant to “pierce the corporate veil” (shield) and bring his/her/its claim directly against the owners of the corporation resulting in the personal assets of the owners being exposed to successful claimants. The courts will find that a corporation is the “alter ego” of an owner(s) where corporate formalities required by the applicable statute or the by-laws are routinely ignored by the owner(s). A corporation will be deemed to be a “shell” where the capital contributed to it by the owner(s) is egregiously inadequate for the business to operate and pay its creditors. To this point in general, in non-financial enterprises there is no state statute requiring a stated amount of minimum capitalization. However, to avoid attacks by creditors alleging that the corporation is “thinly” capitalized and, therefore, that the owners have general liability towards the subsidiary’s creditors, it is necessary that a reasonable amount of capital be invested as capital in the American subsidiary. The amount should be realistic and should be at least roughly equivalent to the anticipated near term debt obligations and operating expenses of the company.

In this regard, one should be aware that there are Internal Revenue Service guidelines relative to the ratio between capital and debt owed to shareholders. The conservative rule of thumb is that the ratio of loans made by the parent to its subsidiary, as compared with capital, should not exceed 3 to 1. If an appropriate ratio is exceeded, there is a possibility that the Internal Revenue Service will take the position that the excess debt is really capital and that interest payments made by the subsidiary to its Swedish parent are really nondeductible dividends.

Absent a piercing of the corporate veil, which requires meeting a very high standard of proof in the courts, a shareholder/investor's liability for the debts, liabilities, acts or omissions of the corporation will be, in all respects, limited to the amount of his/her/its investment (generally, the amount paid to the corporation for the shareholder's stock) in the enterprise.

Factors that could weigh in favor of piercing the shield of liability include comingling of personal and corporate funds, disregard of legal formalities, and, diversion by the corporation of assets to a shareholder to the detriment of creditors.

Limiting personal liability by preserving the corporation's identity and formalities underscores the importance of careful drafting and adherence to the corporation's by-laws and charter documents, in addition to statutory requirements.

### *Taxation*

A corporation is a separate legal person and taxable entity. As such, its earnings and profits are taxed at the entity level, and to the extent any distributions are made to owners of such earnings in the form of dividends or distributions, taxed at the shareholder level, as well. This is commonly referred to as the "double taxation" of corporations:

- **FIRST LEVEL OF TAX:** The corporation is required to pay federal (and state and local, if any) income tax on profits.

- **SECOND LEVEL OF TAX:** When those profits are distributed to shareholders via dividends, distributions in respect of stock or liquidation, those profits are taxed again—as income or capital gains to the shareholders.

### *Limited Liability Companies*

A limited liability company (LLC) can best be described as a blend of the advantages of both a corporation and general partnership (discussed below) without the drawbacks of either form. The LLC combines the pass-through, single level, tax treatment and operational informality (and, thus, flexibility) of a partnership with the general limited liability protections to owners and complete flexibility as to who and how many owners there may be that one finds with a corporation. As with corporations, it is useful to examine the benefits and drawbacks of an LLC in the context of ownership and structuring, liability, and taxation. Increasingly, in many circumstances, LLCs are recommended as the appropriate type of entity for non-U.S. companies to establish a U.S. subsidiary.

### *Ownership and Structuring*

LLCs are created under state law and exist as separate legal and tax entities. Formation of an LLC is simple and inexpensive. An LLC is formed by filing a "Certificate of Formation" with the Secretary of State's office in the chosen state of formation. The governance of the LLC and interests of the members as among themselves and the entity are formalized in an "Operating Agreement," which is required to complete the formation process of an LLC. The owners of an LLC are referred to as "members," as opposed to "shareholders" in a corporation. Unlike partnerships, but like corporations, LLCs may have a single member/owner. This is due in part to the fact that LLCs do not issue stock, but rather membership interests in the LLC. Membership interests may be represented by a written certificate, but no certification is required. Ownership may simply be reflected on an exhibit to the Operating Agreement, which changes automatically as members leave and new members are accepted.

An Operating Agreement is no more than a contract between the members of the LLC to organize and operate a limited liability company. However, unlike corporations, which are necessarily

formalistic by statute, LLCs are creatures of contract between and among the owners giving the founders and subsequent owners great flexibility in the operation, management, and transfer of the entity. Therefore, care should be taken in drafting the Operating Agreement. Unlike a corporation, LLCs are not constrained by statutory formalities. Operation and management are governed entirely by the Operating Agreement, which serves as a living document between the members, which may be amended easily and inexpensively to account for changes in operations, governance, or ownership. Therefore, at any point in time the members have virtually complete freedom to determine how they will own, manage, govern, and take profits and losses from, the LLC. The most common elements of an LLC operating agreement include:

- Powers and purposes
- Structure of management/how decisions are made
- Member contributions to the LLC (initial and subsequent)
- Divisions of profits and losses (does not have to correspond to ownership levels)
- Ownership interests and transfer of ownership
- Tax treatment
- Dispute resolution

Management of an LLC will either be by all the members (member-managed) or by one or more managers (manager-managed). In a member-managed LLC, all of the members of the LLC are responsible for the management of the LLC. All members have a right to participate in the management of the company, subject to any limitations or requirements in the Operating Agreement. The Operating Agreement will specify the vote percentages required in order for the LLC to take various defined actions. In a manager-managed LLC, the members appoint one or more managers to be responsible for the management of the LLC. For an LLC to be manager-managed, the certificate of formation must have stated that the LLC is to be managed by one or more managers. The Operating

Agreement will ordinarily name the initial Manager(s) and detail how Managers may be removed or replaced. The Operating Agreement will often require a “super majority” vote of the members to replace or remove a Manager, thus ensuring that those who control in excess of a majority of the membership interest, also control the day-to-day operations of the entity.

An LLC will ordinarily be manager-managed if the founding members anticipate a need to bring on additional investors as members, but wish to retain control of company management. It is not necessary that a manager be a member of the LLC. Furthermore, a manager may be a corporation or other entity.

### *Liability*

As a separate legal entity, an LLC is capable of suing and being sued. An LLC typically provides the same liability protection to its members for the actions of the LLC, or its manager(s) that a corporation does. Again, this simply means that a member cannot be held liable for the acts or omissions of the LLC beyond the amount the member has contributed in exchange for her membership interest, regardless of the role the member played in the management of the LLC, if any, unless a court allows a creditor to “pierce the veil” of the LLC for the reasons stated above.

As with a corporation, it is possible for a party to pierce this shield of liability and attach the personal assets of a member. When evaluating whether a creditor’s claim can reach the personal assets of a member of an LLC, the most relevant theories of liability are “guarantor” liability and “alter ego” liability. Under guarantor liability, a member can be personally liable for the obligations and wrong doings of the LLC if that member personally guaranteed the LLC’s obligations. Under alter ego liability, the members of an LLC can be personally liable for the obligations of the LLC if the LLC is merely an “alter ego” of its members. The most important factor in this determination is the comingling of personal and LLC funds, or a failure of member(s) to adequately capitalize the enterprise. Absent a piercing of the veil, a member will only be liable to the extent of capital contribution, regardless of their management participation. The only exception to this rule is if the member causes damages to another through the member’s own fraud.

## *Taxation*

An LLC is generally treated as a “pass-through” entity for taxation purposes, meaning that income and losses from the company are passed through, or accounted for, to the members and are taxed only at the member level. This single level tax treatment is similar to that of an S-corporation or partnership, except that LLCs have more flexibility in allocating income or losses to specific investors. Specifically, unlike a corporation, an Operating Agreement may allocate earnings, profits and/or losses to a member, or group of members disproportionately to their respective ownership interests. In addition, employee-owners are required to pay their own payroll taxes (i.e., income, social security, and Medicare) as opposed to having the LLC withhold and remit these taxes to the taxing authority on their behalf. As a result, employee-owners normally experience a high marginal tax liability. However, the total tax expense is likely to be less than if the enterprise is operated as a corporation.

Many non-U.S. institutional investors and companies are hesitant to invest directly in LLCs because of the risk of enhanced tax liabilities from pass-through taxation. Additionally, it should be noted that all of the entity’s earnings and losses must be allocated proportionately to the members each year, whether the entity desires to retain any part of such earnings for growth, or not. This is done by the use of a Form K-1 that the LLC produces and delivers to each member each year that sets forth that member’s share of all of the profits and losses generated by the LLC during the tax year. The LLC will file the K-1’s for its owners with the Internal Revenue Service. Each member must concurrently reflect the amount of profits and/or losses allocated to her in her individual income tax return. Therefore, Operating Agreements will often require that the manager(s) make cash distributions to members each year that are at least enough to cover each member’s individual tax liability caused by the allocation of profits and losses, as shown on that member’s K-1.

LLCs taxed as partnerships and operating a U.S. business can be a tax efficient structure where the owners are all business entities. An LLC can also elect to be taxed as a corporation for U.S. income tax purposes.

## *Partnerships*

Partnerships may be described as “cooperative” business entities, in that at least two “persons” are required to form a partnership. “Persons” can be individuals (U.S. citizens or otherwise), or U.S. or foreign corporations or business entities. More generally, a partnership is a relationship of two or more entities/persons conducting business for mutual benefit. Partnerships are unincorporated business entities, meaning no formal filing is required for formation. Partnerships are formed by partnership agreement, which can be oral or written.

Every state has statutes governing the rights and responsibilities of partners in a partnership. In the absence of a formal partnership agreement, the relationship of the partners is governed by state law and common or decisional law. Far more frequently, a partnership will be formed by a formalized partnership agreement. A partnership agreement generally covers details such as contributions to partnership, management and decision-making, division of profits and losses, compensation, and, ownership interests and transfers. Partnerships have a great deal of flexibility as to how the partnership is to be managed and the duties of the partners to each other. A partnership is not subject to the statutory formalities required of a corporation.

