LEGAL&TAX NEWSLETTER

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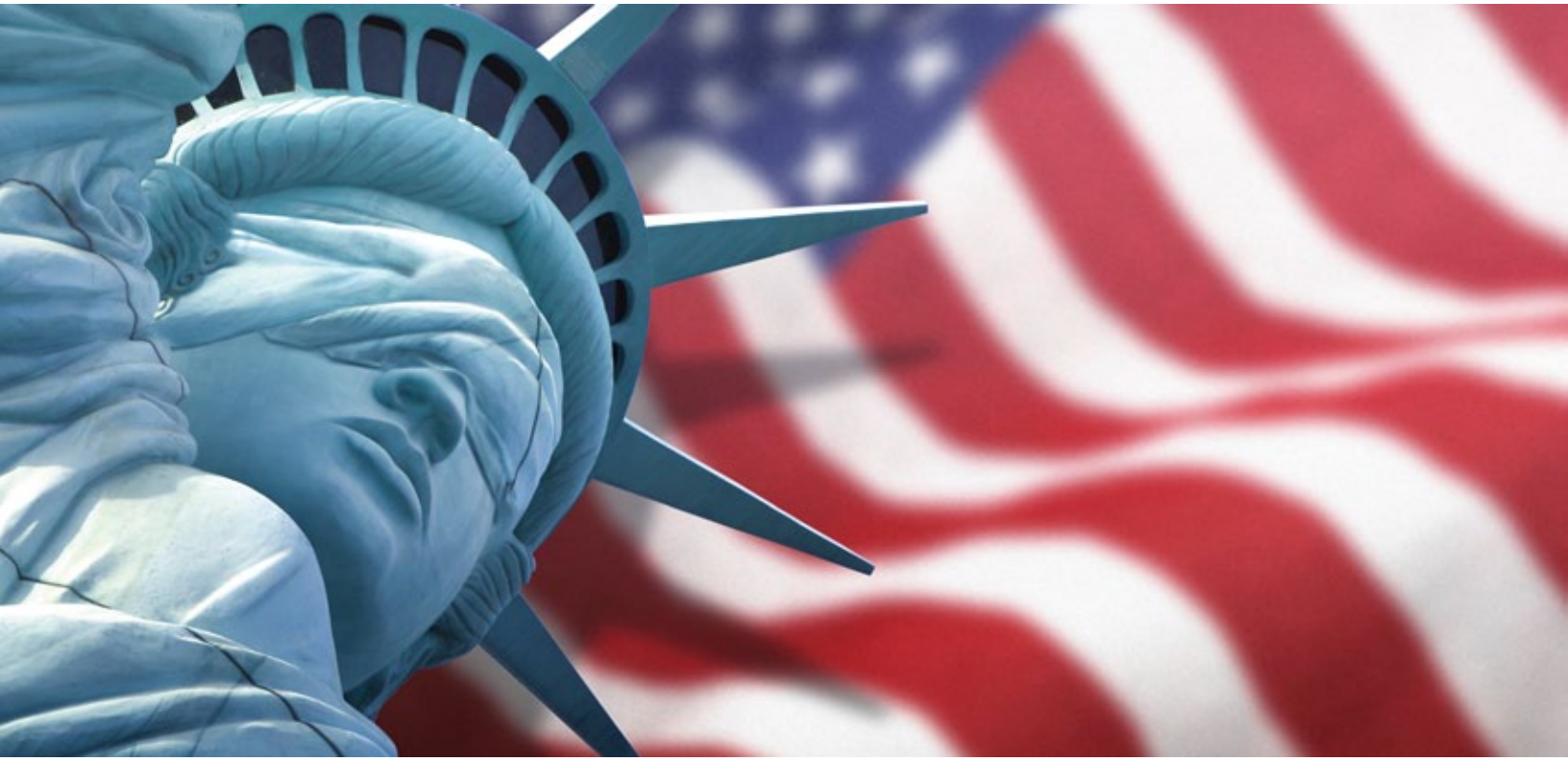

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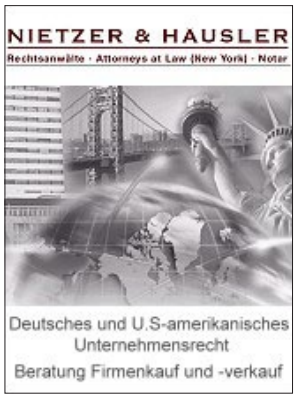

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M&A' Red Flags for the United States

Red Flag 1:

Management may find the current environment tempting to purchase companies out of bankruptcy. Thus, we like to draw the reader's attention to the case MPI Acquisition, LLC v. Northcutt, where the U.S. court held that federal bankruptcy law preempts state law successor liability theories, so as to bar a plaintiff from bringing a successor liability suit against a company that had purchased assets pursuant to a bankruptcy court order declaring the assets free and clear of liabilities. But be aware that bankruptcy court orders do not in all cases assure immunity from successor liability claims under state law, and that the language in the bankruptcy court order is very important in protecting the buyer against such claims. To be on the safe side, we strongly recommend to seek additional protection against successor liability claims by including in the order approving the sale a reservation by the bankruptcy court of jurisdiction over any such claims.

Red Flag 2:

Agreements for the acquisition of a business commonly contain "material adverse change" provisions, which operate to allow the buyer to "walk away" from the transaction if there is a "material adverse change" in the business being acquired. But be aware that U.S. courts will not always construe commonly used legal terminology in a manner consistent with the expectations of the parties. Thus, do not just rely on generic "boilerplate" wording, take the time to draft specific language tailored to address the particular concerns of the parties.

Red Flag 3:

The U.S.court decision Cincom Systems, Inc. v. Novelis Corp. serves as a good reminder that an important step in structuring a transaction is analyzing whether the transaction will trigger the need to obtain the consent of third parties that have contracts with the target company. Where patent or copyright licenses constitute material assets of the target company, that analysis should take into consideration not only the language of the license agreements, but also the federal law presumption against assignability of patent or copyright licenses.

Red Flag 4:

In times of increasingly harsh measures taken by the U.S.Department of Justice or the SEC (see the recent settlement re Daimler AG – the complaint can be retrieved at the US-blog www.usa-recht.de), against violations of the Foreign Corrupt Practices Act

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M&A' Red Flags for the United States

(FCPA), it is a must in a purchaser's pre-acquisition due diligence that questions get asked such as "Does the target have an FCPA policy, and can it produce evidence of that policy being enforced, with FCPA training?" or "How robust are the target's accounting and compliance systems?" or "How frequently must the target interact with foreign regulators to obtain licenser, or obtain governmental inspections?"

