The International Legal Environment

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METHODS OF ENGAGING IN INTERNATIONAL BUSINESS

As more businesses seek to participate in international business, the insurance or risk management professional needs to know the different methods by which a company may get involved, as well as the key issues each method involves.

An organization can engage in international business through any of these methods, each of which involves different levels of investment and business risk:

- Foreign trade
- Foreign contractual relationships
- Foreign direct investments

Foreign Trade

Foreign trade is the importing and exporting of a product from one country to another. It is the most common method used to participate in international business, and, compared with other methods, is the one that requires the lowest level of investment and entails the least amount of **business risk**.

Business risk
Risk that is inherent in the operation of a particular organization, including the possibility of loss, no loss, or gain.

Key issues for organizations involved in foreign trade include both regulatory compliance and the formation of international sales contracts. Export and import controls imposed by the United States government are important regulatory concerns, while international sales contract concerns include terms of sale and methods of payment.

Export Controls

Any kind of good that is sent from the United States to another country is an export. The form of transfer—shipment by carrier, mail, airplane courier, or facsimile—is subject to governmental controls. Any item, even if it leaves the country only temporarily or is not for sale (for example, a gift), is subject to control.

Most exports do not require a license and are sent to other countries under the No License Required (NLR) designation. Some goods require a Commerce Export License, which must be obtained from the Bureau of

Industry and Security (BIS). BIS is responsible for implementing and enforcing the Export Administration Regulations (EAR), which regulate the export and re-export of most commercial items. These goods are often referred to as dual-use items, because they have both commercial and military applications.

Any goods may be subject to a classification system determined by the U.S. Department of Commerce. The Department of Commerce assigns a specific alphanumeric code to goods known as an Export Control Classification Number (ECCN); all ECCNs are listed in the Commerce Control List (CCL). The classification of the good determines its licensing requirements.

Once the classification is determined, the country of destination and end user are reviewed. Depending on the geopolitical climate, some classifications of goods may be prohibited from sale. Other types of goods are classified as EAR99, not subject to the CCL. Generally these items do not require a license in many situations.

The EAR does not control all goods, services, and technologies; other U.S. government agencies regulate more specialized items.[1] The Office of Foreign Assets Control (OFAC) of the U.S. Department of the Treasury administers and enforces economic and trade sanctions as determined by U.S. foreign policy and security objectives. OFAC operates under Presidential national emergency powers as well as authority granted by legislation. OFAC imposes controls on transactions and can freeze assets under U.S. jurisdiction.

OFAC may prohibit trade or financial transactions and other dealings by U.S. entities based on national policy and national security goals. Prohibitions vary and must be reviewed. OFAC may provide for a general license authorizing certain transactions, or it may provide a specific license on a case-by-case basis, depending on the circumstances.

Insurers participating in worldwide insurance markets through global insurance policies can insure global risks without violating U.S. sanctions law by inserting policy language that explicitly excludes risks violating U.S. sanction laws. For example, such a clause in an ocean marine cargo policy would read, "...whenever coverage provided by this policy would be in violation of any U.S. economic or trade sanctions, such coverage shall be null and void." This type of exclusion prevents OFAC compliance problems and ensures that insurance and risk assumption will not be extended to sanctioned countries, entities, or individuals.

If the insurer cannot use the exclusionary language, OFAC also allows for an insurer to apply for a specific OFAC license in order to compete in international insurance markets. A separate license is required for an insurer to pay claims arising under any authorized global policy. OFAC regulations supersede all state regulations, regulating an insurer's ability to decline policies, cancel policies, or withhold claim payments.

Import Controls

The U.S. regulates the import of goods by using one or a combination of four techniques:

- Tariffs
- Quotas
- Licenses
- Prohibited imports

Many goods are imported into the U.S. because it is cheaper to manufacture them in another country. Tariffs are a tax, or duty, assessed on goods imported into the U.S. The tariff is *ad valorem*, a percentage of the price added to the sales price of the goods. The tariff increases the item price for the U.S. consumer, which may make a similar good produced in the U.S. more attractive to the American consumer. The tariff helps to eliminate the cost advantage of the imported good, protecting its American manufacturers and distributors.

Import duties are collected by the U.S. Customs Service. Goods are unloaded from carriers and stored in warehouses until the shipments are examined. Formal entry into the U.S. is made through the presentation of documentation describing the goods for classification so that the correct import duties are assessed.

Quotas are limits on the amount of a good that may be imported into the U.S. Often the good can be manufactured or otherwise produced at a cheaper cost. The imported good, if brought into the U.S. for sale in the quantity American consumers would buy, may provide sufficient supply at a price that precludes American producers from competing. Limiting the amount of a good that is already made in the U.S. protects the American producer.

Licensing, the third method of control of imports, is granted by a country's government. By requiring a license to conduct business, the government ensures that a good will be imported into the country on more favorable terms than if domestic companies competed for the goods for use or resale.

Prohibited imports are goods that are illegal to be imported and sold in the U.S. Obvious examples of prohibited imports are marijuana and cocaine.

International Sales Contracts

International trade is facilitated by agreements between trading partner countries. The United Nations Convention of Contracts for the International Sale of Goods (CISG) provides for a uniform code for international contracts. Similar to the Uniform Commercial Code (UCC), which provides uniformity for commerce within the U.S., CISG provides rules for writing international contracts and transfer of goods under the contracts.

While the same sales contract may not be used by parties for all transactions, the contract terms should clearly define the venue by which any disputes would be decided (choice of law) and the method, timing, and currency of payment. The contract may define whether the goods are to be sold directly to consumers in the foreign country or whether any distributor(s) will be selected. Warranties for the goods may also be addressed in the contract.

Choice of law specified in the sales contract will address most issues regarding differences in contract law because the country, as well as the local jurisdiction (such as state, province, or municipality), is specified in the contract. The method of payment ensures compliance with import and export financial regulations. Timing determines cash flow and delivery dates. Choice of currency addresses the risk associated with inflation and currency fluctuations on the international market.

Often, international sales contracts will include a *force majeure* (French for "superior force") clause. Essentially, incorporating this clause in the international contract frees all parties from obligation when an extraordinary event or circumstance beyond the control of the parties (such as war, strike, riot, earthquake, or volcanic eruption) prevents one or both parties from fulfilling their obligations under the contract.

Selling Terms

The selling terms agreed to by the seller and buyer and referenced in the contract of sale are a key issue in foreign trade.

The selling terms in a contract of sale typically follow standards expressed in either the *Revised American Foreign Trade Definitions (RAFTD)* or the *Incoterms*. The *RAFTD* were adopted by a joint committee consisting of representatives of the Chamber of Commerce of the United States of America and other U.S. trade associations. The Incoterms, developed by the International Chamber of Commerce, are now more widely used in international trade than the *RAFTD*.

The details of all the various selling terms defined in the *RAFTD* and *Incoterms* are beyond the scope of this discussion. However, an example will illustrate how selling terms can affect the respective duties of the seller and buyer in an international sale of goods.

Assume that a French company purchases American-manufactured cloth-covered folding chairs. The chairs are shipped in a metal intermodal container carried on an oceangoing vessel from Philadelphia, Pennsylvania, to Le Havre, France. During the voyage, the goods are damaged by salt water when the container breaks because of a severe storm. The selling terms stipulated in the contract of sale will determine which party (the buyer or the seller) will bear the financial consequences of the loss.

If the selling terms are Free On Board (FOB) Philadelphia, the American firm (the seller) assumes all risk and costs incurred to place the goods safely aboard the vessel named by the buyer. Once the goods are on board the vessel, the French company (the buyer) assumes the risk of loss or damage and must both pay the transportation costs (freight) and obtain cargo insurance if it wishes to insure the shipment.

If, instead of FOB selling terms, the selling terms are Cost, Insurance, and Freight (CIF) Le Havre, the seller's and buyer's responsibilities for loss are essentially the same as under FOB terms. However, under CIF terms, the seller must arrange and pay for ocean transportation to the named port and purchase cargo insurance covering the goods until they reach their destination. Thus, in the example, the buyer would still bear the risk of loss during the ocean voyage, but the cargo insurance purchased by the seller would indemnify the buyer.