### *Ownership and Structuring*

Two basic types of partnerships exist: **general partnerships** and **limited partnerships**. The main difference between the two is the relationship between the partners, and the fact that in a limited partnership the so-called limited partners do not have a right to participate in the management of the partnership. In return for not having that right, they enjoy the same kind of limited liability as does the shareholder of a corporation, or a member of an LLC. The limited partnership will be managed by one or more general partners, who will be jointly and severally liable for all of the debts, liabilities, acts, and omissions of the partnership. For this reason, the general partner of a limited partnership is usually a limited liability entity, such as a corporation or LLC.

In a general partnership, all partners have the right to have an active role in partnership operations and management, and all partners

have the power to enter into contracts on behalf of the partnership. As a general rule, all partners in a general partnership have the same authority to act on behalf of the partnership.

A limited partnership consists of at least one general partner, which, in turn, is often a limited liability entity, such as a corporation or LLC, which manages and operates the business. A limited partnership has one or more limited partners. As stated previously, limited partners can neither be active in the management of the partnership nor have authority to bind the partnership.

### *Liability*

General partnerships are unlimited liability entities. This means the individual partners are personally liable for all the obligations, liabilities, acts, and omissions of the partnership. In addition to each partner being personally liable for the obligations of the partnership, each partner is jointly and severally liable for the obligations of the other partners. In a limited partnership, a limited partner is only liable for its contribution to the partnership. A limited partner has limited liability, but also limited authority. A limited partner who asserts “too much” authority in managing the partnership runs the risk of losing the limitation on his/her/its liability and being treated as a general partner.

### *Taxation*

Unlike corporations, partnerships are not taxed at the entity level. Instead, partnerships are taxed only at the partner level. Partnerships, like LLC’s, are referred to as “pass through” tax entities because the tax code ignores the partnership as an entity and looks directly to the partners for any tax implications. Similar to LLCs, profits or losses are allocated to the various partners through the use of a Form K-1, even if the profits are retained by the partnership and not actually paid to the partners. Each partner will pay income tax on the profits allocated to it, or deduct losses allocated to it.

### *Other Entities*

Other entities that may of interest for foreign investors doing business in the United States are **joint ventures** and **sole proprietorships**.

Both of these entities have advantages, but are typically reserved for specific types of business ventures.

A **joint venture** is a special partnership for a single business purpose, e.g., development of a product, engaging in research and development, or developing a piece of commercial real estate. The existence of the joint venture is limited in duration to the business purpose of the joint venture. Joint ventures are governed by state partnership law, and are a legal organization that takes the form of a short-term partnership to undertake a transaction. Like a partnership, joint ventures can involve any type of business transaction and the “persons” involved can be individuals, groups of individuals, companies, or corporations. There is no limitation of liability in joint ventures in that each joint venturor is, like a general partner, jointly and severally liable for the liabilities of the venture. The parties allocate financial risks, contribution, and division of profits and losses by a joint venture agreement. It also is possible to organize joint ventures as corporations or LLCs with a shareholders’ (or members’) agreement or joint venture between the joint venture participants to define their business arrangements.

Joint ventures can be a popular mechanism for foreign companies to quickly gain access to the U.S. market. Foreign companies generally bring new technologies and business practices into the joint venture, while the domestic companies already have the relationships and requisite governmental permits and approvals within the U.S., as well as being already engaged in the targeted domestic industry.

Joint ventures are treated as partnerships for federal income tax purposes. A joint venture between a foreign company and a U.S. company may also have international trade law implications. It is important to consider what affect these laws may have, if any, to the overall outcome of the joint venture.

A **sole proprietorship** does not exist as a separate legal entity, but rather an entity owned by a single individual. As such, there is no limitation or shield from liability for the liabilities, debts, acts, or omissions of the business enterprise. The owner of a company doing business as a sole proprietorship assumes all liability for the obligations of such company. In many ways, a sole proprietorship is the most common form of business entity in the United States. This

is because there are no formalities associated with the formation of a sole proprietorship. A sole proprietorship exists, for the purposes of taxation and liability, as soon as an individual does business under a personal name or trade name.

The law makes no distinction between a sole proprietorship and the individual doing business as the sole proprietorship. A sole proprietorship terminates upon the death of the owner because the owner and the company are the same legal entity. Income from a company doing business as a sole proprietorship is taxed as the owner's personal income, similar to that of other pass-through taxation entities discussed above. A sole proprietorship is easily transferrable, since there are no formalities to company formation. Transfer of ownership may be as simple as a trade mark or trade name assignment, since a sole proprietorship exists from the instant an individual does business under a personal name or trade name.

A sole proprietorship is generally a small company with limited assets. Since it possesses no limitations on liability and no mechanisms for capital structure, it is generally an inappropriate entity choice for companies looking to grow and expand through investment and retention of profits in the U.S.

## What entity is right for my business?

All U.S. business entities have positive and negative elements in terms of taxation, limitation on liability, and permitted capital structure. The most appropriate choice of business entity is often determined by the type of business and anticipated needs for fundraising.

**Corporations:** A corporation is ideal for any business that desires strong protection for owners against personal liability and will be seeking significant outside funding from as yet unknown U.S. third parties, but does not need pass-through tax treatment prior to such funding. A corporation is a common choice of entity for many business types, including manufacturing, retail, construction, sale of consumer goods, and biotechnology. The corporate structure is favored if the U.S. operations will require additional capital to be raised from U.S. investors.

**Limited Liability Companies:** An LLC is ideal for any business that desires protection for owners against personal liability, pass-through tax treatment, and substantial flexibility with respect to operations, governance, distributions of profits, allocations of losses, and/or management. Enterprises involving consulting, real estate development, and service businesses are ideal candidates for LLCs. Certain private equity and investment funds that previously utilized limited partnerships, are now adopting the LLC structure.

**General Partnerships:** A general partnership is an appropriate choice of entity for two or more persons who want to start a business quickly and inexpensively. This is particularly true if the business will not be seeking outside investment and has limited liability exposure. For example, accounting firms or law firms are common businesses for general partnerships. Partnerships composed of partners that are already limited liability entities, such as corporations or LLCs, will also eliminate the concern about owners' other assets being exposed to liabilities incurred by the enterprise.

**Limited Partnerships:** Limited partnerships are appropriate for businesses that focus on a single or limited-term project, such as a real estate project or a production project. A limited partnership is also common in "labor-capital" partnerships, where one partner or set of partners (general partners) do the work and the other partners (limited partners) provide the capital, such as a private equity firm or hedge fund. Additionally, if significant new capital does not need to be raised or the long-term strategy for the U.S. enterprises is not focused on selling the U.S. subsidiary in the near future, an LLC may prove to be the most efficient and effective entity of choice.

**Joint Ventures:** A joint venture is appropriate for two or more persons who want to conduct business for a specific purpose and duration, such as development of a product. This can be a valuable mechanism for foreign companies looking to quickly enter the U.S. market. Foreign companies able to bring new technologies and business practices are good candidates to enter a joint venture with a U.S. company that possesses specific industry knowledge and relationships. It is best in this structure if all joint venturers are themselves limited liability entities.

**Sole Proprietorships:** A sole proprietorship is ideal for someone who wants to start a one-person business quickly and inexpensively, provided such business will not be seeking outside investment and has limited liability exposure. For example, a service provider like an accountant would be an ideal candidate, particularly if the service provider can buy insurance to protect against any malpractice claims, thus mitigating some of the unlimited liability exposure facing sole proprietorships.

The choices and reasons for choosing a particular entity are numerous and varied. It is important to enlist the assistance of skilled and experienced corporate legal practitioners in the U.S. to guide and inform this decision.

## Taxation of Businesses Operating in the U.S.

### Why Non-U.S. Companies Generally Do Not Operate Businesses Directly in the U.S.

A foreign entity becomes liable for U.S. taxes if the foreign entity is engaged in a business in the U.S. and the income earned is “effectively connected with the active conduct of a trade or business in the U.S.” Simply put, a foreign entity is considered engaged in a U.S. business when its employees or agents are employed in commercial activity in the U.S. on a regular basis. A foreign corporation is also deemed to be engaged in a U.S. business at any time it is a partner (whether a general partner or a limited partner) in a partnership or LLC that is engaged in a U.S. business.

In general, a non-U.S. corporation (or other entity that is taxed as a corporation for U.S. purposes) is subject to two levels of U.S. federal tax. First, the non-U.S. corporation is taxed as a regular U.S. corporation on its income and gains. The current U.S. federal maximum rate for U.S. corporations is 35%. In addition, a so-called “branch profits” tax is imposed on profits of the non-U.S. corporation. The normal rate is 30%, unless reduced by an applicable treaty. The rate would generally be reduced to 5% under the Sweden-U.S. tax treaty for a qualifying Swedish company.

Unusually for U.S. tax treaties, the rate under the Sweden- U.S. tax treaty can be reduced to 0% in the case of a company that: (1) meets

a “publicly-traded” test, (2) meets an “ownership base erosion” and “active trade or business” test (the erosion test is met if not too much of the Swedish company’s income is paid to non-Swedish residents), (3) meets a “derivative benefits” test, or (4) is granted the benefit by the U.S. competent authority. Many Swedish companies will meet one of these tests and qualify for a 0% branch profits tax.