Blog USA: www.usa-recht.de www.gerichtsreporter.us

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U.S. Market Entry via Joint Venture with a Local Partner

For any company, entering a foreign market is most of the time either capital intensive, risk bearing or any combination thereof. A joint venture with a local partner might mitigate both factors.

When considering entering a foreign market, companies often have to either decide whether (i) they would like to acquire a company already established in the desired market, however such undertaking might be costly, or (ii) to start from "scratch" in such foreign market, which bears a great risk of total failure, notably due to lack of experience in the foreign market place. A valuable alternative hereto is to form a joint venture with a company which is already successful in the foreign market. This approach might offer better chances of success because local experience is available from the start and the amounts to invest are generally less than the cost of an acquisition.

The advantages of joint ventures therefore can be: combination of resources, limited investment, immediate availability of foreign talent, overcoming cultural differences with respect to local customers, opportunities to learn from the foreign partner, pre-empting competition etc.

However, on the other hand, joint ventures bear their own specific risks, which can include: dilution of control, allocation of responsibility for management or other tasks within the joint venture, loss of control of certain intellectual property, etc.

Therefore, although such joint ventures generally offer great opportunities when entering a new market, careful consideration should be given to the legal framework and agreements between the joint ventures partners.

Joint Venture partners have to find an agreement among other issues about the purpose of the joint venture, ownership allocation of the joint venture company, control, management (rights), technology transfer, territory, possible regulatory issues, tax considerations, confidentiality agreements, license and other intellectual property-related agreements, dispute resolution, corporate opportunities, breaches, exit and termination rights to only name a few topics.

Generally, the result of such negotiations is materialized by several individual agreements at different stages:

1. The partners negotiate the basic understanding and agree in a so-called memorandum of understanding (MoU) on the issues which should be agreed upon in detail in a joint venture agreement
2. Confidentiality or non-disclosure agreement
3. Joint venture agreement which lays out the venture plan in detail

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4. Formation of venture company
5. Shareholders agreement
6. License agreements
7. Employment agreements etc. depending on the nature of the joint venture.

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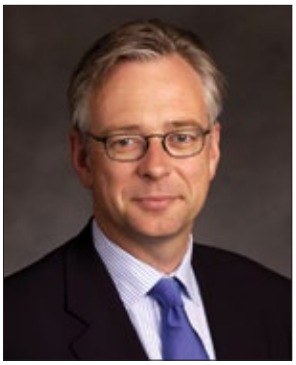

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Convergence of Strategic and Private Equity Deal Terms

As the M&A markets begin to recover from one of the worst crises in history, both strategic and private equity buyers are beginning again to compete for the best deals. During pre-crisis times, private equity firms had two major trump cards: easy access to the debt markets and attractive management incentive structures. The combination of these factors coupled with the willingness to tolerate higher leverage often swayed sellers and target management to sell to private equity. Only strategic buyers who were willing to share future synergies from the combined businesses were able to compete on value; and only those who could offer attractive stock option packages at the parent level were able to compete for management in situations where management continuity was of utmost importance.

As the debt markets began to tighten during pre-crisis times, one key feature of private equity deals received a lot of attention: the reverse break-up fee. Private equity funds typically negotiated downside protection if they were unable to obtain the financing to close a deal. In the earlier days these reverse break-up fees tended to be similar to break-up fees payable by target companies who pursuant to their fiduciary duty obligations terminated a deal in favor of a higher offer. In both cases break-up fees of between 3 – 3.5% of the deal value were not untypical. In recent strategic deals, the parties have begun to embrace similar reverse break-up fee structures that they imported from the private equity world. As this practice began to evolve and the debt markets were tight, some sellers were able to negotiate fees of up to 7% (there is no corresponding fiduciary duty requirement capping reverse-break up fees at 3.5%). From a seller's perspective, such a reverse break-up fee may indeed be a more desirable alternative than forcing an illiquid to close a deal buyer by means of specific performance or seeking damages that may be difficult to prove in a drawn out legal battle. As the debt market begin to thaw, such reverse break-up fees could therefore become far more common deal term also in strategic deals

A second feature of private equity deals has been more difficult for strategic buyers to replicate, but those who succeed may have an advantage over competing bidders. Private equity buyers typically offer target management to participate in an equity pool of between 5 and 15% of the equity value of the target, often subject to vesting schedules, roll-over of existing equity, financing and other terms. Strategic buyers traditionally have had difficulties utilizing such incentives especially when the strategic value of a deal is based on the integration of the target with the buyer's operations and when it is the buyer's desire to control 100% of the equity of the target. However, recently some LLC

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structures were used that provided for two classes of equity, class A which was owned 100% by the buyer and class B which was partially owned by management (say 15%) and by the buyer. The class B equity was structured to capture the economic appreciation or depreciation of the target and provided for put/call mechanisms allowing management an exit at fair value after a certain period of time (based on a vesting schedule).

If terms in private equity and strategic deals such as the ones outlined above continue to converge, we would expect a more level playing field in competing for the deals as the M&A markets recover.

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An Emigrant's Story

Do you have an innovative company in Germany? Are you introducing a new product into the U.S. market? If so, let me share with you the following true story.

Trained as an engineer in Germany, Mr. Ehrlichmann* emigrated with his wife from Germany to Berlin, Wisconsin. They founded a company called Topco* that designs and manufactures parts for industrial equipment. Their three sons took on key roles within the company, helping grow the family business into a leading supplier of innovative parts.

Soon after expanding company facilities to meet demand for its products, Mr. Ehrlichmann was served with a complaint for patent infringement. The claim of infringement was against TapRight®*, one of Topco's best selling products. Since Mr. Ehrlichmann had developed and patented TapRight®*, the fact that someone else could claim rights to it came as a shock.

The lawsuit was filed by Manko*, a manufacturer and distributor of conventional parts for industry. The owner, Mr. Fiesmann*, based the lawsuit on a patent he purchased for next to nothing from Egalco*, a German company not active in the U.S. market. Topco's patents did not cover any of Manko's products.