In addition to addressing who bears the risk of loss, who pays freight costs, and who pays for insurance, selling terms also address issues such as these:

- Seller's duty to provide the goods and the commercial invoice in conformity with the contract of sale
- Seller's duty to assist the buyer in obtaining an export license or other authorization needed to export the goods
- Seller's duty to place the goods at the disposal of the buyer at the named place of delivery or on board a vessel named by the buyer
- Buyer's duty to pay the price stated in the contract of sale
- Buyer's duty to obtain any import license or other authorization needed to import the goods
- Buyer's duty to take delivery of the goods as agreed

Methods of Payment

Despite the selling terms, the seller is actually exposed to loss until it receives the buyer's payment for the goods. The buyer might be unable to make its payment, or may refuse to pay because the goods are damaged or do not meet the specifications agreed upon. The seller usually will define the method of payment in the sales contract. These are four possible methods of payment:

- Cash in advance—Funds deposited prior to receipt of the goods. This is a double disadvantage to the buyer. First, the buyer loses the time advantage of the funds, which is the use of the funds for other investment opportunities. Second, if the seller fails to ship the goods, the buyer may have difficulty recovering the funds.
- Open account—A rotating charge account under which the buyer settles the account at determined intervals. An open account is usually established only if there is a long-term relationship between buyer and seller.
- Draft—A written order by a first party, called the "drawer" (the seller), to the second party, called the "drawee" (the buyer), to pay funds to a third party, called the "payee," or to the bearer of the draft. The seller uses the draft drawn on the customer and sells it to the bank; the bank then discounts the draft. In consideration of the discount charge, the bank uses its

money to finance the shipment. The seller is paid the discounted value of the sale and does not have working capital tied up waiting for payment. If the drawee (buyer) refuses to pay, the bank has recourse against the seller. So, until the buyer pays the draft, the seller is still exposed to loss if the goods are lost or damaged in transit.

- Letter of credit (LOC)—The buyer establishes credit with a local bank, which then contacts a bank in the seller's country, establishing a credit in favor of the seller. The seller then receives a letter of credit in confirmation of the credit. If the seller is domiciled in the U.S., the letter of credit is called an "export letter of credit." If the buyer is domiciled in the U.S., the letter of credit (in favor of the foreign seller) is called an "import letter of credit." The LOC specifies what the seller must do to access the credit. If the LOC requires an insurance certificate or policy, the certificate or policy must be prepared exactly as stipulated. When the seller comes to use the credit, the seller follows the same procedures as though drawing a draft on the buyer and presents the documents to the bank that issued the credit. The seller immediately receives money from this bank, and if the letter of credit is properly drawn, there is no recourse against the seller. Letters of credit that have this no-recourse feature are called "irrevocable letters of credit." Revocable letters of credit are rarely used. The revocable letter merely states the manner in which payment is to be made. It provides no protection for the seller because it can be canceled or amended without notice to the seller.

Foreign Contractual Relationships

A second method for conducting international business is through the use of foreign contractual relationships. In comparison with foreign trade, foreign contractual relationships increase business risk and resource commitment. Two main types of foreign contractual relationships are product licensing and franchising.

Product Licensing

Product licensing is permission granted by one company to another to manufacture its product or to use its distribution facilities or technology. The licensing of products between different countries can occur for three primary reasons:

- A company may decide that selling its product in the second country is economically unfeasible because of labor costs, transportation costs, or regulations.
- A company may decide that it does not have the time or resources to produce the product in another country.
- A company may lack sufficient knowledge about the country's legal, political, social, and business environments.

Licensing technology includes granting the right to use, under specified conditions, the company's intellectual property, such as copyright, trademark, or patents. For example, a common license agreement provides for licensing computer software. A company does not buy the software program in a legal sense, but buys the right to use the program and agrees to do so under set conditions.

Just as software firms are concerned about the illegal use of their products, one of the major considerations for any firm granting a license to a foreign firm is protecting its assets. Before entering into any agreement, the domestic company assesses the trustworthiness of the foreign company it is dealing with and the foreign company's ability to meet the financial requirements of the licensing agreement.

Thoroughly understanding the foreign legal environment regarding copyright, trademark, and patent protection is necessary. A company should consult a lawyer who is an expert in the intellectual property field about global intellectual property legal issues.

Franchising

Franchising occurs when one company assigns to another the right to supply its products or services within a market. A franchise is a contract entered into for a specific time period. The franchisee (who receives the franchise) pays a royalty to the franchisor (who grants the franchise) for the rights assigned, in addition to other possible considerations. The franchisor provides training, technical assistance, specialized equipment, advertising, and promotion as stated in the agreement.

In franchising, the company image and its name are the franchisor's assets. The franchisor allows the franchisee to use its image and certain assets.

An important aspect of franchising is the control over the use of the company's name and the quality of the product or service. For example, many franchisors retain control over all advertising and pricing of products in the markets. Some companies control the risk of improper use of the corporate name or the risk of poor product or service quality by withholding vital technology or required component products. For example, a hotel chain can maintain control of its reservation system, or a grocery cooperative can maintain control of all product distribution.

Foreign Direct Investment

A third method to conduct foreign trade is foreign direct investment, which occurs when a company in one country acquires control over assets located in another country. This type of investment also anticipates managerial control of the assets acquired in the foreign market. This arrangement contrasts with foreign portfolio investment, which occurs when a company purchases foreign stocks, bonds, or other financial instruments. Foreign direct investment usually takes one of two forms, known as subsidiaries and joint ventures.

Subsidiaries

A subsidiary is a company owned or controlled by another company. A subsidiary might be subject to the parent company's complete or partial control. Generally, a company is not a subsidiary unless another company controls 50 percent or more of its shares.

A distinguishing characteristic of a subsidiary, as opposed to a joint venture, is that a subsidiary issues stock. The stock can be 100 percent owned by the parent company, or some of the shares can be publicly traded in the foreign market. In fact, joint ventures are often subsidiaries in which the partners each own a percentage of the stock. In many foreign markets, the government requires a company to form a subsidiary to bring the parent firms and subsidiaries under the local laws of incorporation. These local laws can require both the subsidiary and the parents to comply with local financial reporting and disclosure.

The fully owned subsidiary provides a company with the highest level of control over operations, but presents the highest level of business risk, commitment of capital, and managerial control. With higher risk, a company expects to achieve higher returns. For a company experienced in international operations, this trade-off between risk and return can be acceptable and even desirable.

The time required for a company to enter a foreign market using a subsidiary varies, depending on the entry technique the company chooses or requires. Acquiring an existing company in the foreign market can usually occur relatively quickly. Conversely, if a company develops its subsidiary from the ground up, it might take years to become relevant in the foreign market. This latter approach probably gives the company the greatest control over its foreign affiliates, because the parent company would develop the local management, distribution channels, and product mix. However, this approach also requires a larger investment of resources and time.

Joint Ventures

In the international trade context, a joint venture involves shared ownership and control of a foreign operation. Joint ventures allow a company to enter either a geographic or product market and to acquire technology or revenue that would not otherwise be within reach.

The most common joint arrangement involves a company joining forces with a second company to operate a joint venture in the second company's country. Less common are joint ventures formed by companies from two different countries to operate in a third country. Additionally, companies rarely enter into joint ventures with more than three partners.

Like subsidiaries, joint ventures increase companies' business risk and commitment of resources. A company might have to invest substantial capital or share proprietary technology with its joint venture partners. However, the value of the joint venture can be greater than the sum of the individual partners' contributions.

In some joint ventures, partner companies divide capital expenses among themselves and share the costs, depending on the market and the partners' preferences. Additionally, engaging in a joint venture requires a company to commit substantial managerial resources and might require considerably more time to enter a foreign market than to enter a domestic joint venture or acquire a subsidiary.

Perhaps the single most important aspect of forming a joint venture is choosing the right partner or partners. This choice is important because the companies share resources, managerial responsibilities, technology, and profits, among other things.

A company may choose foreign direct investment over foreign trade for a number of reasons. Barriers to trade, both those occurring naturally (for example, transportation costs and language and cultural differences) and otherwise (for example, tariffs, quotas, or political issues) contribute to a company's need to gain direct access to markets through direct investment.

