A Director's Guide to International Operations

Today the challenges of doing business internationally face even young companies searching for their first customers. International operations can be very complicated, as companies must navigate competing regulations, authorities and cultures. They pose bewildering governance challenges that need to be mastered, not only for the benefit of the shareholders, employees and lenders, but to control the board members' personal risk exposure. Getting your international operations off on the right foot can make the critical difference between a strategically functioning board of a successful, governable enterprise and board endlessly and tactically distracted with compliance and liability issues, high remediation costs, and crippled shareholder value.

Here are some things the board must drive for when starting international operations; management must be clear that you expect these bases to be covered:

1. Recognize you can't do this casually or cheaply. If you do so, you risk loss of profits, ruined local reputations and, in the extreme, sanctions on your ability to enter (or even leave) a particular country in the future. Plan carefully, search for competent advice, and integrate a well-considered plan into your business operations, budgets and corporate governance practices. Beware of hidden costs. Too often the hassles and expense of dealing with issues such as customs duties, transaction fees, exchange controls, travel and communications costs (which a domestic-only company doesn't need to consider) are ignored or underestimated when operating across borders. Recognize that maintaining in-country books, records, annual audits and tax returns of the foreign entities are a necessary part of doing business in those locales. Failure to do so can result in the inability to operate in that country, the inability to enforce local contracts, and can result in legal action against the parent's and the foreign entity's directors.

2. Carefully think through the scope and nature of your anticipated activities and choose the legal structure (subsidiary or branch) carefully. Once an operation commences, some aspects are very difficult and expensive to change. It's one thing to hire a local native for marketing and sales activities, and quite another to have a full-blown U.S.-style subsidiary with sales, marketing, manufacturing and management. Whether you need to establish a formal legal entity in your chosen country or whether you can postpone that for a later time will depend on the country and the activity. For example, having a single sales person engaged in marketing and sales in the European Union will require a formal subsidiary (capitalized, registered and with a governing board) in some countries (such as France), but a "branch office" designation may be acceptable in others (such as the Netherlands). As a general rule, the more local people you employ and the more value-creating their activities are, the sooner you're going to need a legal subsidiary rather than a branch.

3. Of course, a foreign operation is primed to provide more than its fair share of financial and control errors. Be especially mindful of Sarbanes-Oxley requirements and establish proper internal controls. Separate cash and currency management from operations. Assign currency management to your central Treasury function if you have one. Local managers can make operating decisions which they perceive will benefit their local translation effect at the subsidiary level, with harmful impact to the consolidated international currency strategy at the parent level. Establish reward mechanisms to focus operational managers on operations, and Treasury managers on currency management; discourage operational managers from attempting to manage currency effects in an isolated, local manner. Even if your company is private, the concepts used to establish financial controls within a public company would be worth the pain and time necessary to establish at any foreign subsidiary. Investors and lenders may never know how much effort went into those carefully constructed and documented controls, but that will be the reward derived from their successful operation.

4. Properly fund and document intercompany activities. Whether you've got a sole person operating as a branch or a full-blown subsidiary, the parent is going to have to fund the monthly operating cash requirements until the entity is financially self-sustaining. Assuming you want to minimize the amount of your cash in foreign banks in foreign currencies, this will require cash advances from the parent on a monthly basis. Make sure the parent and subsidiary enter into a formal management agreement whereby the subsidiary will perform such-and-such services for the parent in return for a management fee of, say, 10-20% of costs, which may be sufficient to generate enough taxable income in the local country to avoid disputes over transfer pricing. Remember, your management fee arrangement with the subsidiary should be no less favorable than what it would cost you to engage an independent local company to provide those services to you on a contract basis. A good rule of thumb for all intercompany transactions is to document them just as if the parties were not related at all. This applies to invoicing for product transfers/sales, notes for loans, distribution agreements, technical support, warranties, royalty arrangements, management support, etc.

5. There's no substitute for face time: insist that senior management plan on and budget for regular and frequent travel to your subsidiaries. The board should hold occasional meetings in those countries, during which you should make sure to become acquainted with local senior managers.

6. Develop an internal audit capability: it plays an important role in monitoring compliance with the controls embedded in the processes and policies by testing them and looking for any design flaws. It's a natural function for the internal audit staff to travel to all of your locations on a periodic basis to monitor and test operational and financial controls. The higher the risk of material errors the more frequent the visits should be, and foreign operations almost always run a higher risk of error than the equivalent domestic operation. It's better to use internal audit time and talent whenever possible and save the top executive time necessary for travel for review and critique of the results of the compliance review.

7. Hire a CFO with international experience; on-the-job training can be very expensive. Of course, your Audit Chair should have international experience, too.

8. Before offering U.S.-style equity compensation such as stock options and restricted stock to local employees, take the time to understand local and U.S. tax implications to the employee recipients, the subsidiary and the parent. Tax liabilities can arise to all parties in ways that are very different from U.S. tax law, and these liabilities can considerably dilute or even eliminate the underlying incentive you desire to achieve in the first place. Stock option plans will usually need to be registered with local tax authorities.