Not wanting to gamble on the outcome of the lawsuit, Mr. Ehrlichmann made a substantial settlement offer. However, Manko's attorney had convinced Mr. Fiesmann that the lawsuit was worth millions of dollars in past infringement damages, so Mr. Fiesmann rejected the offer. Since Mr. Fiesmann's counter-offer would have put Topco out of business, Mr. Ehrlichmann had no choice but to continue with their legal defense.

After a four-year battle through trial, appeal and remittal, the case finally settled for a nominal amount. When asked if he was glad about the outcome, all Mr. Ehrlichmann could say was, "Even if you win, you lose." He was referring to $1 million in litigation costs which his company, i.e., his family, had to bear. He had no recourse for that cost.

For companies that do not have the resources to conduct extensive legal battles in the U.S., I recommend taking pre-emptive measures to minimize and reallocate the risk of patent infringement. To maximize their effect, such measures should be taken before, or when, the product is introduced into the U.S. market to minimize the risk of uncontrolled liability exposure for past infringement.

If you would like to learn how to take such measures, I'll be glad to meet with you to discuss how your company can be one of the lucky few to have a means for escaping the above trap.

*The names in the above story have been changed to protect their privacy. Any resemblance to the name of a real person, company or product is coincidental.

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Buying IP in the U.S.? Make sure you are getting something of value

When buying Intellectual Property (IP) in the U.S. the mantra is "buyer beware!" You cannot rely on the seller's sales pitch. You have to find out for yourself what you get for your money. This hard work is called "due diligence."

You need to make sure that the IP:

1. Is owned by the seller
2. Is valid and enforceable; and
3. Covers the product or services you intend to sell.

Defects in ownership of IP offered for sale are relatively rare but they do occur. Often the seller itself is not aware of the problem. If the IP was purchased from a third party by the seller, the assignment may exist but may not have been recorded. If a patent was obtained by an employee of the seller, it may not have been formally assigned to the employer. These matters need to be checked out and all assignments properly recorded.

Ownership issues arise more often in connection with copyrights. A writing is required to convey ownership of a copyright, and a such a writing is often missing for works created by a hired consultant.

A more difficult due diligence issue is the validity and enforcement of the patents, copyrights, trademarks and/or trade secrets. This requires the skills of an experienced IP lawyer. Even if a patent application has been examined and has issued, a thorough search of prior art should be conducted to be sure that the invention is novel and "unobvious." A patent is presumed valid over all the references cited by the patent Examiner, but no such presumption attaches to newly discovered prior art. Registrations of copyrights and trademarks are not a condition precedent to the existence of valid and enforceable rights, but such registrations carry additional rights and are highly recommended. Trade secrets are protected by secrecy agreements and proper due diligence should assure that such agreements are in place.

Finally, due diligence is required to make sure that the intellectual property being offered covers the product or service that the buyer intends to market. A patent, copyright, trademark or trade secret that is too limited or narrow, or is directed to some other product or service, is of little use. An IP specialist should make this determination at an early stage before plans are made and dollars are committed.

When purchasing IP, dollars spent on due diligence can and will save you money in the long run.

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Can Flags and State Emblems be Elements of Registered Trade Marks?

Most countries including the USA and the European Union countries are members of the "Paris Convention" for the protection of industrial property. Article 6ter of the Paris Convention prohibits the registration of armoral bearings, flags, and other state emblems as trade marks or as elements thereof.

In a recent case (C-202/08 P) the Court of Justice of the European Union decided about the application of a Community trade mark filed with the European trade mark office OHIM by American Clothing Associates NV, Belgium. The trade mark consists of the image of a maple leaf with the letters "RW" below it.

OHIM refused registration of the mark stating that the mark was liable to give rise to an impression on the public that it was linked to Canada, as the maple leaf in the trade mark is a copy of the emblem of Canada. A notice of appeal filed by American Clothing was dismissed and an action against this decision was rejected by the Court of First Instance.

In its judgement of July 16, 2009 the Court of Justice of the European Union held that a trade mark which does not exactly reproduce a state emblem can nevertheless be covered by Article 6ter of the Paris Convention, where it is perceived by the average consumer as imitating such an emblem. Further it is sufficient for a single element of the trade mark to represent such an emblem for that the mark to be refused registration.

American Clothing´s argument that the Canadian Intellectual Property Office had accepted an identical trade mark for registration could not convice. The Court replied that the registrability of a sign as a Community trade mark is to be assessed on the basis of the Community legislation alone and neither OHIM nor the Community judicature are bound by the decisions adopted in any member state or a third country.

In a similar German case the Federal Patent Court ruled that a trade mark showing a soccer ball covered with reproductions of flags of a number of States can be registered as a national German trade mark. In its decision 33W (pat) 32/07 of Dec. 9, 2008, the Federal Court held that the general prohibition of German trade mark law to register trade marks showing state emblems is applicable only under the condition that the trade mark gives rise to an impression of being linked to a public authority. This impression, however, is not given if the mark is composed of several different national emblems like flags which can not be assigned to a single nation and which give the impression of internationalization with purely ornamental nature.

Conclusion: National authorities in Germany and Canada seem to make less trouble with trade marks showing state emblems than European Community authorities.

Claiming Damages in Antitrust Cases – Private Enforcement

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Gas, Bananas, Candle Wax – the list of cartel cases in which the European Commission imposed fines of up to several hundred million Euros has become long. Alongside the trend of the European Commission to impose tremendous fines, a second trend has recently emerged in Europe called private enforcement. Private enforcement allows those that are affected by an infringement of Antitrust Law to claim damages directly from the infringer. The first private enforcement lawsuits have been brought before German courts, in which plaintiffs claimed amounts of up to several hundred million Euros in damages.

Legal basis

The legal basis for the damage claims resides within the EU law. The European Court of Justice held in its judgment "Courage", case C-453/09[1], that former Art. 81 EC Treaty guarantees a right to claim for damages if one has suffered loss due to a breach of former Art. 81 EC Treaty. The preconditions for such a claim are deter-mined by national law.

German law provides for a claim for damages in Sec. 33 German Unfair Competition Act ("UWG"). A person committing a breach of German or European Antitrust Law is liable for the losses caused by this breach.

According to Sec. 33 UWG (i) findings of German or other EU member states' antitrust authorities, (ii) German or other EU member states' courts or (iii) the European Commission on the existence of a breach of Antitrust Law are binding for the court having to decide on the claim for damages. Nevertheless, those decisions do not conclusively determine whether the claimant has suffered losses. Thus, the claimant has to prove that he suffered losses. This proof of losses leads to complex questions as yet resolved.