Companies seeking direct foreign investment fall into three general categories:

- Resource seekers—Companies that enter a foreign market seeking that country's resources, such as oil reserves, lower-cost labor, or technology
- Market seekers—Companies that enter a foreign market to acquire new customers outside their own countries' boundaries
- Market followers—Companies that follow their customers into foreign countries, a common trend in service industries such as insurance and banking

LEGAL SYSTEMS

Although no two countries have identical legal systems, many nations share legal approaches and concepts. Additionally, some countries classified within one system have incorporated legal concepts found traditionally within other systems. This section provides information about the development of different legal systems to give insurance professionals a basic understanding of the differences they might encounter in the international legal environment.

In a majority of countries, the legal systems fall into these two major categories:

- Civil-law system
- Common-law system

The civil-law tradition developed within these three distinct subsystems:

- Roman (and French)
- German
- Scandinavian (Nordic)

Other predominant legal systems include the East Asian, Hindu, Islamic, and Socialist-Communist systems.

Civil Law

Civil law, or Roman-Germanic law, uses comprehensive codes and statutes to form the backbone of a legal system. This system relies heavily on legal scholars to develop and interpret the law. The civil-law system is the most influential system in the world. More countries use its subsystems, in one form or another, than any other legal system.

It is the dominant legal system of western Europe, almost all of Latin America, and parts of Africa and Asia. Additionally, the civil-law system can be found in parts of some traditionally common-law countries (for example, Louisiana in the United States, Quebec in Canada, and Puerto Rico). However, these legal systems can vary a great deal from one country to another in their legal institutions, processes, and rules.

In the civil-law system, a judge is a civil servant whose function is to find the correct legislative provision within a written code of statutes and apply it to the facts presented in a case. Judges perform little interpretation of a code, and their opinions do not determine their thought processes on legal issues.

The civil-law courts usually are divided into two or more separate sets, each with its own jurisdiction over different issues, with a different hierarchy, judiciary, and procedures.

The typical civil-law case usually is divided into these three stages:

- The preliminary stage involves submission of pleadings and appointment of a hearing judge.
- At the evidence stage, a hearing judge takes evidence and prepares a written summary of the proceedings.
- At the decision stage, the presiding judge decides the case based on the record provided by the hearing judge, the counsels' briefs, and arguments.

The civil law system does not have the common-law system's jury trial; instead, a series of isolated meetings, written communications, motions, and rulings help decide the case. Civil-law countries have varying time frames for these events; some countries' procedures proceed very quickly, and others proceed very slowly.

Roman-French Law

The French civil code of 1804 consolidated the contrasting concepts of law by decree and law by custom. Although a magistrate is the final arbiter of a private law dispute, a court can rely on appointed experts, who have wide-ranging powers to investigate and present evidence to support an opinion rendered by a court. A magistrate usually will not reject an expert's opinion.

However, in France and Italy, a party can appeal a primary court's opinion, although courts in those countries tend to have extremely heavy backlogs. Under these circumstances, the examination of detailed factual or legal issues can be difficult because, with the passage of time, memories fade and some witnesses become difficult to find.

The French civil code was the basis for codes in the Netherlands, Italy, Portugal, and Spain. Haiti also adopted the French Code, and Bolivia and Chile adopted it for the most part. In turn, Ecuador, Uruguay, Argentina, and Colombia used the Chilean code as the model for their own legal systems. Puerto Rico and the Philippines used the Spanish code as their legal systems' model.

German Law

Germany's location in the center of Europe has greatly influenced its political and social history. Many scholars consider the German civil law system as the most developed and influential of all the civil-law subsystems.

The German private law, or *Bürgerliches Gesetzbuch* (BGB), is the civil code that took effect in 1900. Unlike the French Code, which was designed for laypersons to read, the BGB was developed for legal professionals to read and was too technical for laypersons. The German civil law influenced the U.S. legal education system; the American Law Institute's (ALI) restatements, or authoritative treatises, on law; and the development of the Uniform Commercial Code (UCC).

The original German code emphasized the rights of people to enter into contracts freely and dealt with the enforceability of all kinds of contracts. Similarly, the German code requires a finding of fault on the part of a wrongdoer in a tort suit. Although some elements of those concepts still exist, the availability of insurance as a risk- and damage-spreading mechanism has caused the German code to expand individual obligations and potential culpability.

Compensation for damages without culpability has effectively created a "cradle-to-grave" safety net as part of a wide social compact in Germany. For example, German statutes grant compensation for certain types of accidents, regardless of culpability, including railway, traffic, aircraft, electrical, gas, and nuclear power station accidents.

The German and Swiss codes, along with the French code, influenced code developments in Brazil, Mexico, pre-communist China, and Peru.

Additionally, Japan used the German code in the development of its own code, and Turkey used the similar Swiss code in developing its legal system.

Scandinavian Law

The Scandinavian (Nordic) legal system is both a civil-law system and an independent system. The legal systems in the Scandinavian countries are based neither on large bodies of codified regulations, like those of the French and German systems, nor on case (common) law.

The Scandinavian legal systems evolved from a long-established history of customary law. Elements of law by decree developed as a result of Germanic and Russian influences. Additionally, the Scandinavian countries have codified historical business practices as statutes. In tort law, as distinguished from contracts, damages contain a punitive element beyond just and fair compensation.

The development of a virtually distinct legal system in Scandinavian countries resulted from the historically close links among those countries. For example, Finland was part of Sweden for hundreds of years until it became part of Russia, then eventually gained independence. Norway, now independent, was part of Denmark.

Common Law

In the common-law legal system, a judge interprets the facts of a case, examines precedents (prior judicial rulings in similar cases), and makes a decision based on the facts in the current case. Precedents are guides, not rigid frameworks for all decisions. This system tends to be fact-intensive, relying on the judge's reasoning for a final decision.

England and most of the former British colonial countries, including Australia, Canada, India, and the U.S., use the common-law system. Japan's law combines the civil- and common-law systems, particularly relating to corporate law, which resulted from U.S. influence in post-World War II Japan. East Asian legal systems also influenced Japan's legal system. Other examples of blended common-law systems are Canada and the U.S. Both the province of Quebec and the state of Louisiana have state legal systems based on French civil law.

East Asian Law

East Asian countries have a common background profoundly influencing their legal developments over the centuries. China has a dominant presence in East Asia. Although both Korea and Japan have different legal systems, they both reflect the Chinese influence.

Until the 19th century, Japan's civil code was based on the developing German civil code. However, this imported legal code did not supplant the local customary law already existing in Japan. Even today, a tradition of informal compromise, contrasted with individual parties' asserting their rights in negotiations, remains a strong characteristic of the East Asian countries' approach to contract disputes. Japan today has relatively few attorneys, judges, and lawsuits.

Other Asian countries have relied on both civil and common law to varying degrees. French colonialism influenced the legal systems of the southeast Asian countries Laos, Cambodia, and Vietnam for many years. By contrast, England's common-law system influenced the legal systems of Singapore, Malaysia, and Brunei. U.S. influence was prevalent in post-World War II Japan and in the Philippines after the Spanish-American War.

Hindu Law

Hinduism provides religious and philosophical rules in India and some surrounding countries. The Hindu legal system is perhaps the oldest in the world. The customs and laws of Hinduism have applied separately and distinctly to the members of four major caste groups: Brahmans (priests), Kshatriyas (warriors), Vaishyas (tradesmen), and Sudras (servants and artisans). Movement from one caste to another historically was not permitted, even with professional or political success, although laws have attempted to eliminate the rigid caste system. Legislation in India has voided all the rules of the caste system when they conflict with social justice.

By the early 1800s, most of India was under the control of the British, whose policy in settling colonies was to retain existing law, allowing Hindu law to become the official system for the Hindu population. The effect of British rule on Hindu law was the development of legislation, the judiciary, and the legal education system. A statutory code of commercial, criminal, and civil procedure has replaced the Hindu law of contracts and property. However, India's legal system still reflects remnants of the caste system.

Islamic Law

The Islamic legal system is used in countries whose citizens are almost entirely followers of the Islamic religion. This legal system is based on the foundations of the *Book of the Qur'an* (*Koran*) and includes almost all of the countries of the Middle East and northern Africa, southern Asia, southeastern Europe, and parts of southeast Asia.

More Islamic countries are members of the United Nations than countries whose majorities follow any other religion. Islam is the second most prevalent religion in the world, with approximately 1.2 billion followers.