The branch profits tax is intended to be equivalent to a U.S. withholding tax on dividends paid by a U.S. subsidiary to its non-U.S. parent. But, in fact, it is more onerous, since it is based on a formula for profits and is not triggered by distributions. It can be reduced by reinvesting earnings in the U.S. By contrast, a U.S. subsidiary can decide to defer the withholding tax by simply not paying a dividend. If there is a liquidation of the U.S. subsidiary or sale of the U.S. subsidiary, no U.S. withholding tax is paid on these undistributed earnings.

The branch profits tax is one of the main reasons why non-U.S. companies operate through U.S. subsidiaries. This is because it is automatically imposed based on profits and can be difficult to avoid. However, if a Swedish company qualifies for a 0% branch profits rate under the Sweden-U.S. tax treaty, this reason becomes a nonfactor. The other important reason why non-U.S. companies do not operate directly in the U.S. is to avoid the obligation to file U.S. and state income tax returns.

A U.S. partnership with a foreign partner that is engaged in a U.S. business is required to withhold tax quarterly on a foreign person’s pro rata share of income that is effectively connected with a U.S. trade or business regardless of whether the income has been distributed to the partner. The withholding rate equals the highest corporate tax rate, if the foreign partner is a corporation, or the highest individual rate, if the partner is a non-corporate entity or individual, which is 35% in either case. Generally, a foreign partner is allowed to treat the tax paid by the partnership as a credit against the partner’s U.S. tax liability when the income is reported on the partner’s U.S. tax return.

In addition, U.S. source passive income (i.e., dividends, interest, royalties, rents, etc.) that is received by a foreign investor that is not effectively connected with a U.S. business is subject to a U.S.

withholding tax of 30% absent reductions under a treaty. Withholding taxes are collected through a withholding tax agent when the income is paid to the non-U.S. investor.

## Taxation of U.S. Corporations

Most non-U.S. corporations operate through a U.S. subsidiary. The maximum U.S. corporate federal income tax rate is 35%. State corporate income tax rates generally range from 4% to 10%. State (and local) income taxes are deductible against federal income, which reduces the combined effective tax rate.

A dividend paid by a U.S. corporation to a foreign owner is subject to a U.S. 30% withholding tax, unless it is reduced by a tax treaty. For a qualifying Swedish resident, under the Sweden-U.S. tax treaty, the withholding rate in the case of dividends would be 15% or 0%. The withholding rate is 0% on dividends paid by a U.S. subsidiary to a Swedish parent company, so long as the Swedish parent company (i) has owned 80% or more of the U.S. subsidiary's voting stock during the 12-month period ending on the dividend record date, and (ii) qualifies for treaty benefits as a Swedish tax resident under certain specified provisions of the new "limitation on benefits" rules.

Interest on a loan paid by a U.S. corporation to a non-U.S. lender is generally subject to a U.S. 30% withholding tax, unless it is reduced by a tax treaty. For a qualifying Swedish resident that is the lender, the U.S. withholding tax is entirely eliminated.

Unused losses incurred by a U.S. subsidiary can be carried forward, twenty years for U.S. federal income tax purposes. Once profitable, the U.S. subsidiary can use the loss carry forwards to shelter most of the income from its operations. A special rule (the alternative minimum tax) prevents, however, 100% use of the loss carry forwards and in effect results in a 2.6% federal income tax. Many states permit loss carryovers, but it is becoming more common that such loss carry forwards are severely limited.

## Loans by Swedish Parent Company to U.S. Subsidiary

A useful capitalization technique is for the Swedish shareholder to loan part of the capital needed by the U.S. subsidiary. In that case, the

interest expense reduces the U.S. taxable income of the U.S. subsidiary (which is taxed at a maximum of 35% for U.S. federal income tax purposes). In addition, for a qualifying Swedish shareholder, under the Sweden-U.S. tax treaty, there is no withholding tax on interest income (and there is never withholding with respect to a repayment of loan principal).

There are significant restrictions on related party interest expense. Interest payable to a related foreign party is only deductible when paid, rather than when accrued.

The deduction of interest expense paid or accrued to a foreign related party may also be limited under the U.S. "earnings stripping" rules. These rules limit the extent to which a foreign investor can use debt to strip out earnings of a U.S. company through a deductible expense (interest) that reduces the U.S. tax base and avoids U.S. withholding tax. The earnings stripping rules apply if the debt equity ratio of a U.S. company exceeds 1.5 to 1. If this is the case, the amount of related party interest expense disallowed is the lesser of (a) the amount of interest expense paid to a foreign related party, or (b) the amount by which the U.S. company's net interest expense exceeds 50% of its adjusted taxable income. Any amounts disallowed under this limitation are carried forward indefinitely and are deductible in future years to the extent 50% of the taxpayer's adjusted gross income exceeds its net interest expense.

It is also possible that third-party debt may be impacted under these rules. For example, interest paid to a bank may be subject to earnings-stripping limitations if a foreign related party guarantees the obligation of the U.S. borrower, whether or not the assurance is in writing or whether or not it is legally enforceable. Moreover, back to back loans through an unrelated party cannot be used to avoid the earnings-stripping limitations. For example, if a foreign parent makes a deposit with an unrelated bank and that bank lends the same amount to a U.S. subsidiary and the bank has the right to use the parent's deposit as collateral, the interest paid by the U.S. subsidiary is treated as related party debt subject to the earnings stripping rules.

There is also potentially another limitation that could apply on a loan to a U.S. corporation that has a term in excess of five years and where interest payments are significantly deferred.

Notwithstanding these limitations, the benefits of debt financing are still significant with proper planning.

## Other Ways to Repatriate U.S. Profits

Another way to repatriate profits to Sweden would be to provide for a royalty on use of intangible property (patents, trademarks, copyrights, know-how) owned by the foreign entity and licensed to the U.S. operating subsidiary. Under the Sweden-U.S. tax treaty, the normal 30% withholding rate is reduced to 0%.

The U.S. has in place rules that require royalties to be based on commensurate profitability of the intangible asset. These so-called “super royalty” provisions might be used favorably by a foreign owner to enhance the profitability of valuable IP.

Another technique to repatriate profits is to apply a management or service fee agreement. Payments under a legitimate management fee arrangement may be deductible for U.S. tax purposes if the charges are justified and are based on arms’ length pricing. If the management fees are earned or performed outside the U.S., they would not be subject to a U.S. withholding tax.

In any intercompany pricing arrangement, be it management fees, royalties, or for the sale of tangible property, the transfer pricing rules must be considered. The transfer pricing rules permit the Internal Revenue Service to reallocate or reapportion income and deductions among related companies to reflect arms’ length pricing with respect to any intercompany transactions.

A major concern of the Internal Revenue Service is that foreign companies historically have artificially manipulated their transfer pricing in order to minimize their U.S. income tax. There are significant penalty provisions that apply where transfer pricing is not economically justified and thoroughly documented. The non-deductible penalties range from 20–40% of the tax deficiency.

The Internal Revenue Service would insist that any sales or other transactions between a foreign company and its U.S. affiliate reflect arms’ length prices. Section 482 of the tax law is intended to ensure that transfers between related taxpayers take place on an arms’ length

basis. The law authorizes the Internal Revenue Service to reallocate income, deductions, or credits between or among related taxpayers to prevent the evasion of taxes or to clearly reflect income. The arms’ length standard requires that the prices charged in intercompany transactions be consistent with results that would have been realized if uncontrolled taxpayers had engaged in the same transactions under the same circumstances. The regulations describe several transfer pricing methodologies, including the comparable uncontrolled price method, the resale price method, the cost-plus method, the profit-split method, and the comparable profits method. The Internal Revenue Service would require the best method to be utilized. The bottom line is that the Internal Revenue Service would want to see that the U.S. affiliate is not being overcharged in purchasing a product and that it is earning a fair profit on the resales (say, perhaps 3% to 6%). The Internal Revenue Service would want to ensure that the U.S. affiliate has a profit after payment of its operating and overhead costs. If the Internal Revenue Service audits the U.S. affiliate and determines that the profits are substantially understated, it may impose a 20–40% understatement penalty on the shortfall of taxes. Taxpayers can protect themselves from the penalty if they keep proper documentation establishing that the prices charged were fair and at arms’ length. Thus, ideally, it is advisable to obtain studies from an economist to establish a fair transfer price. In some situations, the revenues involved do not merit spending a considerable amount of money on a full-blown economic study that would provide certainty against the imposition of the substantial understatement penalty. However, we would recommend that at least some guidelines be obtained from an economist regarding a fair profit margin.

Because of this increased Internal Revenue Service scrutiny, many companies consider screening an advance pricing agreement with the Internal Revenue Service. This is an agreement where facts are provided and the Internal Revenue Service pre-approves the transfer pricing methodology to be applied to intercompany transactions. Generally speaking, an advance pricing agreement is a complex and costly process and is not to be taken lightly.

Another limitation on the transfer price for goods imported into the U.S. is that an importer may not claim a transfer price for income tax purposes on goods purchased from a related party that is higher than what was claimed for U.S. custom purposes.

## Taxation of U.S. Real Property

There is an important exception to the rule that foreign persons are not subject to U.S. tax on income that is not effectively connected with a U.S. business. That exception relates to dispositions of U.S. real property interests. The gain on the sale or exchange or other disposition of U.S. real property (land and buildings) is taxed at regular U.S. tax rates after reduction for appropriate deductions.

This rule is expansive in scope. It applies not only to direct investments in real property, but also includes dispositions of the stock of a U.S. corporation that is considered a U.S. real property holding corporation. Stock of a U.S. corporation is presumed to be a U.S. real property holding corporation unless it is established that the fair market value of its U.S. real property is less than 50% of the market value of all of its assets. Alternatively, a book value test might be applied with the presumption that if 25% or less of the total book value of the company is U.S. real property interests, then the company is not tainted under the rules.