In principle, under German law, the claimant needs to prove two facts in order to show that he suffered losses: The actual price and the hypothetical market price at the time of the infringement. The amount of the losses suffered would be determined by deducting the hypothetical price from the actual price.

Regarding the hypothetical price, several calculation methods exist: One can compare (i) prices during the existence of the infringement to prices paid before or after the infringement or (ii) prices from a geographic region not within the scope of the infringement to prices within the scope of the infringement. Also, the claimant can rely on (fixed) costs and standard prices of downstream products produced with the overpriced product. Finally, an econometric analysis can be used for calculation.

German courts may also assess the amount of damages if they are provided sufficient facts. The applicability of such assessment in private enforcement cases remains to be determined.

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Convergence of Strategic and Private Equity Deal Terms

Another open question is whether the defendant can rely on the "passing-on-defence". Sec. 32 UWG provides that damages are not excluded because goods or services have been resold. Nevertheless, under German law the defence that higher prices were passed on to clients would usually be admissible.

Collective redress

German law does not provide for ways of collective redress comparable to a US Class Action. A Belgian company called Cartel Damage Claims SA ("CDC") never-theless is trying to bring collective claims for damages in the style of an opt-in class action. CDC's business model is to buy potential damage claims from allegedly in-jured parties. CDC pays the injured party a fixed price and additionally – if successful – 85 % of the damages. So far, CDC has filed two pending lawsuits in Germany: one concerning a German cartel for cement and another concerning a European-wide cartel for Hydrogen peroxide.

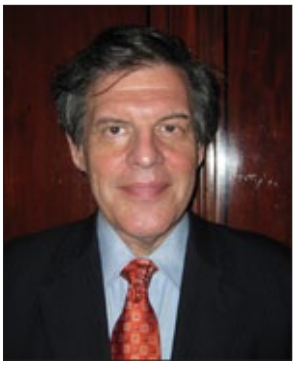
International Aspects

On an international level, problems arise especially when cartel members or injured parties are incorporated in different countries. Regarding international jurisdiction it is unclear whether the plaintiff can bring all his alleged claims against cartel members from different countries before a single national court. The question of the applicable law to the damage claim also remains open.

Conclusion

American companies could be affected by private enforcement lawsuits in two ways: It is possible that American companies – after having been fined by the European Commission for an infringement of Antitrust Law – could be sued for damages before European courts. American companies could also act as claimants in private enforcement cases. Therefore, American companies should be aware of the risks and the opportunities of this new development.

[1] The decision can be found under http://curia.europa.eu/



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How to Reduce Duty Liability and Avoid Penalties With U.S. Customs

Almost all importers treat customs transactions as the exclusive domain of the logistics and freight departments. By not regularly reviewing their import operations, these importers lose the possibility of saving substantial sums of money by reducing duties and eliminating the possibility of penalties.

Duties may be reduced or eliminated in a variety of ways. First, duty-free programs such as Free Trade Agreements (FTAs), the GSP program which permits duty-free entry of most products (other than textiles, apparel, shoes, and steel) from most developing countries, and other regional programs which permit duty-free entry even of most textile and apparel from the poorest countries.

The value of the merchandise declared to Customs may also be reduced by using the "first sale" in the manufacturing country, instead of using the price charged by the middleman to the U.S. purchaser. When used pursuant to the law and regulations, this can reduce duties by a third to a half. Sales commissions are dutiable, but buying commissions are not, so when using agents, it is wise to ensure that the paperwork supports the true nature of any buying agent relationship. Importers should also be aware that certain royalty payments are dutiable while others are not. Therefore, importers should structure the details of the sale – to the extent permitted by law – so that these commissions are not dutiable. Finally, sales between related parties which are not at arms'-length may be structured in such a way that duties can be lowered if certain test-values are met. Importers should investigate the possibilities in reducing their duty liability by using these methods.

Today, U.S. Customs focuses more on penalties than on duty collection, as a source of revenue generation. Audits of import firms are common, and every importer is likely to undergo a customs audit every five years or so. The first thing that the Customs auditors check to see is whether the importer has a functioning internal customs operations manual which is used and is functioning. If the importer follows correct procedures in entering, classifying, and valuing merchandise and in declaring the proper country of origin, the importer may avoid customs penalties which may be many times the value of the merchandise. Since determining the correct country of origin varies on the program which is used (the country of origin determination is different depending on whether NAFTA, GSP, or non-duty preference is used), and because valuation and classification of merchandise is such a complex and nuanced exercise (made infinitely more complex by the authority of Customs to enforce the rulings of the FDA, USDA, Consumer Products Safety Agency, and other agencies), all importers should use ex-

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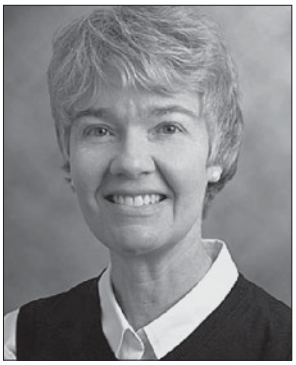
How to Reduce Duty Liability and Avoid Penalties With U.S. Customs

perienced customs counsel in reviewing their import operations.

Sidney N. Weiss is a customs and international trade lawyer in New York, and the former president of the Customs and International Trade Bar Association, the largest association of customs and trade lawyers in the world.

The Foreign Manufacturers Legal Accountability Act: Made in Germany – At Risk in U.S.A.?



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Pro-plaintiff bills recently introduced in the United States Congress would make it easier for U.S. courts to exercise jurisdiction over foreign manufacturers in lawsuits by U.S. consumers claiming to have been injured by defective products. In the Senate, the Foreign Manufacturers Legal Accountability Act of 2009 (S. 1606) is currently before the Finance Committee. Its companion bill in the House, the Foreign Manufacturers Legal Accountability Act of 2010 (H.R. 4678), was referred in February to three Committees: Agriculture, Ways and Means, and Energy and Commerce.

These legislative proposals have been prompted by highly-publicized reports of defective products (such as contaminated drywalls or toys) imported into the United States from low-cost producers like China. But once enacted into law, they would equally apply to all importers – including those of German high end products.