With the end of World War I and the collapse of the Ottoman Empire, Europeans regained control of most of the territories that Islamic warriors had captured in previous centuries. In the decades following World War II, many Islamic peoples attempted to gain their independence, often from European countries. Internal debates, still ongoing, centered on whether states should be theocracies or should be secular states that follow Islamic law.

The primary system of law within the Islamic countries is the *Shari'ah*, with a secondary system of jurisprudence called the *fiqh*. The *Shari'ah* consists of the two primary sources of Islamic law from which all legal principles derive, the *Qur'an* and the *Sunnah*. The *fiqh*, or Islamic jurisprudence, is the process of applying *Shari'ah* principles to both real or hypothetical cases.

The *Qur'an*, the highest source of law within Islam, gives followers of Islam the authority to make law and render opinions. The *Sunnah* forms a second tier of the *Shari'ah* and mandates the standard of conduct people are to follow to comply with the *Qur'an*.

The *Qur'an* is a religious book, not a legal code or book of law, but it serves as the foundation for the Islamic legal system. It contains specific precepts about ethics, crime, business transactions, domestic relations, inheritance, and war. The *Qur'an* differs from a code of law in that it does not mention the legal consequences of the disregard of its rules.

The *faqh* refers to the body of laws developed from the *Shari'ah*. Five schools of *faqh* (*faqh madhhabs*) exist today. Four are within the *Sunni* sect of Islam. The fifth school is within the *Shai* (*Shiite* or *Shiah*) sect of Islam. At times, conflict has divided the different *faqh madhhabs*. Identifying with a different school or attempting to change affiliation can be considered heresy. Additionally, at times judges prohibit intermarriage between the different *faqh madhhabs*.

Approximately 90 percent of all Muslims identify themselves as *Sunni*, with the balance being *Shai*. The *Shai* live primarily in Iran, southern Iraq, Syria, and Lebanon and believe that the leader of the Islamic religion should be a direct descendant of Muhammad. *Sunni* Muslims do not have this requirement. A significant difference between *Shai* and *Sunni* is that *Shais* also believe that individual reasoning (*ijtihad*) is a legitimate source of Islamic law.

Socialist-Communist Law

The socialist system originated with the Marxist overthrow of czarist Russia in the October Revolution in 1917, which created the Soviet Union. Before the revolution, Russia was a civil-law country.

The result of the Marxist takeover was the imposition of socialist ideology over the civil-law system that already existed. The central idea of the system was the emphasis on the state's interest over that of individuals. Russia developed new codes that reflected the Marxist ideas that the laws should serve the interests of socialism.

Private-sector business legal principles, such as contracts, commercial law, torts, property, and bankruptcy, are of little use within a socialist system. Public law replaces private-sector legal principles. For example, because the government owns all property and production, all contract law is public. In a socialist country, the socialist political party controls and influences the entire legal system, including the courts. All decisions from the courts, although independent in nature, are subject to party control or revision.

Western civil- and common-law systems heavily influenced the law in Russia. Asian socialist-communist countries discovered problems applying the Soviet-style legal principles in their societies. The communist People's Republic of China, for example, abandoned the legal principles introduced to them by the Soviets and developed a more informal system more similar to East Asian traditions.

With the fall of the Soviet bloc in the 1990s, former eastern European bloc countries abandoned the socialist-communist legal system in favor of a civil-law system. Many changes were profound, with legislatures endorsing basic free market principles. The actual changes varied by country. Today, Russia is a civil-law country. However, the Russian government often changes the legal applications of civil law with regard to individuals and businesses.

Several other communist-ruled or communist-influenced countries, such as Cuba, North Korea, Vietnam, and the People's Republic of China, still use the Soviet-based legal system. The People's Republic of China now permits a private economy and has adopted it as part of the Constitution of the People's Congress. China's dominant constitutional principles still require observance of socialist doctrine. China also has adopted civil-law type of codification, the General Principles of Civil Law, and is developing an ever more extensive codification.

INTERNATIONAL LAW

In any legal dispute arising between parties from different countries, public and private international law must be considered.

Those resolving international disputes between individuals or corporations first apply any applicable public international law, such as an international treaty, that governs the dispute. If no international treaty applies, then any relevant laws of the involved countries are applied to the dispute in accordance with the principles of private international law.

Public International Law

Public international law concerns the interrelation of nation states and is governed by treaties and other international agreements.

Public international law
A law that concerns the interrelation of nation states, and that is governed by treaties and other international agreements.

International treaties agreed to by a business's country of origin govern some international business transactions. These treaties may be between two countries, or they may be multilateral treaties among many countries.

The North American Free Trade Agreement (NAFTA) is a trilateral treaty governing all business interactions involving Canada, Mexico, and the U.S. Other treaties, such as the World Trade Organization's General Agreement of Tariffs and Trade (GATT), involve more than one hundred countries as signatories.

These international agreements affect member countries by requiring that they amend their national laws to comply with the agreements' requirements. For example, countries that signed GATT agreed to adjust their tariff rates on imported goods from other GATT member countries. However, these agreements are not limited to trade and tariffs. For example, NAFTA includes investment provisions, and the World Trade Organization's Trade-Related Aspects of Intellectual Property Rights Agreement ensures that the laws of member countries set basic standards for the protection of intellectual property.

Private International Law

Private international law
A law that involves disputes between individuals or corporations in different countries.

Private international law involves disputes between individuals or corporations in different countries and is also referred to as conflicts of law. It involves questions about which laws apply in settling the disputes and how they apply. It determines which jurisdiction's law applies to the business transaction in question, which country's court hears a dispute, and whether other countries will enforce the foreign decision.

In any legal dispute arising between parties from different countries, these two issues must be considered:

- Whether a court in one country will recognize the decision of another country's court
- Whether a court has the right to hear the legal dispute

The first issue is referred to as comity, the practice by which one country recognizes, within its own territory or in its courts, another country's institutions. Comity can also apply to the rights and privileges acquired by a citizen in a country. Many experts believe that comity is the basis for all private international law.

The second issue is referred to as jurisdiction. Just as in domestic cases, one of the basic questions of international law is whether a court has the right (jurisdiction) to preside over a particular case.

More specifically, courts in international cases must determine whether they have jurisdiction over the person or entity (*in personam* jurisdiction) and over the subject matter (*in res* jurisdiction) and if they have jurisdiction to render the particular judgment in the case.

In international cases, personal jurisdiction is based on whether the person or entity is present in the country or has committed the act in question in that country.

A significant issue frequently arising in international law is whether one country's courts have jurisdiction over either another country's citizen or a corporation with its place of business in another country. Jurisdictional issues are increasing in importance and complexity as governments try to control the increase in international business.

For example, one country's jurisdiction over Internet commerce originating in another country raises complex jurisdictional questions. Other cases involving jurisdictional issues include the U.S.'s attempt to prevent U.S. residents from purchasing prescription drugs from other countries, China's claim to all Chinese-language domain names and its blocking of certain Web sites, and some European courts' claiming authority over Web sites from outside their countries' borders.

MULTINATIONAL ORGANIZATIONS AND AGREEMENTS

Several prominent international organizations and agreements affect practically all international business dealings. They also can influence the direction of world business developments.

The international organizations and agreements discussed here are these:

- United Nations (UN)
- World Trade Organization (WTO)
- The North American Free Trade Agreement (NAFTA)
- European Union (EU)
- Association of Southeast Asian Nations (ASEAN)
- Asia-Pacific Economic Cooperation (APEC)

United Nations (UN)

In 1944, representatives of China, the Soviet Union, the U.K., and the U.S. met to propose a new international organization, the United Nations (UN). They signed the UN Charter in 1945. Over the years, the number of UN member states has grown to 192 countries.

Under the UN Charter, the UN's purposes are as follows:

- To maintain international peace and security
- To develop friendly relations among nations
- To cooperate in solving international economic, social, cultural, and humanitarian problems
- To promote respect for human rights and fundamental freedoms
- To be a center for harmonizing the actions of nations in attaining these goals

Five principal UN bodies are currently active:

- General Assembly
- Security Council
- Economic and Social Council
- International Court of Justice
- Secretariat

The UN entity, however, is much larger than these five bodies, actually encompassing some fifteen agencies and several programs and bodies. The General Assembly is the UN's deliberating body and comprises representatives of all the member states. Decisions on important questions, such as those involving peace and security, the admission of new members, and budgetary matters, require a two-thirds majority vote for passage, while a simple majority vote can decide other matters.