One of the usual steps in any due diligence in the acquisition of a U.S. company is to determine whether a stock acquisition might give rise to U.S. real property holding company characterization. These rules can override the normal non-recognition rules and cause an otherwise non-taxable transfer of shares of a U.S. corporation to be taxable. Any person acquiring the stock of a U.S. company from a foreign person is responsible for collecting a withholding tax unless the buyer determines that the stock is not a U.S. real property interest. Therefore, careful attention to this matter is of utmost importance.

## State and Local Income Taxation

Most states impose income tax rates ranging from 4% to about 10%. A few local governments, such as cities (including New York City), also impose income taxes. Businesses are subject to state taxation if they have “nexus” in the state. Nexus should be thought of as the minimum contacts necessary to subject a company to a state’s income tax. Generally, mere solicitation of business is not enough to create nexus, but more must be done such as having an office in a state or buying and holding inventory in a state.

Although many state corporate income tax laws are similar to the federal rules, there are significant differences.

The federal tax system allows a deduction for state and local income taxes. Therefore, the true out-of-pocket impact for state and local taxes is less than the statutory rate. Moreover, many states provide incentives for investment within the state that also could reduce the true out-of-pocket costs.

Businesses that operate in more than one state are required to apportion their income among the states. Generally this is done on a three-factor formula that includes relative amounts of sales, payroll, and property located in each state. Many states, such as California, impose a tax under a “unitary” tax method. This serves to allocate profit of related entities involved in the same or related businesses to a particular state based upon the three-factor formula even though the operations in a particular state may be conducted by only one of the related entities and that entity’s activities may be unprofitable if accounted for on a separate entity basis.

The unitary system allocates profit either on a water’s edge method (only related U.S. entities) or combined worldwide reporting (related entities throughout the world).

## Distribution Arrangements between Swedish Suppliers and Their U.S. Subsidiaries: Avoiding a U.S. Permanent Establishment and Other U.S. Tax Matters

Many suppliers of products from Sweden and other non-U.S. countries seek to distribute their products in the U.S. through their wholly-owned U.S. subsidiaries. In doing this, a Swedish supplier should attempt to structure its operations to avoid being treated as a U.S. permanent establishment under the Sweden-U.S. income tax treaty. If the U.S. business activities are carried out by a U.S. subsidiary but are not structured properly, the Swedish supplier may be deemed to have a U.S. permanent establishment. If a U.S. permanent establishment exists, the Swedish supplier will be required to file U.S. federal and state income tax returns and pay U.S. federal and state income tax on a portion of its profits attributable to the U.S. operations.

The following discussion addresses how to structure a distribution arrangement between a Swedish supplier and its U.S. subsidiary so as to avoid a U.S. permanent establishment. It also discusses how the Swedish supplier may still need, in order to claim an exemption under the Sweden-U.S. tax treaty, to file a protective U.S. federal income tax return showing no U.S. income and to disclose the treaty-based position. Failure to file such a return (or an extension) by March 15, 2012, for example, may result in a \$10,000 penalty being imposed for calendar year 2011.

#### *Conducting a Trade or Business in the U.S.*

A Swedish corporation that at any time in a year has income that is “effectively connected with the conduct of a trade or business within the United States” will be subject to U.S. federal income tax.

Whether a Swedish supplier will be treated as conducting a U.S. trade or business depends on all the facts and circumstances. The threshold level of activity is relatively low. Any one of the following activities could subject a Swedish supplier to U.S. federal income tax:

- The Swedish supplier ships goods to the U.S. and title to the product passes in the U.S.
- The Swedish supplier’s employees or agents travel regularly in the U.S. to make sales calls or to engage in marketing activities, demonstrate products, or solicit orders.
- The Swedish supplier’s employees or agents travel regularly in the U.S. to assist customers with installations, training, or servicing products.
- The Swedish supplier stores product at a warehouse in the U.S.

#### *U.S. Treaty Protections — Permanent Establishment*

A Swedish supplier that has income that is effectively connected with a U.S. trade or business may not be liable for U.S. federal income tax if the Swedish supplier is entitled to claim the benefits of the Sweden-U.S. income tax treaty. In a typical U.S. income tax treaty, a non-U.S. corporation will be subject to U.S. tax on its business profits only if it carries on business in the U.S. through a U.S.

“permanent establishment.” A permanent establishment is a fixed place of business through which a non-U.S. corporation carries on a business, including (i) a place of management, (ii) a branch, (iii) an office, or (iii) a factory.

Under the Sweden-U.S. and many other U.S. tax treaties, the following fixed places of business are not considered a permanent establishment:

- The use of facilities for storage, display, or delivery of goods or merchandise;
- The maintenance of a stock of goods or merchandise for storage, display, and delivery or for processing by another person;
- The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing another enterprise; and
- The collection of information in the U.S.

In addition, in most U.S. treaties, advertising, supplying information, or scientific research done in the U.S. that is preparatory or secondary to the business does not rise to the level of a permanent establishment.

Accordingly, a Swedish supplier that maintains a stock of inventory in a U.S. warehouse will not by that reason alone be treated as having a U.S. permanent establishment. However, as discussed below, such a Swedish supplier will still have certain U.S. tax return filing requirements, which if not met may result in the imposition of harsh penalties.

#### *U.S. Subsidiary Acting as an Agent That Creates a U.S. Permanent Establishment*

A Swedish supplier may be treated as having a U.S. permanent establishment if its U.S. operations are carried out by a U.S. subsidiary acting as an agent. The idea seems to be that since a non-U.S. company that conducted business in the U.S. itself would have a U.S. permanent establishment, it should not be able to avoid

permanent establishment treatment by conducting business through a U.S. agent where the non-U.S. company continues to bear the risk of loss and exercise control over the U.S. operations.

A Swedish supplier may be treated as having a U.S. permanent establishment if the U.S. subsidiary has the authority to negotiate and conclude contracts in the name of the Swedish supplier and regularly exercises that authority. To avoid this treatment, at a minimum the Swedish supplier must approve the prices and contracts outside the U.S. Close questions may arise if a course of conduct is established whereby the U.S. subsidiary regularly negotiates the price and other important terms with the U.S. customer and the terms are typically approved by the Swedish supplier without change.

In addition, a Swedish supplier may be treated as having a U.S. permanent establishment if the Swedish supplier has a stock of goods belonging to the Swedish supplier from which orders are regularly filled by the U.S. subsidiary on behalf of the Swedish supplier.

Even if neither of the circumstances in the above two paragraphs is present, a U.S. subsidiary could be treated as an agent that gives rise to a permanent establishment if the Swedish supplier bears substantially all the risks of the operations in the U.S. and exercises control over the manner in which U.S. operations are carried out. This issue is exacerbated in the case of a parent company-subsidary relationship, where the subsidiary has virtually an exclusive relationship with the parent company.

#### *Distribution Arrangements*

The standards discussed immediately above regarding how a U.S. subsidiary is utilized could result in a Swedish supplier being treated as having a U.S. permanent establishment, and, therefore, not entitled to the benefits of the tax treaty, need to be considered in structuring a distribution arrangement between the Swedish supplier and its U.S. subsidiary and in drafting a distribution agreement. Some common distribution arrangements in the U.S. are as follows.

Independent Distributor Model. Under this approach, the U.S. subsidiary acts as an independent company and distributor. The Swedish supplier sells its product to the U.S. subsidiary, with title

passing outside the U.S. The U.S. subsidiary performs the marketing and sales efforts in the U.S., makes the sales to U.S. customers, and bears the risk of loss that the product in the U.S. will be damaged, that prices will fall, or that the U.S. customer does not pay. Because the U.S. subsidiary bears substantially all of the risk of loss, the U.S. subsidiary typically will have higher profits than under other approaches. From a business perspective, the independent distributor approach may be used if there is a desire for U.S. customers to deal with a U.S. company. Since this approach carries the lowest risk that the Swedish supplier/parent will be deemed to have a permanent establishment in the U.S., it is, in our view, the favored structure.

Commission Model. Under this approach, the U.S. subsidiary serves as the sales representative or commission agent for the Swedish or other non-U.S. supplier. The U.S. subsidiary solicits sales in the U.S. Actual sales are made by the Swedish supplier to the U.S. customer from inventory maintained by the Swedish supplier in a warehouse in the U.S. The Swedish supplier bears the risks that the product will be damaged in storage, that prices will decline, and that the customer does not pay. Because the Swedish supplier bears substantially all of the risk of loss, the U.S. subsidiary typically will have lower profits than under other approaches. The U.S. subsidiary must bear the risk that its sales and marketing efforts will not be adequate to pay the cost of its operations. Depending on how operations actually are conducted, this approach carries some risks that a permanent establishment will be found.

Consignment Model. Under this approach, the U.S. subsidiary markets and solicits sales from U.S. customers. In form, the U.S. subsidiary sells product directly to the U.S. customer. At the time a sale is made, title to the product transfers from the Swedish supplier to the U.S. subsidiary and then from the U.S. subsidiary to the U.S. customer. Accordingly, title is with the Swedish supplier while the product is stored in a U.S. warehouse. However, the U.S. subsidiary bears the risk that the customer will not pay. The U.S. Internal Revenue Service permitted this arrangement in a letter ruling where the U.S. subsidiary bore the cost of shipping and the risk of loss of damage to the product while it was in the U.S. Due to risk of loss considerations, the U.S. subsidiary typically will have more profits under this approach than under the commission approach.