The bills seek to reduce the delay and expense encountered by U.S. consumers wishing to sue foreign manufacturers and to level the playing field for U.S. product manufacturers vis-à-vis their foreign competitors. U.S. consumers attempting to serve process on foreign manufacturers often have difficulties to locate and/or establish personal jurisdiction over them in U.S. courts. The proposed legislation is intended to remedy this situation:

- Each foreign manufacturer whose products are sold in the United States and are regulated by the Consumer Product Safety Commission (CPSC), the Food and Drug Administration (FDA), or the Environmental Protection Agency (EPA), would be required publicly to designate a registered agent in at least one U.S. jurisdiction to accept service of process on its behalf for the purpose of all civil and regulatory actions in state and federal courts – saving the consumer the hassle of going through the cumbersome process under the Hague Convention or even letters rogatory.

- The identity of foreign manufacturers' registered agents would be publicly available through a registry searchable on the Internet.

- Each foreign manufacturer would also be required to consent to the jurisdiction of a court in the state in which its registered agent is located.

- Any foreign manufacturer failing to comply would be barred from the U.S. market.

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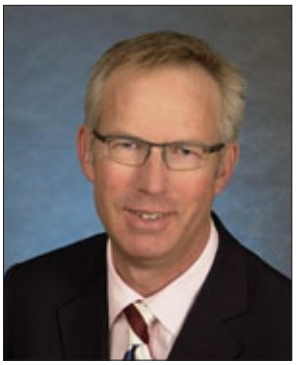
The Foreign Manufacturers Legal Accountability Act: Made in Germany – At Risk in U.S.A.?

If the proposals are enacted into law, there will be fewer legal obstacles to product liability litigation brought by U.S. consumers against foreign manufacturers. As their exposure to such litigation increases, the importance to exporters into the U.S. market of adopting the internal procedures long used by U.S. producers to mitigate such risks also increases.



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In-court mediation in Germany – a success story

Mediation, as a means of dispute resolution during a pending lawsuit, has a long time been considered suitable only for conflicts between private individuals, namely in family and child support matters. However, in recent years in-court mediation has quite successfully been promoted in commercial and business litigation also. The main reason seems to be that mediation is now being suggested by the judge in cases where he or she feels that after many lengthy proceedings, witness and expert hearings, a judgment would not provide justice to the parties; because, either, the subject matter of the litigation is only the tip of the "iceberg" of a much deeper conflict between the litigants, or it could damage the relationship between the parties if they are to continue in business as shareholders of the same company, business partners of a manufacturer-dealer relationship, or the like.

How does in-court mediation work and what are its advantages as compared to normal court proceedings ?

In those cases where the judge having jurisdiction thinks mediation could be a more efficient way of conflict resolution, he or she suggests to the litigant parties to consider this option. Provided both parties agree, the file will be sent to another judge (usually at the same court). However, he does not act as a judge but as a mediator (of course, with the experience of a judge). If the mediator is successful in bringing the parties to a settlement, he or she may even record the settlement agreement. Its terms can be enforced like a judgment. The parties, usually assisted by their respective counsel, and the mediator, are free to decide how and where the meetings are to be held (usually in a court room, no records are being taken). Everything that happens in mediation is up to the parties.

Conflict resolution through mediation is typically much faster than conducting normal court proceedings in civil or commercial matters. Results can be much more constructive than through a judgment. For example, parties can call technical experts or business partners to the meetings to help them find a solution to their problems. Also, parties can find solutions that reach far beyond the initial conflict. For some matters it may also be important that in-court mediation is a more discreet way of conflict resolution and that parties can agree on absolute confidentiality of their outcome.

Mediator-judges report that they bring more than 90 % of the cases to an agreement. Where this does not happen, the matter will be relegated to the judge having jurisdiction. Given the high degree of success, it seems worthwhile trying in-court mediation because, if it fails, the loss in time is a minor issue in comparison to the average duration of civil and commercial litigation in Germany.

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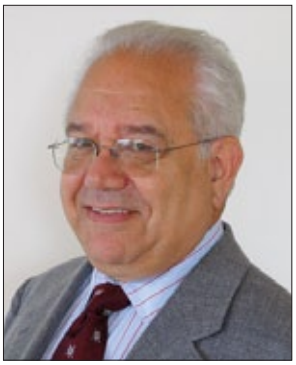
International Litigation in America – Settlement and Trial

The parties to litigation will be given opportunities to settle a case through mediation, non binding arbitration or a settlement conference before a judge. If they are unable to settle the case, a trial date will be given to the parties and their attorneys. Trial may take place on that date or it may be postponed for days, weeks or months depending upon whether there is a judge available to hear the case. Some courts will not tell the attorneys if there will be a delay and that mean that a international client might have to travel to court more than once before the case is heard.

Most civil trials are jury trials. Jurors are local citizens who know nothing about the case. After a selection process, the jury is empanelled and will hear all of the evidence in the case. The Jury decides what the facts are, who is at fault, whether that fault resulted in damages to the other party and what the monetary value of the damages is. The Jury decides. The Judge is present to rule on questions of law. After the evidence is presented to the Jury, the Jury will go over the evidence by themselves and make a decision. The decision is given to the Judge and the Judge reads the decision in open court.

Litigation in America is much more complex than I have described in these three short summaries. The international company or individual is advised to seek the advise and opinion of an experienced international litigation attorney before becoming involved in any law suit.



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Discovering Discovery Issues in Cross-Boarder Disputes

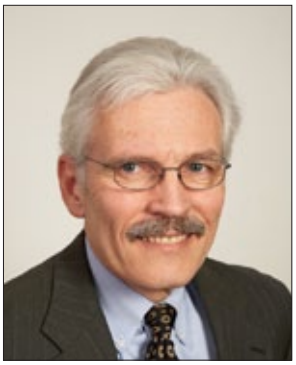
Inevitably, a foreign entity doing business in the U.S. will find themselves the subject of a lawsuit in an American courtroom. In defending themselves, litigants from civil law countries like Germany are often surprised by the depth of U.S. discovery orders and the invasive information gathering mechanisms available to plaintiffs. These discovery rules give foreign entities the impression that this litigation phase is little more than a fishing expedition. Problems frequently arise when adhering to U.S. discovery orders would directly violate foreign laws, known as "blocking statutes," which are enacted to prevent applying U.S. orders in the foreign nation.