General Assembly

Under the UN Charter, the functions and powers of the General Assembly include these:

- To consider and make recommendations on the principles of cooperation in the maintenance of international peace and security, including the principles governing disarmament and arms regulation
- To initiate studies and make recommendations to promote international political cooperation; the development and codification of international law; the realization of human rights and fundamental freedoms for all; and international collaboration in economic, social, cultural, educational, and health fields
- To elect, jointly with the Security Council, the judges of the International Court of Justice
- On the recommendation of the Security Council, to appoint the secretary-general

Security Council

The Security Council's primary responsibility is to maintain international peace and security. It functions continuously with representatives of each of its members present at all times at the UN Headquarters in New York City.

When a complaint concerning a threat to peace comes before it, the Security Council's first action usually is to recommend to the conflicting parties that they try to reach agreement by peaceful means and then, in some cases, to investigate and mediate.

When a dispute leads to armed conflict, the Security Council's first concern is to end it as soon as possible. The Security Council also authorizes the UN to send peacekeeping forces to help reduce tensions in troubled areas, keep opposing forces apart, and create calmer conditions in which peaceful settlements might result. The Security Council also can decide on other enforcement measures, economic sanctions, or collective military action.

The Security Council has five permanent members (China, France, Russia, the U.K., and the U.S.) and ten nonpermanent members elected by the General Assembly for two-year terms and not eligible for immediate reelection.

Economic and Social Council

The UN's Economic and Social Council (ECOSOC) is responsible for promoting higher standards of living, full employment, and economic and social progress through many other UN agencies. ECOSOC is also responsible for these tasks:

- Identifying solutions to international economic, social, and health problems.
- Facilitating international cultural and educational cooperation.
- Encouraging universal respect for human rights and fundamental freedoms ECOSOC's responsibility extends to over 70 percent of the human and financial resources of the UN organization system. In carrying out its mandate, ECOSOC consults with academicians, business sector representatives, and more than 2,100 registered non-governmental organizations (NGOs).

International Court of Justice

The International Court of Justice (ICJ), located at the Peace Palace in The Hague (Netherlands), is the UN's principal judicial organ. The ICJ has a dual role:

- To settle, in accordance with international law, the legal disputes that countries submit to it
- To give advisory opinions on legal questions that duly authorized international entities and agencies refer to it

The ICJ comprises fifteen judges elected to nine-year terms by the UN General Assembly and Security Council. The ICJ cannot include more than one judge of any nationality. Judicial elections take place every three years, for one-third of the seats, with rules allowing reelection of judges. ICJ judges do not represent their national governments but act as independent ICJ magistrates.

ICJ judges must have the qualifications required in their respective countries for appointment to the highest judicial offices or must be jurists of recognized competence in international law. The ICJ's composition also reflects the principal legal systems of the world. When the ICJ does not include a judge representing a country that is party to a case, that country can appoint a person to sit as an ad hoc judge only for that case.

The ICJ can hear disputes in one of the following ways when a concerned country has accepted jurisdiction:

- By the conclusion of a special agreement between parties to submit the dispute to the ICJ.
- By virtue of a jurisdictional clause, typically, when the countries in question are parties to a treaty.
- Through the reciprocal effects of declarations the countries have made under a law providing that each has accepted the jurisdiction of the ICJ as compulsory in the event of a dispute with another country that has made a similar declaration. More than sixty countries have such a declaration in force. However, a number of these declarations are subject to the exclusion of certain categories of dispute.

Secretariat

The Secretariat is the UN's international staff, working around the world to carry out the UN's daily operations. The General Assembly appoints the secretary general, who heads the Secretariat on the Security Council's recommendation for a renewable five-year term.

World Trade Organization (WTO)

The World Trade Organization (WTO) deals with trade rules among nations. The WTO's existence depends on agreements that most of the world's trading nations have negotiated and ratified. The WTO's goal is to help producers of goods and services, exporters, and importers conduct their business. The organization has over 150 members. The entire membership makes the WTO's decisions, by consensus.

WTO members operate a non-discriminatory trading system. Each country receives guarantees that its exports will receive fair and consistent treatment in other countries' markets, and each country promises to do the same for imports into its own market.

Approximately, three-quarters of the WTO member states are developing countries. The WTO system gives these countries longer time periods to implement agreements and commitments, opportunities to increase trade, and support to help them build an infrastructure for WTO work, handling disputes, and implementing technical standards.

In the WTO, no board of directors or WTO executive has power to run the organization. Members enforce all decisions and rules under agreed procedures that they themselves have negotiated, including the possibility of trade sanctions. Sanctions imposed are authorized by the membership as a whole. In this respect, the WTO is different from some other international organizations, such as the World Bank and International Monetary Fund (IMF), which have bureaucratic structures in place to enforce actions.

WTO agreements are the legal ground rules for most international commerce. They guarantee member countries important trading rights. The three primary WTO agreements include these:

- The General Agreement on Tariffs and Trade (GATT)
- The General Agreement on Trade in Services (GATS)
- The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement)

The General Agreement on Tariffs and Trade (GATT) began with trade in goods. From 1947 to 1994, GATT was the basis for negotiating lower customs duty rates and other trade barriers. Since 1995, the updated version of GATT has become the WTO's umbrella agreement for trade in all goods. It has annexed dealings with specific sectors, such as agriculture and textiles. It has also annexed dealings with specific issues, such as state trading, product standards, subsidies, and actions taken against **dumping**.

Dumping

The act of selling a large quantity of goods at less than fair value, including selling goods abroad at less than the market price at home.

The General Agreement on Trade in Services (GATS) sets forth the principles that allow service providers (such as banks, insurers, telecommunications companies, hotel chains, and transport companies) wanting do business abroad to enjoy the same principles of free and fair trade that originally applied to trade in goods. WTO members have also made individual commitments under GATS, stating which of their services sectors they are willing to open to foreign competition and how open those markets will become.

The Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS), the WTO's intellectual property agreement, sets forth rules for trade and investment in ideas and creative work. TRIPS states how all intellectual property (such as copyrights, patents, and trade secrets) should be protected in international business and trade.

North American Free Trade Agreement (NAFTA)

The North American Free Trade Agreement (NAFTA) is a comprehensive regional trade and investment agreement that Canada, Mexico, and the U.S. entered into in 1994 to improve all aspects of doing business in the North American market.

The objectives of this agreement, as elaborated more specifically through its principles and rules, including national treatment, most-favored-nation treatment and transparency, are to perform these functions:

- Eliminate barriers to trade in, and facilitate the cross-border movement of, goods and services between the territories of the parties
- Promote conditions of fair competition in the free trade area

- Substantially increase investment opportunities in the territories of the parties
- Provide adequate and effective protection and enforcement of intellectual property rights in each party's territory
- Create effective procedures for the implementation and application of the agreement, for its joint administration, and for the resolution of disputes
- Establish a framework for further trilateral, regional, and multilateral cooperation to expand and enhance the benefits of this agreement

NAFTA eliminated nearly all tariffs between the U.S. and Canada by 1998 and nearly all tariffs between the U.S. and Mexico by 2008.

NAFTA also removes many of the non-tariff barriers, such as import licenses, that have helped to exclude U.S. goods from the other two markets, particularly Mexico. NAFTA ensures that restrictive government policies will not coerce investment and that U.S. investors receive treatment equal to domestic investors in Mexico and Canada. At the same time, NAFTA's extensive easing of cross-border services rules ensures that U.S. companies need not invest in another country to provide their services if they do not wish to do so.

NAFTA establishes a mechanism for settling disputes between NAFTA countries over the interpretation and application of the agreement. It also contains separate dispute resolution mechanisms for antidumping and countervailing duty matters, as well as for specific sectors, such as investment and financial services.

For a U.S. product to be eligible for lower tariff rates when entering Mexico or Canada, the product must be produced in the U.S. entirely of NAFTA component parts; or, if the product consists of foreign component parts, a substantive transformation from the foreign component part to the final product must have occurred. Between 1993 and 2007, trade among the three countries tripled.