Commissionaire Model. In a commissionaire approach, which is common in Europe, the distributor acts in its own name but for the account of the principal. However, using a commissionaire will often lead to a permanent establishment in the U.S., unless the agent fully acts as an independent agent.

#### *United States Income Tax Return Filing Requirements*

##### Effectively Connected Income But No U.S. Permanent Establishment.

If a Swedish supplier has income that is effectively connected with a U.S. trade or business (for example, by maintaining a stock of product in a U.S. warehouse), but does not have a permanent establishment in the U.S. under the Sweden-U.S. income tax treaty, the Swedish supplier must still file a U.S. corporate federal income tax return. The Swedish supplier must file to disclose the U.S. source income and the treaty-based position. The return can show zero U.S. taxable income. If the Swedish supplier is uncertain as to whether it has income that is effectively connected to a U.S. trade or business, it may want to consider filing a U.S. federal corporate income tax return as a protective measure.

If a filing is required, the due date for filing generally is the 15th day of the 3rd month following the end of the fiscal year of the business. If the fiscal year is a calendar year, then the filing deadline for 2011 is March 15, 2012 (an extension can also be filed).

If a Swedish supplier files late, but no tax is due because of the treaty exemption, no interest and penalties will apply if a second deadline is met. For corporations, this deadline is 18 months after the original due date. This extended due date may provide a Swedish supplier with an opportunity to avoid interest and penalties from the failure to file a U.S. tax return for 2011.

If a corporate Swedish supplier misses the second deadline and relies on a treaty position to claim an exemption, a penalty of \$10,000 may be charged for each item of income. It is possible that the penalty could be waived if the Swedish supplier establishes to the satisfaction of the Internal Revenue Service that the failure was not due to willful neglect.

Non-U.S. Supplier Has Taxable Presence in the U.S. If a Swedish supplier has income that is effectively connected to a U.S. trade or

business and there is no treaty that applies to exempt the income, or a U.S. permanent establishment in fact exists, the same filing requirements set forth above apply. A corporate parent must pay normal U.S. federal income tax rate on net income plus the branch profits tax (5% under the Sweden-U.S. tax treaty). If a corporate Swedish filer misses the second deadline, it may be denied the ability to use deductions and may be taxed on its gross income. Accordingly, it may be important for a Swedish supplier that does not believe it is subject to U.S. federal net income taxation to file a “protective return” showing zero U.S. taxable income in order to protect its ability to claim deductions in case the Swedish supplier is later determined to have a taxable presence in the U.S.

#### *U.S. Federal Transfer Pricing Rules*

In order to comply with U.S. federal income inter-company transfer pricing rules, the charge to the U.S. subsidiary for the product (if there is a sale to the U.S. subsidiary) or the commission paid to the U.S. subsidiary (if there is a commission earned) should be an arms’ length amount. The arms’ length standard requires that prices charged in inter-company transactions be consistent with results that would have been realized if uncontrolled companies had engaged in the same transactions under the same circumstances. The section 482 regulations describe several transfer pricing methodologies, including the comparable uncontrolled price method, the resale price method, the cost-plus method, the profit-split method, and the comparable profits method. The U.S. Internal Revenue Service requires the best method to be utilized. If the Internal Revenue Service audits the U.S. subsidiary and determines that its profits are substantially understated, it may impose a 20% or 40% understatement penalty on the shortfall of taxes. Taxpayers can protect themselves from the penalty if they keep contemporaneous documentation supporting the position that the prices charged were fair and at arms’ length.

#### *U.S. State Taxation*

Even if a Swedish or other non-U.S. supplier does not have a U.S. permanent establishment, the states in which the non-U.S. supplier has “nexus” have the power to impose state income tax. Technically, states are not bound by U.S. treaties. In general, it is easier for a Swedish supplier to have nexus in a state than to have a permanent establishment. A Swedish supplier may have nexus in a state if it

regularly maintains a stock of product in the state, or if its employees or dependent agents enter the state to conduct business more than a few times per year. New York State, for example, requires a company that has nexus with the state to file tax returns and to pay tax on the portion of worldwide taxable income of the company that is allocated to the state. Although the amount of tax may be small, there are penalties for not filing the return.

In addition, state sales tax needs to be considered. If a Swedish supplier has title to products in the U.S. and the products are sold to the U.S. subsidiary for ultimate sale to the U.S. customer (for example, under the consignment approach), state sales tax typically may be avoided if a “resale” certificate is issued by the U.S. subsidiary. However, in order to claim the resale exemption, the Swedish supplier generally must register with the state. If a Swedish supplier sells directly to the U.S. customer and the transfer of title occurs in the state (for example, in a commission arrangement), the Swedish supplier must withhold the applicable sales tax and remit it to the state.

Each state also has its own tax return filing requirements and deadlines. These typically differ from the U.S. federal income tax return requirements and deadlines.

#### *What to Do*

Swedish suppliers that distribute products in the U.S. through their U.S. subsidiaries need to pay careful attention to U.S. federal income tax rules, as well as to state and local income tax and sales tax rules. For example, even a Swedish supplier that can claim an exemption from federal income tax under the Sweden-U.S. income tax treaty may still be required to (i) file a protective U.S. income tax return with the proper form attached taking the treaty position, (ii) file a state income tax return and possibly pay state income tax, and (iii) file state sales tax returns and possibly pay state sales tax. Failure to comply with any one of these requirements can result in substantial penalties.

## Protecting Intellectual Property in the U.S.

Original writings, inventions, processes, and discoveries are constitutionally protected in the United States. Article I, Clause 8 of the United States Constitution declares that:

The Congress shall have power to promote the progress of science and the useful arts by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries.

Various processes and mechanisms have been established in the United States that must be complied with in order to secure the protections guaranteed by the U.S. Constitution. Basically, inventions, processes, and discoveries may be entitled to the issuance of a patent by the United States Patent and Trademark Office (“USPTO”) or they may be maintained as a “Trade Secret” without registration of any kind. Likewise, original works of authorship, including writings, music, works of art, photographs, software, etc. are protected upon creation by common law, but can be further protected by registration with the U.S. Copyright Office. Trademarks may be protected at common law as well, although, as discussed below, there are many benefits to the federal registration of trademarks in the U.S.

#### *Patent Protection*

Inventors may file an application with the United States Patent & Trademark Office, together with a required fee. If a patent is granted, based on meeting the standards of patentability, the inventor/owner will have the right to exclude others from making, using, selling, offering for sale, or importing the claimed invention for a period of 20 years from the date the application was filed, 17 years for applications filed prior to June 8, 1995. Further, the inventor/owner will have the right to exclude others from exporting component parts to be assembled into an infringing device outside the U.S. and/or importing an infringing device assembled outside the U.S. During this exclusionary period, no one may use the claimed invention or process without express permission of the patent holder. This permission is often granted in the form of exclusive or nonexclusive, royalty paying or nonroyalty paying, defined territorial or worldwide licenses. The trade-off for the market exclusivity granted to the patent

holder is that the existence of the invention, as well as its operational and mechanical characteristics becomes public information because all filings with the USPTO are (or become) public documents within 18 months of filing of the patent applications.

The application process can be lengthy and expensive, depending on the technology and the subject matter pursued in the claims. The process involves the filing of a written application that specifically sets forth the background of the invention, including a discussion of relevant technology in general, problems encountered in such technology, so-called “prior art” which details other ways in which the technology has been approached in prior writings, and, a brief description of the invention, its mechanical operation and make-up, which often includes schematics, drawings and examples. In other words, the application must teach the public how to make and use the claimed invention. A detailed description of the invention must be included, which set forth what the invention can, or is intended to do. The goal of the application is to fully support the “Claims” for the invention, which, in turn, will define the reach of the patent’s protection.

The construction of an application and the Claims being made must follow well established protocols. It is critical to retain the services of an experienced patent lawyer to develop and create the application and the Claims being made. The reason for this is that in the current state of intellectual property law in the United States patent infringement cases will routinely rise or fall on the basis of the completeness, or lack thereof, of the support for the Claims set forth in the original application.

It should be noted that only the inventor is entitled to file a patent application. It is common for U.S. companies to have their employees execute agreements whereby the employee-inventor agrees that any ideas, inventions, or discoveries made by him/her in the course of employment, or using the employer’s assets, facilities, or equipment, are the property of the employer, and that the employee agrees to assign his or her rights in the invention to the employer at the employer’s request.

The application is filed with the USPTO, together with fees that vary depending on the size of the entity filing the application (e.g.,

not-for-profit, small business, or large corporation), the number of pages, the number and types of claims submitted, and whether the application is filed electronically. The filing date establishes the beginning of exclusivity for the patent, if it is subsequently awarded (excluding the one-year period for provisional patent applications). The filing date also provides the “priority date” after which public domain materials cannot be applied against the Claims.

The application will be examined by a U.S. Patent Examiner (“Examiner”) at the USPTO who has expertise in the relevant technology as reflected in the Claims. The Examiner will search the public record for “prior art,” which includes issued patents, or previously filed applications containing the same or similar invention or technology.

The Examiner also reviews the Claims against the standards for patentability to determine whether any or perhaps all of them should be rejected as unpatentable or already subject to an issued patent. If the Examiner rejects any of the Claims, the applicant will be notified in writing and will have a specified period of time (generally six months with the payment of fees) to respond to the Examiner’s determinations by either amending the Claims or arguing that the Claims, as presented, are patentable. Assuming the Examiner’s objections can be overcome, the Claims are allowed and the application will mature into a granted patent.

In the event the Examiner and the Applicant cannot agree on any objections issued by the Examiner, the application will either be abandoned by the applicant or the matter may be appealed to the Board of Patent Appeals and Interferences (“BPAI”). The BPAI is an administrative law body within the USPTO, but reviews the Examiner’s position without bias. Appeals before the BPAI are typically conducted in writing, although oral hearings can be requested. Additional appeals are available in the U.S. courts.