9. Carefully consider the domicile of IP ownership and licensor agreements. This isn't just a question of who owns the patents or licenses; it also refers to copyrights, trademarks, trade names, distribution rights, and so on. Once established in a particular domicile, moving these assets to other affiliates in different countries or back up to the U.S. parent can be very cumbersome and expensive from a tax liability viewpoint. In particular, think long and hard about domiciling these assets in tax havens; doing so can tie up a significant amount of cash offshore, and you risk letting the tax strategy drive the business objectives.

10. Identify and retain competent international, and local, tax and legal counsel with experience in the locales in which you will operate. Operating in multinational environments requires different tax and cash management policies. China, for example, has quite restrictive currency controls. The U.S. has reciprocal tax treaties with many countries, and typically all those in the G8, but your target country may not have a tax treaty. Countries without a treaty with the U.S. will most likely withhold a significant portion of any funds that you attempt to repatriate back to

the U.S., and even those with a treaty will usually withhold 10-15% of repatriated cash. Include competent local national and municipal counsel; sometimes cities, as well as nations, have onerous tax statutes. Include competent local labor counsel; many countries (in Latin America and Europe, for example) maintain strict employee-protective laws, including onerous vacation and termination provisions.

11. In addition to technical advice from accountants and lawyers, seek input from someone who has set up a similar operation in the same country. They'll have a lot of practical advice, especially regarding pitfalls to avoid. Additionally, they can provide references to the myriad local service providers, such as bankers, realtors, lawyers, headhunters, etc., that may be required. Make one or more trips to your target country and interview key service providers to identify those you can trust, and establish a personal relationship with them.

12. Understand and establish a sound and supportable "transfer-pricing" policy for intercompany allocations. Until proven by a supportable transfer-pricing model (which in many countries like the UK requires objective, third-party evidence), foreign tax policy makers presume that costs are allocated to, and revenue shifted out of, the entity in their jurisdiction with the intent to reduce local profit and therefore reduce tax collections. A competent and experienced international tax advisor is required for this topic.

13. Establish, as necessary, banking relationships allowing for issuance of Letters of Credit ("LOC"), which can usually be handled through major U.S. based banks who have correspondent relationships worldwide. Anyone operating overseas should absolutely have a non-U.S. bank relationship. The days of 25 basis points for a stand-by LOC are long gone, but you may be able to get a better rate from an overseas bank, though you may find that your creditworthiness may be viewed differently overseas. With respect to LOCs, it is important to know your customer's bank credit with your bank, which can make or break collecting on your customer's letter of credit. Also, you want to have relationships with as many of the major U.S., Asian and European banks' letter of credit groups as possible, as they know the smaller international banks that are often your customers' local banks, not all of which have bank-to-bank credit relationships facilitating prompt confirmation and collection.

14. Investigate local currency requirements. While it may be preferable to express contractual requirements in U.S. dollars, this may not always be possible. Determine proper banking relationships to properly effect foreign exchange ("FX") needs, if necessary. Consider the need for possible FX forward contracts or currency hedging. While some consider using hedging to be speculative in nature, be aware that not hedging your currency positions exposes you to possible significant swings in FX over time. Consider locking in profits on large contracts expressed in foreign currencies. Also, you might consider whether you want to hedge your principal exposure, anticipated future cash flow exposure, or both.

15. Currency translation losses and gains are tricky to manage. Understand and explicitly define your foreign currency management strategy and policy. Understand the impact of FAS 52 and FAS 133 on your FX exposure. Integrate your currency-management policy with the impact of the "transfer-pricing" and tax structures identified above. Become acquainted with an experienced international banker. Remember that U.S. GAAP requires determination of the "functional currency" for foreign affiliates (either the U.S. dollar or the local-currency must be defined as the "functional currency").

16. Apply for and establish trademark, service mark and copyright protection early. U.S.-style "first use" doctrine does not necessarily apply in other countries, and trademark/servicemark protection can be based more narrowly on intended use and application, not just on the name. In such countries you can find your application opposed by companies with a similar mark in

completely unrelated applications. Further, getting trademark or service mark protection can take a couple of years or more from the date of application, and much longer if your application will be opposed by another company.

17. Localize your recruiting, HR activities, policies and compensation structures from the start. Most other countries have comparatively bureaucratic and cumbersome employment practices and regulations, particularly when it comes to layoffs and redundancies. You will be wise to understand these in detail, and budget accordingly should you anticipate any possibility of reducing foreign staff. Further, when it comes to local executive compensation, executive perquisites considered unusual in small venture-funded U.S. companies, such as car allowances, retirement contributions, and even housing subsidies, are common and expected overseas. Also, American employment and management practices can be perceived as harsh, so tread lightly until you thoroughly understand the local business customs.

18. Just because a subsidiary operation is in a foreign country doesn't make it exempt from U.S. laws or regulations such as Sarbanes-Oxley, the Foreign Corrupt Practices Act, U.S. taxation, etc. Failure to comply overseas can open the company, management and directors to criminal prosecution in the U.S. Management of the foreign operation should know very clearly what is expected of them in all these areas.

By getting started right and setting proper expectations you will go a long way to avoiding self-absorbing situations which are at best frustrating and at worst personally expensive. The tradeoff in additional ongoing expense is far cheaper than future remediation. Starting right will allow you to fully contribute in the ways you envisioned when you agreed to join the board in the first place.

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