European Union (EU)

The European Union (EU) is a group of European democratic countries committed to working together for peace and prosperity. The EU is unique in that each member state delegated some of its national sovereignty so that decisions could be made on specific matters of joint interest democratically.

The Treaty of Maastricht (1992) introduced new forms of cooperation between the EU member state governments; for example, on defense and in the area of "justice and home affairs." By adding this intergovernmental cooperation to the original "European Community" system, the Treaty of Maastricht created the European Union (EU). All EU decisions and procedures are based on EU treaties, to which all member countries agree.

In the early years, much of the cooperation among EU countries centered on trade and the economy, but now the EU also deals with other issues, such as citizens' rights; ensuring freedom, security, and justice; job creation; regional development; and environmental protection.

Five EU institutions play specific roles:

- The European Parliament, one of two legislative bodies in the EU, is elected by the people of the member states.
- The Council of the European Union, the other legislative body in the EU, represents the governments of the member states.
- The European Commission is the EU's executive body.
- The Court of Justice is the EU's judicial body.
- The Court of Auditors is an external investigatory agency whose primary role is to audit the EU budget.

These institutions are supplemented by the following five other important EU bodies:

- The European Economic and Social Committee, which makes recommendations relating to economic and social issues
- The Committee of the Regions, which represents regional and local authorities
- The European Central Bank, responsible for monetary policy and managing the common EU currency, the euro
- The European Ombudsman, who deals with citizens' complaints about administration by any EU institution or body
- The European Investment Bank, which finances EU investment projects

The member states over time removed all barriers to trade among them and turned their **Common Market** into a genuine single market in which goods, services, people, and capital could move freely across borders. The single market was formally completed at the end of 1992, though the EU countries still have more to accomplish to complete the Common Market, such as creation of a genuinely single market in financial services.

Common Market
The European Union's member countries' single, unified market in which goods, services, people, and capital can move freely across borders.

Additionally, in 1992, the EU decided to go forward with an economic and monetary union (EMU), involving the introduction of a single European currency, the euro, managed by the European Central Bank. The euro became a reality in 2002, when euro notes and coins replaced national currencies in twelve of the fifteen countries of the European Union. As of 2010, the euro is the official currency of sixteen of the EU's twenty-seven member states.

Association of Southeast Asian Nations (ASEAN)

Five member states (Indonesia, Malaysia, the Philippines, Singapore, and Thailand) established the Association of Southeast Asian Nations (ASEAN) in 1967. Later, Brunei, Cambodia, Laos, and Myanmar joined ASEAN.

ASEAN's purposes are twofold:

- Accelerating the economic growth, social progress, and cultural development in the region through joint endeavors in the spirit of equality and partnership to strengthen the foundation for a prosperous and peaceful community of Southeast Asian nations
- Promoting regional peace and stability through respect for justice and the rule of law in the relationship among countries in the region and adherence to the principles of the United Nations Charter

ASEAN members have made significant progress in lowering intraregional tariffs through the Common Effective Preferential Tariff (CEPT) Scheme of the ASEAN Free Trade Area (AFTA) agreement.

Asia-Pacific Economic Cooperation (APEC)

Asia-Pacific Economic Cooperation (APEC) began in 1989 as a loose organization of countries set around the Pacific Ocean. APEC has attempted to facilitate economic growth, cooperation, trade, and investment in the Asia-Pacific region. Since its inception, APEC has worked to reduce tariffs and other trade barriers across the Asia-Pacific region, creating efficient economies and increasing exports.

The key to achieving APEC's vision is what is referred to as the Bogor Goals (adopted in Bogor, Indonesia, in 1994), which call for free and open trade and investment. Member countries aim to achieve these goals by 2010, with developing country members achieving these goals by 2020.

APEC is the only inter-governmental body that operates on the basis of nonbinding commitments, open dialogue, and equal respect for the views of all participant countries. Unlike the WTO or other multilateral trade bodies, APEC has required no treaty obligations of its participants. APEC members reach all decisions by consensus and undertake commitments totally on a voluntary basis.

APEC has twenty-one member states, including, among others: Australia, Canada, Japan, the U.S., the People's Republic of China, Hong Kong, and Mexico.

UNITED STATES LAWS AFFECTING INTERNATIONAL BUSINESS

The international business operations of a company domiciled in the United States are affected not only by international law and the laws of other nations but also by various U.S. laws.

Important examples of U.S. federal laws influencing international business and foreign investment are the tax code (Internal Revenue Code), the

Foreign Corrupt Practices Act, and the Patriot Act. Each of these laws affects an organization's earnings and practices in relation to international trade and business.

Tax Code

Within the U.S. tax code (Internal Revenue Code, or IRC),[2] a number of sections specifically address international business and foreign investment.

These sections can either help or hinder international investment and trade. For example, the current IRC allows a U.S. company to claim a credit against its U.S. taxes for taxes paid in other countries. These credits help avoid the double taxation of earnings that arise from the U.S.'s worldwide tax system.

Foreign tax credits are limited to the U.S. corporate tax rate. The U.S. federal corporate income tax code contains six marginal rates ranging from 15 to 39 percent. The majority of corporate income is taxable at a 35 percent marginal tax rate. The marginal tax rate refers to the highest published tax rate at which a taxpayer's last dollar earned is taxable. With a corporate tax rate at this level in the U.S., many companies form subsidiaries in tax haven jurisdictions and even move their incorporation to another country.

Repatriation of earnings is the process by which a U.S. parent company moves earnings from its foreign-based affiliates back to the U.S. to the parent company or to its stockholders. In the U.S., the Internal Revenue Service (IRS) levies corporate income tax at the time earnings are repatriated. IRC Subpart F codifies the federal government's system of "anti-deferral" rules, which lead to the taxation of certain kinds of foreign-source income in the year the company earned it, even though the U.S. parent company did not repatriate those profits during the year.

Foreign Corrupt Practices Act

U.S. companies, including insurers, planning to do business in foreign markets must be familiar with the Foreign Corrupt Practices Act (FCPA).[3] In general, the FCPA prohibits payments to foreign officials to obtain or keep business.

Passage of the FCPA was a result of an SEC investigation in the mid-1970s in which more than 400 U.S. companies admitted making questionable or illegal payments to foreign government officials, politicians, and political parties to secure or maintain business. Congress enacted the FCPA to stop these acts and to restore public confidence in the integrity of the U.S. business system.

The FCPA also requires companies who list their securities in the U.S. to meet certain accounting provisions. These accounting provisions operate in tandem with the anti-bribery provisions, requiring a company to keep accounting records that accurately reflect all the company's transactions and to maintain an adequate system of internal accounting controls.

The FCPA has had a significant effect on how U.S. companies conduct international business. Several companies that paid bribes to foreign officials have been the subject of criminal and civil enforcement actions, resulting in large fines and suspensions and debarment from federal procurement contracting. Additionally, some of these companies' employees and officers have gone to prison.

Following the passage of the FCPA, Congress became aware that U.S. companies were operating at a strategic disadvantage to foreign companies that routinely paid bribes and that, in some countries, could even deduct the cost of these bribes as business expenses from their taxes. In 1988, Congress directed the Executive Branch to start negotiations in the Organization of Economic Cooperation and Development (OECD) to obtain agreements with the U.S.'s major trading partners to enact legislation similar to the FCPA. In 1997, the U.S. and thirty-three other countries signed the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. Since 1998, the U.S. has also applied FCPA to foreign companies and individuals who perform any act to further a corrupt payment while in the U.S.

The U.S. Department of Justice is responsible for all criminal and civil enforcement of anti-bribery provisions regarding domestic and foreign companies and nationals. The SEC is responsible for civil enforcement of the anti-bribery provisions regarding issuers.

Any person or company violating the FCPA can be barred from doing business with the federal government, and an indictment alone can lead to suspension of the right to do business with the government. Furthermore, any conduct that violates the anti-bribery provisions of the FCPA also can create a private cause of action under the Racketeer Influenced and Corrupt Organizations Act (RICO Act) or under other federal or state laws.

The Patriot Act

Congress enacted The Patriot Act of 2001 as a reaction to the terrorist attacks on the World Trade Center in New York City and the Pentagon in Washington, D.C., on September 11, 2001. The law's stated purpose is "to deter and punish terrorist acts in the United States and around the world, to enhance law enforcement investigatory tools, and for other purposes." The Patriot Act increases the surveillance and investigative powers of U.S. law enforcement agencies in several ways.