As noted, allowed patent Claims will not become a granted patent until fees are paid to the USPTO. Further, maintenance fees must be paid to the USPTO due 3 ½, 7 ½, and 11 ½ years after grant of the patent in order to keep the patent in full force and effect.

Patents may be awarded for (1) processes—the method or process for doing something, (2) machinery or mechanical devices—a combination of mechanical elements, (3) an article of manufacture—a tangible product that has been manufactured or changed by human effort, and/or (4) a unique composition of matter (including many life forms) or chemical compounds. Although the USPTO has issued business method patents to protect a specific methodology of conducting business, this practice is under increased negative scrutiny. Such patents could include patents on software.

In order to be patentable the claimed subject matter must have:

- “novelty”—the invention must be distinguishable from the existing “prior art”;
- be “non-obvious”—it must not have been obvious to a person of ordinary skill familiar with the state of the art, which supports the patentable subject matter at the time the invention is created (akin to “inventiveness” in the European Patent Office); and,
- have “utility”—it must be useful in ordinary life.

As stated previously, an issued patent will provide the owner with the right to exclude others from making, using, selling, or importing the claimed invention, process, or item subject to the patent for 20 years from the date of the filing of the application. It should be noted that a patent holder does not necessarily have the right to practice its invention, although it can prevent others from practicing its invention.

The current judicial climate in the United States is very supportive of the protection of issued patents. The reason for this is that, by applying for patent protection, the inventor has already relinquished any possibility of keeping the knowledge of the invention, and its mechanical characteristics, confidential. Therefore, the economic benefit that should inure to the inventor to compensate him/her for the innovative thought and effort that went into the creation of the invention will be lost unless the courts aggressively protect those rights. For this reason, it is very important to be attentive to the patent rights of others in order to avoid a time consuming and expensive infringement claim in which the patent holder will have a significant advantage. Often it is good insurance to retain the services

of an experienced patent attorney to determine whether a patent infringement suit is possible and, if so, the chance of its success, before proceeding with activities that might infringe the protected rights of others.

#### *Trade Secret Law*

An inventor has an alternative means of protecting his/her invention in the U.S. by treating it as a Trade Secret. A Trade Secret may consist of any formula, pattern, device, or compilation of information that is used in one’s business and provides an advantage over competitors who do not know of it or use it. Obviously, the protection of intellectual property as a Trade Secret is entirely in the hands of the owner of the invention. It will remain protected so long as no member of the public learns of it. However, if the Trade Secret enters the public domain through any means, including by way of a breach of contract or breach of faith by one who has knowledge of it, the protection of the Trade Secret will be lost forever.

The most well-known example of a Trade Secret and how effective it can be is the formula for Coca-Cola. If this formula were patented, it would have become public knowledge in the late 1800s, and, therefore, useable by any member of the public by the early 1900s. Today, more than 100 years after its invention, the formula remains protected as a Trade Secret.

Even though disclosure of a Trade Secret in the public domain will essentially eliminate its protectability, there would be a cause of action against anyone who violates a confidential relationship or unlawfully obtains a Trade Secret with the intent to use it or disclose it in the public domain. If such a state of facts is discovered by the inventor before the Trade Secret becomes public knowledge, it is possible to obtain court protection of the Trade Secret in the form of an injunction. In such an event the Trade Secret protection of the information would be preserved. However, as a practical matter, such cases are rare since oftentimes the first knowledge of a problem is when the Trade Secret enters the public domain.

As between patent protection and the use of a Trade Secret to protect intellectual property, patent protection has the following advantages:

- (a) Trade Secrets are difficult to define while patent protections are defined by their Claims.
- (b) Trade Secret protection, unlike patents, requires that secrecy be absolutely maintained.
- (c) Trade Secret protection DOES NOT prevent others from independently developing and using the same idea nor does it protect against reverse engineering of the invention or ideas off of what the Trade Secret holder sells into the public marketplace.
- (d) Effective injunctive relief is very difficult to obtain against a Trade Secret misappropriation, while injunctions are routinely imposed against patent infringers.

Some of the advantages of protecting intellectual property through the use of Trade Secrets over patents are:

- (1) Unlike patents, which have a specified timeframe for effectiveness, Trade Secrets may last as long as secrecy can be maintained. The Coca-Cola formula has been protected for more than 100 years.
- (2) Trade Secret protection is available for an invention, process, mechanical device, or formula that may not be patentable in accordance with current standards.
- (3) Patent applications fully disclose all aspects of the invention, which therefore becomes public knowledge.
- (4) There are no filings or other administrative procedures that must be met in order to obtain Trade Secret protection. Rather, one must simply keep the invention a secret.

#### *Trademarks and Trade Names*

Trademarks, trade names, and trade dress (“Marks”) may all be granted significant protection at the federal level in the United States. In today’s economy, as is the case with all intellectual property, the value of a company is in large part a function of the intellectual property that it owns and has protected.

A trademark could be any word, name, symbol, slogan, package design, or other unique attribute or combination of such attributes that serves to identify and distinguish a specific product or service from others in the trade or marketplace. Trademarks could include the name of a company, or a specific product or product line (brand marks), a name or mark that distinguishes the services offered by one company from those offered by another (service marks), the designation of the quality of the product, the materials contained in a product or their origin (certification mark), the identity of the members of a collection or group (collective marks), and the look and feel of an object or product, including the color, shape, size, and physical identity of packaging (trade dress).

The protection of trademarks, trade names and trade dress is straight forward and relatively inexpensive in the United States. A detailed application is filed with the USPTO, together with a relatively nominal fee of currently \$325.00 per International class. (As in many other countries, including Sweden and the European Union in general, the USPTO classifies the goods and services with which a trade or service mark will be used and/or registered, into various International Classes, in part to assist with searching for similar marks.) Depending on the application filing basis (use, intent-to-use, foreign application, or registration, or Madrid Protocol), the USPTO could require that an applicant provide a specimen of use of the mark in commerce in or with the U.S. prior to registration.

Once filed, the application is reviewed by an Examining Attorney at the USPTO to ensure that the requested Mark, name or trade dress is distinctive, appropriate, and unlikely to mislead, confuse, or deceive consumers. The Examining Attorney will review all prior registered marks and pending trademark applications to determine whether the applied-for mark is confusingly similar to any of these registered or pending marks. The standard used by the USPTO is “likelihood of confusion” not actual confusion. In other words, the trademark Examining Attorney will essentially compare the marks and the goods/services to determine whether there is likelihood that consumers in the marketplace will be confused by the use of the proposed mark in the same industry as other marks. The trademark Examining Attorney will also examine the application to determine whether it meets all other statutory requirements, including whether the proposed mark is merely descriptive of the goods/services or

primarily geographically descriptive of the goods/services, as well as many other requirements. The USPTO only examines marks registered or pending at the USPTO. It does not perform a search of common law rights.

If the trademark Examining Attorney locates an already registered mark, or an application for a confusingly similar mark with an earlier filing date, the Examining Attorney will issue an “Office Action” refusing registration and granting the applicant six months in which to amend its application or argue against (and overcome) the Examining Attorney’s refusal to register. If the applicant is able to satisfy all of the Examining Attorney’s requirements and overcome any issued refusals, the mark will be approved for publication. If the applicant is unable to satisfy all requirements and/or overcome any refusals, the trademark Examining Attorney will issue a second, usually “final” trademark Office Action that will essentially deny the Mark registration.

An approved application will be published in the *Federal Register* for a period of 30 days in order to give other persons or entities who believe they would be damaged by the registration of the mark the opportunity to object to its registration. The trademark opposition process is similar to federal court litigation, with the exception that evidence and testimony are submitted in writing rather than through an in-person trial process. Further, it should be noted that decisions of the Trademark Trial and Appeal Board relate only to the registerability and registration of marks, and not to whether these marks can be used in commerce. In other words, even if an applicant loses an opposition proceeding, it could still use the mark in commerce unless the opposer brought a successful federal court litigation resulting in an injunction. It should also be noted that opposition proceedings are generally less expensive than federal court litigation, although such proceedings can often cost more than \$100,000.

If an applicant is unable to satisfy the requirements of the trademark Examining Attorney, or if an applicant is unable to overcome refusal(s) issued in a second (“final”) Office Action, an appeal can be taken to the Trademark Trial and Appeal Board. The Board may,

at its discretion, overrule the Examining Attorney and allow an application to be registered (or published for opposition) over the Examining Attorneys objections.

In the event no third party objects to the registration of the mark, the application will proceed to registration, depending on the filing basis and whether the applicant has filed documents showing that the mark is in use in commerce in or with the U.S. If an application was based on the intention to use the mark in commerce, there must be a showing that the mark is used in commerce before registration will issue. A number of extensions are allowed by the USPTO to show use. Once “use” is shown, registration will be granted, and the effective date of use will be the application filing date.

Because trademark rights in the U.S. are based on use, not registration, a prior user of an unregistered mark could claim trademark rights in its geographic trading area that are superior to the rights of the owner of a federal trademark registration with a subsequent first-use date. Thus, even after a mark is registered, it remains vulnerable to an attack by the owner of a confusingly similar mark, even if that owner has not registered its mark. We note that after the fifth anniversary of the registration of a mark, we recommend filing documentation with the USPTO precluding, or at least severely limiting, such an attack. To reduce the risk of an attack by such an unregistered user, we generally recommend a search, prior to filing an application, of not only the records of the USPTO, but of common law records as well, to determine whether a potential mark is available for use as well as registration.