Generally, courts have been unsympathetic to foreign defendants facing this dilemma. Recently, a Utah district court ordered a German company to produce customer complaints that they had received even though revealing such information would likely violate the German privacy laws[1]. The court here cited Societe Nationale Industrielle Aerospatiale, a Supreme Court case holding that foreign statutes do not deprive American courts the power to order production of evidence despite the possibility that the order may violate the statute[2]. Similarly, just last month, a court in New York went so far as to order a non-party foreign bank to produce information about a defendant's bank accounts irrespective of foreign banking secrecy laws prohibiting such disclosure[3].

But it is important to note that some foreign companies have been successful in protecting private corporate documents and abiding by their local laws. Some courts have held that when the laws of a foreign nation protect relevant information from discovery, the interests of the domestic court must be balanced with those of the foreign statute. Accordingly, in Texas, German car manufacturer Volkswagen was able to overturn a discovery order that violated German privacy laws when the trial court failed to properly balance these interests or to consider whether the information sought could be obtained by other means[4]. Suggested strategies for foreign litigants might be to request amicus briefs from the foreign government, file affidavits by experts and to show that compliance with the U.S. order would result in legal ramifications at home. Other factors to consider include the importance of the information, the specificity of the requests, whether the information originated in the U.S. and any alternative means available to secure the information.

Based on U.S. case law and applicable German laws, including recently adopted amendments to the German Federal Data Protection Act[5], great consideration must be given to complex discovery issues regarding depositions, document requests and the serving of interrogatories on persons or entities outside the U.S.

[1] AccessData Corp. v. Alste Techn. Gmbh, 2010 WL 318477 (D. Utah 2010)
[2] Societe Nationale Industrielle Aerospatiale v. United States District Court, 482 U.S. 522 (1987)
[3] Gucci America v. Curveal Fashion, 2010 WL 808639 (S.D.N.Y. 2010)
[4] Volkswagen, A.G. v. Valdez, 909 S.W.2d 900 (Tex. 1995)
[5] Bundesdatenschutzgesetzes (German Federal Data Protection Act)



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Important Tax Considerations: First Year of Residency

Many German nationals come to the U.S. to work for U.S. or German employers and later find themselves facing unexpected and unfamiliar U.S. tax issues. For many non-U.S. persons, U.S. taxation can be very complex, particularly for the year in which an individual arrives in the U.S. and a determination of residency status must be made. Since U.S. residents are taxed on their worldwide income in much the same manner as a U.S. citizen, the concept of residency is important and depending upon the facts, an individual may be treated as a nonresident, a dual-status resident, or a full year resident in the year of arrival. Under the "substantial presence test" for determining residency, an individual is a resident if he is present in the U.S. for 183 days or more, counting 100% of the days in the current year, 1/3 of the days in the preceding year, and 1/6 of the days in the second preceding year. In addition, the individual must be present for at least 31 days during the current year. If this test is met, the residency starting date is generally the first day of physical presence in the U.S. (with the exception of certain de minimis vacation trips that can be excluded). Any taxpayers arriving after January 1st will be dual-status taxpayers in the year of arrival.

Dual-status taxpayers are considered to be U.S. residents from their residency start dates to the end of the year. The benefits of nonresident status for the early part of the year is that only U.S. source income will be taxed and certain interest and capital gain income will be exempt from tax. In contrast, worldwide income is included and taxed in the residency period. Also, dual-status aliens cannot take the standard deduction and married taxpayers cannot file jointly or use the married filing joint rates.

There is a first-year election known as either a "6013(g) or 6013(h) election" that is available to certain married couples enabling them to file jointly and use the more favorable rates. Under this election the taxpayer and spouse are treated as U.S. residents for the entire year and are taxed on their worldwide income.

Single taxpayers who fail the substantial presence test, while ineligible to make the elections above, can make an election (the "7701(b) election") to be a part-year resident if they satisfy certain requirements. This election would enable a taxpayer to deduct certain itemized deductions paid during the period of residency that are not available to nonresident taxpayers.

Since first-year residency determinations can be complex, taxpayers should consult their tax advisors to ensure that all favorable elections are made to minimize tax liabilities. Initial tax compliance can even be further complicated due to special situations such as reliance on the residency tie-breaker rules under the tax treaty, qualifying for certain exemptions such, or if the unique rules applicable to certain trainees or students apply. Also, don't forget the often overlooked states tax issues that must also be considered.

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Foreign Account Tax Compliance Act – Expansion of Us Tax Compliance for Foreign Financial and Non-Financial Institutions

On March 18, 2010, President Barack Obama signed into law a statute which incorporates certain provisions of the Foreign Account Tax Compliance Act of 2009 ("FATCA").

FATCA will require a non-US financial institution ("FFI") such as a bank, private equity fund or hedge fund to enter into an agreement with the Internal Revenue Service to identify US account holders and to provide certain information about them annually. If the FFI does not enter into such an agreement, US withholding tax at the rate of 30% will be imposed on, among other things, dividends and interest from the FFI's US portfolio securities paid to the FFI after December 31, 2012 (subject to a grandfather rule). An FFI which satisfies procedures (yet to be issued) which are designed to ensure that it does not maintain accounts held by US persons may be exempted from the requirement to identify US account holders.

FATCA also imposes information reporting burdens on non-US non-financial entities ("NFIs"). An NFI will need to certify that (a) there are no "specified US persons" that own a greater-than-10% interest in the NFI and (b) there are no investment vehicles such as US hedge funds or US private equity funds that own any interest in the NFI. An NFI which does not make such a certification will need to furnish the name, address and US taxpayer identification number for each US person that does own such an interest, in order to avoid the 30% withholding tax described previously.

Interpretation and implementation of the new rules will largely depend on regulations that have yet to be issued. Qualified Intermediaries ("QIs") will need to satisfy the new information reporting rules in addition to existing QI requirements.

Should you have any questions about FATCA's new information reporting and withholding tax rules, please contact Charles Chromow, Senior Counsel with Wuersch & Gering LLP.

Circular 230 Disclosure: To ensure compliance with requirements imposed by the Internal Revenue Service, we inform you that any U.S. federal tax advice contained in this communication, including attachments, was not written to be used and cannot be used for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.

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Growing Importance of State and Local Tax Planning in the U.S.

Tax jurisdiction in the U.S. is divided among the federal government, the 50 states plus the District of Columbia, and local counties and municipalities. Taxes are levied by all three levels of government: federal, state and local. Most states and some municipalities impose corporate or individual income tax, sales tax, and real property tax. State and local income taxes generally follow the federal income tax in a way income is calculated. However, they may differ from the federal tax in that they apportion the income of an out-of-state corporation by a formula, rather than by determining specific state earnings. Most income taxes paid to the state and local governments by a business are deductible from income for federal tax purposes.