The Patriot Act's implications for online privacy are considerable. It extends the government's ability to gain access to personal financial information and student information without any suspicion of wrongdoing, simply by certifying that the information likely to be obtained is relevant to an ongoing criminal investigation. Additionally, several sections of the law apply directly to business, including those that track and invest internationally. Here are some examples of such sections of the Patriot Act:

- Section 215 revises the Foreign Intelligence Surveillance Act (FISA) provisions governing access to business records for foreign intelligence and international terrorism investigations. The Patriot Act broadens the FBI's ability to obtain business records pursuant to a court order. Previously, Section 501 of FISA (50 U.S.C. section 1862) had subjected only common carriers, public accommodation facilities, physical storage facilities, and car rental facilities to FISA business record authority. The Patriot Act eliminates these categories and allows the FBI to issue subpoenas to any person, including Internet service providers, banks, and any other business within the reach of business record authority.
- Subtitle B (Sections 351-366) amends the banking and finance laws to permit the government access to information from banks that might relate to terrorism. Section 351 gives the institutions and their directors, officers, employees, and agents protection from liability for reporting suspicious activities. The section also applies to securities brokers and dealers regulated by the Securities and Exchange Act of 1934 and consumer reporting agencies governed by the Fair Credit Reporting Act.
- Additionally, Section 351 allows the Secretary of the Treasury to impose sanctions, including cutting off all dealings with U.S. financial institutions or banks in foreign nations whose bank secrecy laws deny information to U.S. agencies. Foreign banks maintaining correspondent accounts in U.S. banks must designate someone in the U.S. to receive subpoenas related to those accounts and their depositors. If those subpoenas are not answered, the accounts can be ordered closed.
- Section 352 prohibits financial institutions from knowingly becoming involved in unlawful financial transactions with suspected terrorists and requires that companies establish and maintain written, anti-money-laundering programs that, at a minimum, do the following: (1) incorporate internal policies, procedures, and controls based on the company's assessment of its money-laundering risks; (2) designate a compliance officer; and (3) establish ongoing employee-training programs as well as independent audit functions to test programs.

FINANCIAL CONSIDERATIONS IN INTERNATIONAL BUSINESS

An important reason, if not the most important reason, for an organization to enter the international market is to generate revenue. Possible financial risks and opportunities are, therefore, of concern.

Pegged currency
A currency based on the fixed exchange rate of another country's currency.

Financial considerations in the international insurance market include:

- Currency and foreign exchange markets
- Expropriation
- Accounting issues
- Taxation issues
- Tax havens

Currency and Foreign Exchange Markets

A business operating in the international market must consider both currency and foreign exchange markets because sales, profits, or investment can increase or decrease in value based merely on the change in the value of the other country's currency.

A currency is a unit of exchange, facilitating the transfer of a good or service between individuals, companies, countries, or a combination of these entities. A country or region has a specific currency that is the dominant medium of exchange for goods and services. Exchange rates are prices at which currencies, goods, and services can be exchanged for each other, and they facilitate trade between countries.

Almost every country has a single currency. Some countries share the same name for their currencies. For example, Canada, Hong Kong, and the U.S. all name their currencies "the dollar." Some countries share the same currency (such as the Euro), and some countries declare the currency of another country to be legal tender.

If the value of the currency is **pegged currency**, the government in question maintains its value at a fixed rate relative to the other currency. For example, if Nation Y pegs its dollar to the U.S. dollar at an 8:1 ratio, this means that $8 in Nation Y's currency is equal to $1 U.S.

The exchange rate (foreign exchange rate or FX rate) between two currencies shows how much one currency is worth in terms of the other. For example, an exchange rate of 100 Japanese yen to the U.S. dollar means that ¥100 is worth the same as $1. If a country's currency is appreciating, it becomes more valuable, and the exchange rate increases. Conversely, if the country's currency is weakening, the exchange rate decreases.

Supply and Demand

If a country's currency is allowed to float freely, its exchange rate against other countries varies, and it changes constantly within the financial markets around the world. A currency tends to become more valuable whenever demand for it is greater than the available supply and less valuable whenever demand is less than available supply.

An increase in demand for a specific currency results from either an increase in transaction demands for currency or an increase in speculative demand for the currency.

The transaction demand for money is highly correlated to the country's level of business activity, gross domestic product (GDP), and employment levels. The greater the number of people who are unemployed, the less the public as a whole spends on goods and services.

Central banks typically have little difficulty adjusting the available money supply to accommodate changes in the demand for a currency resulting from business transactions. Speculative demand for money is much harder for central banks to accommodate. However, central banks try to accommodate this demand by adjusting domestic interest rates, thus allowing an investor to choose to buy a currency if the interest rate generates a high enough return for the investment. The higher a country's interest rates, the greater the demand for that currency.

International Assets

When a corporation is involved in international business, it must be concerned that its international assets will retain their value in the future. A company does not want investments or income that will devalue in the future.

A currency tends to lose value, relative to other currencies, if that country's inflation level is relatively high, if the country's level of output is expected to decline, or if a country is troubled by political uncertainty. In the foreign exchange markets, rate fluctuations usually are linked to the world economy or significant events in a specific national economy.

Expropriation

When dealing in another country, a business must be aware of the possibility that the government will expropriate its assets. Expropriation, in its legal sense, means a government's lawful acquisition of property without the owner's consent. The government acquires property rights, and the owner loses them. The term usually refers to a government's takeover of private property, often without fair compensation, but usually with a legal assertion that the government has a right to do so.

The power of eminent domain is a government's power to confiscate private property for public use. Most governments use eminent domain when they require property for the completion of a public project such as a road, and the owner of the property is unwilling to negotiate a price for its sale.

The exercise of eminent domain is not limited to real estate but can also involve personal property. Governments can also condemn the value in a contract, such as a franchise agreement. For this reason, many franchise agreements stipulate that, in condemnation proceedings, the franchise itself has no value. Owners' rights vary by country.

The U.S. Constitution requires payment of just compensation upon use of eminent domain. In France, the Declaration of the Rights of Man and of the Citizen mandates giving just and preliminary compensation to the property owner.

Accounting Standards

A demand for and supply of capital transcending national boundaries often drive international business transactions in today's capital markets. High-quality accounting standards are a necessary element of a sound capital-market system. Companies use different forms of accounting to determine their financial situations. However, with the increase in cross-border capital-raising and investment transactions comes an increasing demand for a set of high-quality international accounting standards that companies could use as a basis for financial reporting worldwide.

In the U.S., for example, domestic firms that are registered with the Securities and Exchange Commission (SEC) must file financial reports using U.S. generally accepted accounting principles (GAAP). Foreign firms filing with the SEC can use U.S. GAAP, their home country GAAP, or international standards. However, if they use their home country GAAP or international standards, foreign companies must provide a reconciliation to U.S. GAAP.

The Financial Accounting Standards Board (FASB) is the designated organization in the private sector for establishing standards of financial accounting and reporting in the U.S. Those standards govern the preparation of financial reports, and the SEC and the American Institute of Certified Public Accountants (AICPA) officially recognize them as authoritative. Such standards are essential to the economy's efficient functioning because investors, creditors, auditors, and others rely on credible, transparent, and comparable financial information.

The London-based International Accounting Standards Board (IASB), organized in 2001, is developing a single set of high-quality global accounting standards that require transparent and comparable information in general-purpose financial statements. The IASB receives funding from the major accounting firms, private financial institutions, industrial companies, central and development banks, and other international and professional organizations throughout the world.

In 2002, the FASB and the IASB issued the Norwalk Agreement, a memorandum of understanding that marked a significant step toward formalizing their commitments to the convergence of U.S. and international accounting standards. Work continues on the project. As of 2005, the European Union required that all EU-listed public companies prepare their consolidated financial statements using IASB Standards.

Taxation

Corporations involved in international business must deal with issues of taxation in their home country jurisdictions as well as in the foreign country in which they conduct business or invest.

In today's business environment, many countries seek to attract investment by offering a "tax holiday," ranging from a partial to a total exemption from corporate income tax to an exemption for a number of years. At the end of the tax exemption period, a normal corporate tax rate applies to the corporate earnings of the investment.