A registered mark will be valid so long as it remains in use and does not become generic (i.e., Aspirin or Kleenex) and the owner files timely Declarations with the USPTO over the life of the mark attesting to its use in commerce in or with the U.S. Even marks registered in the U.S. based on a registration or registrations in other countries, which do not require proof of use of mark prior to registration, must file such periodic Declarations. Currently, between the fifth and the sixth anniversary of the date of registration, a Declaration of use must be filed with the USPTO to maintain the registration. Then, between the ninth and tenth anniversary of the date of registration, and every ten years after that, a Declaration of use must be filed

with the USPTO to maintain the registration. It should be noted that these use requirements are different from the requirements of most other countries.

Upon obtaining a federal trademark registration, the registrant is entitled to use the registration symbol, “®,” with its mark. In the alternative, the “TM” or “SM” symbols, which can be used even during the pendency of the application, can be used to provide notice to the public that a company is claiming trademark rights in a mark.

Registration of a trademark, trade name, or trade dress with the USPTO carries with it a number of very distinct advantages. A registration on the principal Register provides prima facie evidence of the registrant’s ownership of the mark and its exclusive right to use the mark in commerce. In other words, there is a presumption that the owner of a federal trademark registration has the right to use that mark in commerce anywhere in the United States. Federal registration also allows the owner of the mark to access the federal judiciary system to protect it, to obtain damages from infringers, and to enjoin others from unauthorized use of the mark in the United States. It also enables the owner to prevent the importation into the United States of products that infringe the owner’s mark. U.S. federal law contains very strong anti-counterfeiting measures for the benefit of the owners of registered marks. The registration of a mark at the USPTO facilitates the further registration of the mark in foreign jurisdictions and prohibits the states from interfering with the use or display of the mark.

One additional advantage of filing a trademark application in the U.S. is the ability to file such an application before the mark is in use. Such an application, called an “intent-to-use” application, entitles an applicant to claim its application filing date as its effective first use date upon registration. Because trademark rights in the U.S. are based on use not registration, this effective filing date can prove vital in protecting trademark rights in the U.S. Therefore, an application for registration may be filed with the USPTO either before the mark is used in the public domain, or after.

As stated previously, the United States legal system puts a high value on the ownership of registered marks and provides a number

of significant protections against infringement. These potential protections include the granting of injunctions, the ability of a mark’s owner to obtain damages for unauthorized use, including seeking lost profits against the infringer, allowing the owner of the mark to force the recall of infringing products and goods, allowing the owner to recover monetary damages and costs for a proven infringement, and the leveling of severe fines for the intentional counterfeiting of registered trademarks. While monetary damages are possible, in many cases, the best result to be expected in a claim of trademark infringement is an injunction.

The protection of trademarks is the subject of a coordinated effort among a large number of jurisdictions. The Madrid Protocol Implementation Act allows the owner of a mark registered with the USPTO to file a single application for registration with more than 80 member countries. Obviously this will reduce the cost of transactions and enforcement, increase the scope of protection as more countries join the Protocol, reduce the number of marks that the owner must maintain, and allow for the renewal or transfer of a mark amongst all the countries in the Protocol by one application. That being said, there are some inflexibilities built into the international application and registration process, including that the failure of an application or mark in its home jurisdiction will render it void in all member jurisdictions, there is no ability to amend a registered mark under the Madrid Protocol, and the due diligence search necessary for new marks will be necessarily expanded.

#### *U.S. Copyright Law*

Copyright is an exclusive common law property right that protects original works or expressions of an idea or information, and renders such property to the exclusive ownership of its creator. Copyright may protect a wide range of artistic, creative, or intellectual works, including literary works, movies, musical works, sound recordings, art (including paintings, designs, sculptures and compositions), photographs, software, and industrial designs. Copyright protects only the work, expression, or ideas as they are presented in a document, recording, film, or other media. Copyright does not protect the actual concepts, facts, or techniques that are embodied in the protected work.

By common law, copyright protection attaches from the moment the work is created, so it is possible for two independent parties to create the same work simultaneously. Once created, the copyright holder owns the exclusive right to reproduce, display, distribute, or otherwise publicly share the work. The copyright owner has the right to license others, with such limitations, abilities, and for such compensation as the copyright owner desires, to use, display, distribute, and otherwise share the copyrighted work. Generally, an employer retains the copyright to works, ideas, designs, etc., created by employees within the scope of their employment.

Copyrighted works are entitled to be designated with the “©” symbol to put potential infringers on notice that the work is protected. Such a designation is not required, but is recommended for all original works and can be used by the originator of the work, even though the work has not been formally registered with the U.S. Copyright Office. While copyright protections are available without formal registration, formal registration provides a number of additional benefits and should be seriously considered.

The formal registration process in the United States consists of the filing of a relatively simple application with the U.S. Copyright Office, essentially identifying the work to be protected, the author or authors (as well as the owners, if different) and in most cases, submitting two copies of the work (one for the U.S. Copyright Office and one for the Library of Congress). There is a minimal filing fee, currently less than \$100. Additionally, one may preregister work with the Copyright Office so long as (1) it is likely that someone may infringe the work before it is publicly released, and (2) the creator/applicant has begun the work but not yet completed it.

Among other benefits of formal registration, registering a copyright provides the owner with the right to: (1) reproduce the work in copies or phonorecords, (2) prepare derivative works based upon the work, and (3) perform or display the work publicly. Further, a registration is a prerequisite to bringing an action alleging infringement (only if the country of origin of the work is the U.S.). When certain other requirements are met, a certificate of copyright registration is considered prima facie evidence of the validity of the copyright and the statements made on the registration certificate. Perhaps

most importantly, copyright registration allows the owner to recover statutory damages, which are useful in cases where actual damages are minimal.

Simply put, copyright infringement occurs when a person publicly displays, copies, or uses copyrighted material or a copyrighted work without the owner’s prior consent. Penalties for infringement can include injunctions (restraining orders) preventing further infringement, monetary damages, as well as attorneys’ fees and costs in certain circumstances. Additionally, because willful infringement is a crime, substantial fines and/or imprisonment are also possible.

There are certain exceptions to the protections offered by the copyright law defined as the “Fair Use” doctrine. These exceptions include the ability to display copyrighted material for the purpose of commenting on it, or criticizing it. Sections 107 through 118 of the Copyright Act contain various limitations on the exclusivity of copyright. The “Fair Use” doctrine is set forth in Section 107 of the Copyright Law, which contains a list of various purposes for which the reproduction or use of a particular work may be considered fair, such as criticism, comment, news reporting, teaching, scholarship, and research. This doctrine has been developed over many years and through a large number of court decisions. The four factors that are taken into account into considering whether a particular use is “fair” are:

- (1) the purpose and character of the use, including whether such use is of commercial nature or is for nonprofit education purposes;
- (2) the nature of the copyrighted work;
- (3) the amount and substantiality of the portion used in relation to the copyrighted work as a whole; and
- (4) the effect of the use upon the potential market for, or value of, the copyrighted work.

The distinction between infringement and fair use is often difficult to determine, and “fair use” is likely the most common defense to claims of copyright infringement. For example, there is no specific number of lines or amount of material that may be safely used without

permission. Additionally, acknowledging a copyright does not equate to obtaining permission for an unlawful use. Consequently, one must be careful when invoking the “fair use” doctrine as a justification for the use of copyrighted materials without permission.

As with patents, there is a Universal Copyright Convention, which includes 80 countries, including the United States. In the Convention, each member state grants the same protection to copyrights from other member states as it grants to copyrights from within its boundaries. Other international treaties that provide some protection for copyrighted work include: the BERNE Convention for the Protection of Literary and Artistic Works; the Collection of Laws for the Electronic Access of Works from the World Intellectual Property Organization (which provides an electronic archive of international intellectual property legislation); The Convention for the Protection of Producers of Phonograms; International Convention for the Protection of Performers, Producers of Phonograms, and Broadcasting Organizations; provisions of the GATT of 1994; World Intellectual Property Organization Copyright Treaty (1996); World Intellectual Property Organization Performances and Phonograms Treaty (1996); and the World Intellectual Property Organization Basic Proposal for Substantive Provisions of the Treaty on Intellectual Property and Respective Databases.

## Raising capital in the U.S.

Similar to the situation in Sweden, funds needed for the growth and operation of businesses in the U.S. are raised through a combination of the sale of equity of the business (stock, membership interests in LLC’s, partnership interests), or the acquisition by the business of debt financing. Debt can take various forms in the United States, including corporate bonds or promissory notes (secured or unsecured). More commonly debt will be obtained from an institutional source such as a bank, credit union, or government business lender such as the U.S. Small Business Administration (“SBA”). The SBA will often facilitate the acquisition of debt from institutional lenders through its various guarantee programs, which make larger amounts of capital available at lower interest rates. Such loans may have variable or fixed interest rates and are commonly secured by a lien on the assets of the business or a mortgage on its

real estate. Such loans are commonly in the form of “term” facilities in which the principal and interest is repaid over a specified period of time, or “line of credit” facilities that remain open for a specified period of time during which the principal owed will rise and fall with the necessities of the business.

Raising capital through the sale of equity and other forms of securities is very common in the U.S. However, this activity will be closely regulated by both the federal and one or more state governments that have a connection to an offering, as explained in more detail below. Securities are broadly defined in both federal and state law, and include stock, investment contracts, notes, debentures, and participations, such as memberships in limited liability companies. As a general rule, the federal government will require securities that are intended to be offered and sold to members of the public be “registered” with the Securities and Exchange Commission (“SEC”) pursuant to the Securities Act of 1933 (the “’33 Act”), or entitled to an exemption from registration. Registration of a security with the SEC, allows the security to be sold to the general public, either through an Initial Public Offering (“IPO”), or a subsequent offering of new securities after an IPO. In such a situation, the issuer may offer the securities to the public through the use of general solicitation, for example newspapers, publically disseminated brochures, or radio or television advertisements. Additionally, the issuer must provide for the general dissemination to members of the public of detailed information and offering materials.