State and local taxes have become more and more important in the past years due to an increase in social needs for health care, education and safety. Even if a general approach could be viewed such as aligning state income tax laws to federal tax laws one significant and fundamental difference remains: the set-up of a state income tax system as a so-called unitary or non-unitary tax system. In a unitary tax state the filing of a combined (consolidated) corporate income tax return that includes affiliates (even worldwide affiliates) considered to be part of the unitary business is required whereas in a non-unitary system only the income of the entity conducting business in the state is included on the corporate income tax return. The goal of both approaches is to allocate and apportion income earned by the taxpayer doing business in multiple states. Whereas in the federal system the international standard of the arm's length principle is applied the unitary approach seeks to apportion to a state that amount of income that was generated by contacts with the state. The unitary approach is thereby based on specific formulas. What makes things difficult is that different states apply different formulas (even if most of the states should follow the so-called "Uniform Division of Income for Tax Purposes Act"). Tax planning potential but also additional complexity might result from activities that are carried out in unitary as well in non-unitary tax states. Another level of complexity results from that state tax authorities have developed certain creativity while applying and enforcing state tax laws and that substantial penalties may be imposed on a taxpayer in case sufficient documentation cannot be provided.

Proper state and local tax planning is strongly recommended in order to avoid double taxation of the same profits in several states, penalties and administrative procedures and to make sure that compliance rules are followed in the right way.

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Mission Incomplete – New Filing Rules for International Tax Forms

The Internal Revenue Service (IRS) calculates penalties and interest on the amount of unpaid tax owed by the taxpayer. Two separate forms of penalties exist: (1) Failure-to-**file** and (2) Failure-to-**pay.**

Filing due date for calendar-year corporations is March 15 of the year following the end of the tax period while individuals who reside in the US have to file their return by April 15, and out-of-country citizens and permanent residents are entitled to an automatic extension for filing, but not paying until June 15.

However, filing returns on time and making appropriate payments is not sufficient if submitted forms are incomplete. The recent Amendment of Section 6501(c)(8) of the Internal Revenue Code (IRC) suspends the running of the three-year statute of limitations period when information required by IRC section 6038D is not provided or there is a failure to file information returns regarding passive foreign investment companies (PFIC).

As amended, section 6501(c)(8) now provides that "…the time for assessment of any tax imposed by this title with respect to any **tax return,** event, or period to which such information relates **shall not expire** before the date which is three years after the date on which the Secretary is furnished the information required to be reported under such section."

The forms affected are:

926 – Return of a U.S. transferor of property to a foreign corporation
5471 – Information return of U.S. persons with respect to certain foreign corporations
5472 – Information return of a 25% foreign-owned U.S. corporation or a foreign corporation engaged in a U.S. trade or business
8621 – Return by a shareholder of a passive foreign investment company or qualified electing fund
8858 – Information return of U.S. Persons with respect to foreign disregarded entities
8865 – Return of U.S. Persons with respect to certain foreign partnerships
3520 – Annual return to report transactions with foreign trusts and receipt of certain foreign gifts
3520-A – Annual information return of foreign trust with a U.S. owner

The correct completion and filing of these forms is a new top compliance priority especially for taxpayers with cross-border transactions and those who provide these services. It seems that lawmakers just added another detour to their maze of regulations for international taxpayers. The amended section will be effective for returns for which the assessment statute of limitations is open after March 18, 2010.

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Comprehensive Health Care Reform Legislation with Significant Tax Provisions Enacted Into Law

On March 30, President Barack Obama signed into law the Health Care and Education Reconciliation Act of 2010. The Act contains a number of significant tax provisions including codification of the economic substance doctrine.

As developed by the courts, the economic substance doctrine allows a transaction to be disregarded for tax purposes even though the transaction complies with the literal terms of certain sections of the Internal Revenue Code. The disallowance is available if, except for the expected Federal income tax benefits, the transaction lacks economic substance.

Under the legislation, a transaction is treated as having economic substance only if

(1) The transaction changes in a meaningful way (apart from the Federal income tax effects) the taxpayer's economic position, and

(2) The taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction.

The Codification of the criteria to establish economic substance is not expected to alter a court's determination as to whether the economic substance doctrine is relevant to a transaction.

A specific grant of regulatory authority that was part of the original House version of health care legislation approved last November was not included in the enacted legislation. Notwithstanding the elimination of this provision, the IRS has general regulatory authority to provide guidance relating to the enforcement of this provision. The IRS, in providing regulatory guidance under the new law, is expected to consider the technical explanations released by the Joint Committee on Taxation ("JCT"). The JCT technical explanation states that codification of the economic substance doctrine is not intended to alter the tax treatment of certain basic business transactions that are respected under longstanding judicial and administrative practice merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. The explanation provides illustrative examples of such basic transactions, such as the choice between capitalizing a business enterprise with debt or equity.

The legislation creates a new 20% penalty for underpayments attributable to any disallowance of claimed tax benefits by reason of the transaction lacking economic substance. If the relevant facts affecting the tax treatment of the transaction are not

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adequately disclosed, the penalty increases to 40%. This penalty is a strict liability penalty, i.e., the taxpayer may not avoid this penalty by demonstrating reasonable cause. As a result, a taxpayer cannot rely on a third party opinion as protection from the imposition of this penalty if the underlying transaction is found by court to lack economic substance.

The new codified economic substance standard applies to transactions entered into after March 30, 2010.

JCT estimates that this provision will raise USD 4.5 billion over 10 years.

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Cancellation of Indebtedness Income

Included in the American Recovery and Reinvestment Act is a tax relief provision to defer cancellation of indebtedness (COD) income in connection with the reacquisition of an applicable debt instrument. A reacquisition is defined as the acquisition of a debt for cash or property, an exchange of one debt instrument for another including a modification of the debt instrument, an exchange of the debt instrument for corporate stock or partnership interest, the contribution of debt instrument to capital and the complete forgiveness of the debt by the holder of the debt. The debt instrument is one that is issued by a C corporation or by any other person in connection with the conduct of a trade or business. The debt instrument means any bond debenture, note, certificate or other contractual arrangement which comprises indebtedness. Additionally, more than one debt instrument can be aggregated with another and treated as one but certain exceptions exist.