However, as explained below, the federal law provides for a number of exemptions from the registration requirement of the U.S. Securities Act of 1933 (“’33 Act”), if certain parameters are complied with. In the U.S., no securities may be offered for sale or sold unless they are either registered at both the federal and state levels, or are covered by one or more exemptions available at both the federal and state levels. While there are a number of exemptions available, as a general matter, the ones most commonly and successfully sought involve situations where the offer and sale of the security are of a limited, nonpublic nature, and substantially involving wealthy investors.

The offer and sale of securities at the federal level is governed by the Securities Exchange Act of 1934 (“’34 Act”), together with their adopted rules and regulations. The ’33 Act was originally created to

prevent fraud, deception, and misrepresentation in the offer and sale of securities. The '33 Act requires those who were offering securities to the public to register those securities with the SEC through the filing of a detailed registration statement and accompanying documentation, financial information, and reports, and to provide potential investors with a detailed prospectus, often called a private placement memorandum or offering circular, communicating pertinent information, both pro and con, about the issuer and the securities being offered.

The '34 Act was created to regulate the securities markets in the United States. The Act requires parties issuing public securities to disclose in filings to the SEC all of their financial and business information on a periodic basis. Such filings are public. The Act requires additional registration reporting, including specific requirements for foreign issuers (not including foreign governments or entities that are primarily owned or operated by U.S. citizens or residents).

As stated, unless subject to an exemption, any security offered for sale in the U.S. must be registered at both the federal and state level before it may be offered for sale. On the federal side, the registration process for securities to be offered to the public is time consuming and expensive, requiring counsel and accountants who are highly experienced in the raising of capital in the public capital markets. However, a registered public offering brings with it the benefit of being able to offer securities to the general public through the use of general advertisements, securities brokers, and broad solicitations, thus providing a mechanism to attract larger amounts of capital from a broad spectrum of investors. There are very few limitations as to the size, character, or type of investor who may be a purchaser of such securities, and no limits on the amount of capital that can be raised. Registration under the '33 Act brings with it the burden of continuing reporting requirements and ongoing compliance with some burdensome laws and regulations such as the U.S. Sarbanes-Oxley Act of 2002.

However, the regulatory scheme at both the federal and state levels provides an alternative ability to raise capital in a more timely, less onerous, and much less expensive manner by structuring a private offering wherein the securities would be offered and sold to a small defined group of wealthy investors. The size of the offeree pool, the

amount of capital that can be raised, and what constitutes “wealthy” are defined in Regulation D of the '33 Act and in the securities registration statutes of each of the 50 states (so-called “Blue Sky Acts”). Each state’s Blue Sky Act is unique, although there are legal and regulatory aspects that are common to all of them. Both the rules under Regulation D and those promulgated under the various state Blue Sky Acts will set the ground rules for the offering and issuance of equity securities to investors without the need to be registered. This process is often referred to as conducting a “private” or “nonpublic” offering. Because of the fact that such offerings can be done in a relatively short period of time and at considerably less expense than an IPO, raising capital through the use of a private or nonpublic offering in the U.S. is much more common than conducting an IPO.

In order to avail oneself of the benefits of a private capital raise, an exemption from the registration requirements of the SEC, as well as the registration requirements of the state(s) wherein one or both of the issuer of the security and/or any offeree or purchaser of the security resides, must be obtained. The rules determining whether a private offering exemption is available at the federal level are found in Regulation D promulgated under the '33 Act. They are Rules 504, 505, and 506. Which of these rules applies to a situation will depend on the size of the intended offering, as well as the character and nature of the investors who are being solicited. Because an exempted private offering of securities is necessarily premised on the idea that the issuer will not have to provide as much or as detailed operational and financial information to potential investors as it would be required to do in a public offering, the federal law is very concerned about the nature and character of investors in a registered private placement, and their presumed ability to understand the information provided. The Rules under the '33 Act, therefore, speak in terms of “Accredited” and “Unaccredited” investors. In large part, the number of potential investors who are approached and/or purchase the offered securities and whether any of them are “Unaccredited” will determine whether an issuer is entitled to an exemption for a private offering at the federal level.

Currently, an “Accredited” investor is defined by Rule 501 of the '33 Act as any one of:

1. A bank, insurance company, registered investment company, business development company or a small business investment company;
2. An employee benefit plan, within the meaning of the Employee Retirement Income Security Act (“ERISA”);
3. A charitable organization, corporation, or partnership with assets exceeding \$5,000,000;
4. A director, executive officer or general partner of the company selling the securities;
5. A business in which all of the equity owners are Accredited Investors;
6. A natural person who has individual net worth, or joint net worth with the person’s spouse that exceeds \$1,000,000 at the time of the purchase (excluding the value of the primary residence);
7. A natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year; or
8. A trust with assets in excess of \$5,000,000, not formed to acquire the securities offered, and where the securities are purchased by a sophisticated person.

Everyone else is an “unaccredited investor.”

”Rule 504 of the ‘33 act exempts the offering of securities intended to raise up to \$1,000,000 in any consecutive twelve (12) month period. All of the investors must be accredited and no general solicitation, such as newspaper advertisements, handouts, brochures, or general mailing, may be used. The securities sold will be “restricted,” which means they cannot be resold without either being subsequently registered under the Act, or qualified for a new exemption from registration. The securities must also be sold to investors who reside in states that require the registration of securities and the dissemination to offerees of detailed information about the offered securities. Finally, the issuer must file a Form D with the SEC within fifteen (15) days of the first sale of such securities.

Rule 505 applies to an offering where up to \$5,000,000 is sought to be raised in any twelve (12) month period. The investor group can be composed of an unlimited number of Accredited Investors, and up to 35 Unaccredited Investors. Any Unaccredited Investor offeree must be provided with information that is similar in detail to that provided to an offeree in a public offering (a private placement memorandum). As with Rule 504, there can be no general solicitation of offerees, and a Form D must be filed with the SEC within 15 days of the first sale.

Rule 506 allows for the raising of an unlimited amount of capital from an unlimited number of Accredited Investors and up to 35 Unaccredited Investors. Additionally, each Unaccredited Investor-offeree must either be “sophisticated,” which is defined as having sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment, or be represented by a Purchaser Representative who is. Again, there can be no general solicitation of offerees, and Unaccredited Investors must receive information similar to that provided to an offeree in a public offering. Additionally, Form D must be filed with the SEC after the first sale. It should be noted that Rule 506 is the only rule established under Section 4(2) of the ‘33 Act that specifically allows for a private offering of securities as an exemption from the Act’s registration requirements. This is important because the National Securities Markets Improvement Act of 1996 (“NSMIA”) will preempt the securities registration laws in all fifty (50) states relative to a security that is entitled to a federal exemption under Section 4(2) of the ‘33 Act or rules established pursuant to that section (Rule 506). Therefore, if one is entitled to an exemption under Rule 506 at the federal level, then one is also entitled to an exemption from any state’s securities registration statute.

In addition to obtaining an exemption under the federal scheme, any sale of securities in the U.S. must also be either registered or entitled to an exemption from registration under the Blue Sky Acts of the state in which the issuer is located and/or the investor resides.

Blue Sky Acts will generally provide exemptions from registration for private offerings based on the nature of the securities being offered and/or the nature of the transaction. These exemptions

are not mutually exclusive. For example, in New Hampshire, securities issued by a bank, savings institution, or trust company organized under federal law or the law of any state are exempt from registration. Likewise, a New Hampshire issuer whose securities are being offered and sold in a transaction wherein they are (1) sold to no more than 10 investors located in any state within any 12 month period and to no more than 25 investors during the life of the issuer, (2) where no public solicitation is made, (3) no commissions are paid to “finders” or brokers, and (4) the issuer reasonably believes all investors have purchased for their own purposes and not for resale, is entitled to an exemption from registration for securities sold to residents of New Hampshire. It is important to note that a private placement must qualify for an exemption under the Blue Sky Act of every state wherein any offeree or purchaser of the security resides. Consequently, the breadth and structure of such an offering must be carefully planned before it is initiated.

If properly structured, a private placement of securities will avoid the need to register the securities at both the federal and state levels, thus saving significant time and expense. Obviously, the disadvantages to private placements include the inability to utilize general solicitation to find potential investors and, therefore, the limited number of potential offerees there can be, which, as a practical matter, will limit the amount of capital that can be raised.

Overlying the entire area of raising capital are the considerations embodied in Rule 10b-5 promulgated under the ‘34 Act. This is the so-called “antifraud rule.” The rule makes it unlawful for anyone involved with offering and/or sale of securities in the U.S. to:

- a. employ any device, scheme, or artifice to defraud; and/or
- b. make any untrue statement of a material fact, or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

A violation of Rule 10b-5 will destroy any federal or state exemption available, as well as provide any purchaser of securities a right to rescind the purchase and receive back the full purchase price.

Additionally, the party responsible for the violation will be subject to both civil and criminal sanctions. Consequently, great care and attention must be paid to all aspects of the offer and sale process, including, specifically, the structuring and contents of all offering circulars or private placement memorandum.

The raising of capital in the U.S., while commonly done safely and expediently, is a process requiring skilled and expert assistance from counsel and financial advisors.



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