Under Section 108(i) a taxpayer may elect to defer recognition of COD income occurring for 2009 and 2010 and to recognize the income beginning in 2014 equally over the subsequent five year period from date of deferral. The recognition of the COD income however is accelerated if the business is terminated or substantially all of the business assets are sold.

There are special rules for Partnerships, S-Corporations, and Members of Consolidated Groups.

Partnership issues have always been dealt with at the partner level but under this election of Section 108(i) by the partnership a more flexible allocation amongst partners is allowed. A significant rule based on partnership election permits a partner to either take advantage of the deferral or not depending on their particular tax situation, such as usage against NOL's.

S-Corporation issues are similar to partnerships in certain respects but have two major differences. One is that it doesn't allow the shareholders to allocate deferred and includable COD income and the second is that it limits deferral to shareholders immediately before the transaction and not new equity owners.

Members of Consolidated Groups issues must follow special rules under the Treasury regulations but can take advantage of intercompany inbound transactions.

Procedures to follow in making this election include attaching a statement to the tax return indicating Section 108(i), each applicable debt instrument and its description, a general description of the reacquisition, and the amount of COD income being deferred. These procedures are general to all situations and additional information is required for the various entity situations.

In summary, the enactment of this does provide certain tax relief in the form of deferrals but is complicated in its particular analysis to each situation.

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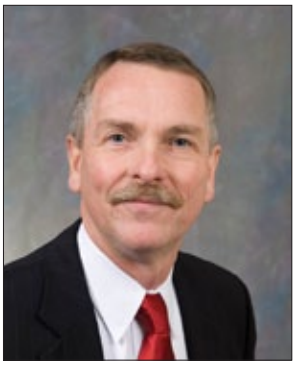

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Hybrid Vehicles (Tax Not Automotive)

The use of hybrid entities in international tax planning has been relatively predictable since the check the box regulations were introduced in 1997, although the IRS has from time to time suggested various changes to the rules. A hybrid entity is an entity formed in one jurisdiction that is treated differently in another jurisdiction. For example, a corporation formed in a foreign country may be treated as a partnership for US tax purposes. By filing a check the box election, the US planner, within limits, can proactively choose what type of tax characteristics the entity will have for US tax purposes. He can elect to have it treated as a flow through entity, more commonly referred to as a partnership, or if it only has one owner, a disregarded entity.

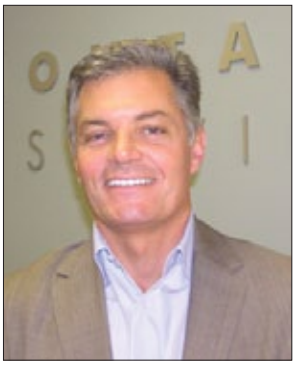
The advantage of such planning is that the tax characteristics of the entity will be respected in the foreign jurisdiction, yet the tax treatment in the US may be diametrically opposed, e.g., taxable entity in the foreign country and flow-through (non-taxed) entity in the US. Such a choice will have ramifications, including allowing the US to tax the foreign corporate parent on its' branch's income, whether it is US source or effectively connected with a US trade or business.

Many planning opportunities exist with regard to international structures that include hybrid entities. For example, a foreign parent corporation owns two subsidiary corporations also incorporated in foreign jurisdictions. Part of each foreign subsidiary's activity includes a US trade or business that generates effectively connected income. One foreign subsidiary generates US losses, while the other foreign subsidiary generates US income. If the two subsidiaries are treated as corporations for US tax purposes, one corporation will file an 1120F reflecting US losses, while the other will file an 1120F reflecting US income and incur a tax.

The alternative, where the foreign parent corporation files a timely entity classification election on Form 8832, electing to treat both foreign corporate subsidiaries as disregarded entities for US tax purposes, results in the foreign parent corporation filing a single Form 1120F and reporting both subsidiaries' US income and loss, thereby allowing the losses from the first corporation to be offset against the income of the second corporation, providing an overall result of minimized taxes.

There are a number of other planning techniques using the check the box election, but trouble may be brewing on the horizon. In 2009, the Obama administration proposed significant changes to the US international tax rules that would make deferral of income more difficult, and, if adopted, could actually cause certain entities' status to switch from disregarded to regarded, resulting in a potential transfer tax.

Aspects of Cross Border Reorganisations in US and German Tax Law



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Reorganisations and restructurings are significant features in the lifecycle of businesses. Cross border reorganisations often have a material financial volume: the merger of the German Daimler-Benz AG and the US-American Chrysler Corp. in 1998 with 40 billion US$ and the merger of the British Vodafone AirTouch Plc. with German Mannesmann AG in 2000 with 190 billion US$.

The main tax issue of changes in asset and shareholding structures is the treatment of hidden reserves which is often presented by intellectual property or other intangibles. Reorganisations basically lead to a disclosure of these hidden reserves that is subject to tax. This may present a financial difficulty because a reorganisation is usually not a sale that includes a cash inflow and no funds are available to pay taxes accordingly. Thus main condition is that cross border reorganisations remain tax neutral.

Another important matter to consider is that one country can lose its right of taxation in favour to the other according to the double taxation treaty between both countries. Main aim of structuring such transaction is to sort out both problems.

A successful reorganisation from tax point of view will lead in most cases to a result of doubling hidden reserves: once in received shares and secondly in transferred assets. According to US rules mainly the sec. 351 to 368 IRC are applicable for corporate organisations and reorganisations. Germany has a reorganisation tax act that is mainly applicable in this regard. The US as well as the German legislation know a tax-free incorporation in exchange for stock in such corporations according Sec. 351 IRC.

A remuneration for transfer of an asset others than stock (boot) will also be treated differently in both countries. Unlike to German tax law it is possible that according to US provisions two ore more companies can be involved. Another difference between both tax laws is caused by treatment of capital gains by a corporation according to German tax law is that 95% are tax free. An individual only has to pay 25% plus surcharges on such gains. This concept of tax benefits (einbringungsgeborene Anteile) does not exist in US tax law although there is a concept of a special treatment of capital gains.

To structure such transactions and solve the problems mentioned above is a long way round required. The practise uses the broader space of the US tax law especially triangular mergers as it was realised in the Daimler Chysler and the Vodafone

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Aspects of Cross Border Reorganisations in US and German Tax Law

– AirTouch cases. A foreign – to – foreign stock sec. 351 IRC transaction via foreign holding company had been used from the US perspective.

The complexity of such transaction requires specifically a clear concept and preparation.

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