Some countries have placed conditions on tax holidays, requiring that the corporation agree not to close down operation at the expiration of the tax holiday. Countries impose this requirement because many corporations have discovered that it is profitable, at expiration of the tax holiday, to close operations and relocate to a different country, often a country offering another tax holiday.

Countries use different approaches, including these, to tax corporations' earnings in the context of international commerce:

- Territorial tax systems tax all companies only on the economic activity that occurs within the country's geographic boundaries, regardless of the location of the company's incorporation or operations. For example, Ireland does not tax an Irish company on profits earned through sales in the U.S. However, both U.S. and Irish firms pay taxes on profits they earn through the sale of products in Ireland.
- A worldwide tax system taxes domestically incorporated companies on their total earnings from both domestic and international activities. Foreign companies are taxed on their economic activity within the country's geographic boundaries. For example, a U.S. company pays taxes on profits earned through its sales in the U.S. and in Ireland. An Irish company pays taxes in the U.S. on profits it earns only on sales in the U.S.
- Border tax adjustments (BTAs), rebates on exports and taxes on imports, are instruments governments use to establish a "tax-neutral" setting for international trade and investment. The General Agreement on Tariffs and Trade (GATT), which defines the scope of international BTAs, recognizes only consumption taxes (taxes applying directly to goods and services) as eligible for BTAs. A Value Added Tax (VAT) is BTA-eligible, but corporate income taxes are not.
- Corporations can use several processes to reduce their tax liability relating to international commerce. Earnings stripping arrangements usually involve the extension of debt from one corporate affiliate to another. The debt accumulates within the corporation's high-tax jurisdiction, which

allows it to deduct interest payments from its taxable income in the high-tax country.

- Inversion, or expatriation, or reincorporation is the process by which a corporate entity established in a low-tax country purchases the shares and/or assets of a domestic corporation. The domestic company's shareholders typically become the new foreign parent company's shareholders. This process allows the domestic company to change its legal location and become a foreign-based corporation. An inversion typically does not change the company's operational structure or physical location; however, it does change the parent company's tax structure. A corporation may accomplish an inversion by setting up a foreign company and then reverse-engineering a merger to move the company's legal location. Large companies calculate each of their divisions' profits and losses separately.

Transfer price
The price one part of a company charges for products and services it provides to another part of the same company.

Countries also have differing transfer pricing laws, a concern for all companies that do international business. The **transfer price** is the price one part of a company charges for products and services it provides to another part of the same company. Under transfer pricing laws, companies are required to charge another affiliate or division the same price it would demand in an "arm's-length transaction," that is, a transaction between two unrelated entities.

Many experts believe transfer pricing is the most important international tax issue facing multinational corporations. Most countries impose strict transfer pricing rules on international transactions. Noncompliance can lead to pricing adjustments and large penalties.

Tax Havens

Tax haven
A country whose regulations offer financial and business incentives encouraging organizations from other countries to do business there.

In many countries, regulation imposes high costs on domestic businesses. Consequently, many companies seek **tax havens**. To move a business or division of a corporation offshore to operate in a pro-business climate usually requires nothing more than forming an offshore corporation in a tax haven country and transferring assets from the domestic corporation.

One of the reasons companies "go offshore" is to reduce corporate taxes. Many tax havens impose few or no taxes on foreign companies and have strict privacy laws. Corporations' decisions about tax havens are based on the advantages for the particular international investment project.

A business should consider these factors when establishing a subsidiary in an offshore tax haven:

- The country's tax structure
- The country's level of enforcement of its privacy laws
- The country's language
- The type of judicial system the country has
- The country's political stability

- The country's independence from the parent company's home country
- The costs of establishing the new subsidiary in the country

Tax havens are typically countries that have no taxes of any kind, whether personal or corporate income tax, capital gains tax, foreign investment tax, withholding tax, estate tax, sales tax, value added tax, and so forth. They have no financial reporting requirements. Some examples of well-known tax havens are Antigua, the Bahamas, Belize, the British Virgin Islands, the Isle of Man, Luxembourg, Nevis and St. Kitts, and Turks and Caicos.

To understand the precise role of tax havens, it is important to distinguish between two types of income: return on labor and return on capital. Income from labor derives from work: salary, wages, fees for professional services, and the like. Income from return on capital is the return on an investment: dividends on shares of stock; interest on bank deposits, loans, and bonds; rental income; royalties on patents.

Most corporations seek to use tax haven benefits for income derived from the return on capital and income from an investment portfolio. When a corporation forms a subsidiary or a trust in a tax haven, return on capital can be almost tax free, or at least taxed at a very low rate.

Types of Corporate Tax Structures

A tax haven country may have one of these four types of corporate tax structures.

- *Low or minimum taxes.* Some tax haven countries impose low or minimal taxes on all corporate income, wherever earned. Many countries with this system have double-taxation agreements with the high-tax countries that might help reduce the withholding tax imposed on income derived from the high-tax countries by local corporations.

Double taxation arises because of competing claims of tax authorities of a home corporation's home country and the country of the source of income. Generally, the income source country gives way to the home country, with exceptions.

- *No corporate taxes.* Some tax haven countries have no income, capital gains, or wealth (capital) taxes. They allow companies to incorporate and/or form trusts. These countries primarily charge small fees when a corporation files incorporation documents, on issuing of shares, and on annual registration fees. Any income these governments derive from corporations is not related to corporate income.
- *No taxes on foreign income.* Some tax haven countries impose income taxes, both on individuals and corporations, but only on locally derived income. These countries exempt from tax any income earned from foreign sources that involve no local business activities. Often, these countries do not tax income derived from the export of locally manufactured products. The countries that have no tax on foreign income fall into two different

groups. The first group consists of countries that allow a corporation to do business both internally and externally but that tax only the income derived from internal sources. The second group consists of countries that tax a corporation for income derived from local business but do not tax income derived from external business. Some companies would conduct only foreign business and thus be exempt from taxation.

- *Special tax concessions.* Some tax haven countries impose all or most of the usual taxes, but either provide concessions to special types of companies or permit some special corporate structure allowing for lower taxes. Some special tax haven countries give tax exemptions on shipping or to movie production companies, for example.

Information Privacy

Tax haven countries also offer corporations some advantages relating to privacy of stock information.

Bearer share

A corporate share that is owned by the holder of the share certificate and is not registered; therefore, ownership remains private.

These tax haven countries allow for the issuance of **bearer shares**, stocks that are owned by the holder, the one who has possession of the share certificate. No one but the bearer of the shares knows who owns stock in the corporation. The ownership remains private, and shares can be bought, sold, or exchanged in complete privacy.

Registered share

A corporate share on which records are kept indicating the share's owner and its selling and buying price.

In contrast, most jurisdictions (including the U.S., Canada, and Great Britain) require shares to be registered with a government agency. With **registered shares**, the government and other parties know who owns a corporation's shares and the selling and buying prices for the shares.

Another privacy advantage that tax havens offer to corporations results from their laws forbidding financial institutions (such as banks, brokerages, and insurance companies) and advisers (such as brokers, accountants, attorneys, and investment advisers) from divulging information about clients or accounts to any third party. These privacy laws apply to all third parties, including individuals, companies, and governments.

NON-LEGAL FACTORS AFFECTING INTERNATIONAL BUSINESS

In addition to dealing with applicable laws and financial considerations, a company engaged in international business faces challenges and barriers resulting from various other factors.

Companies involved in international business have different needs and requirements based on their type of business and the intended outcomes of their business transactions. Each company and each international transaction is affected by the following factors:

- Language
- Culture
- Time differences
- Distance and space
- Types of government

Language

A language barrier can be the first challenge to a company in an international transaction. Although English has become the language of international business, skills with other languages are still necessary in most international transactions. In an international investment or sale of a product to a foreign market, numerous foreign language issues can arise, including interpretation of contracts, advertising, packaging information, product instructions, and warranties, as well as language issues regarding legal and regulatory compliance.

In many countries, it is common to speak more than one language—a possible advantage for international business in those countries. The ability to speak multiple languages gives a businessperson an advantage, not only in direct business negotiations, but also in personal interactions. Language ability also prevents misunderstanding or mistranslation through a third-party translator.

Culture

Differences between cultures can be challenging to any business transaction. Many Asian and African cultures, for example, are very different from the U.S. culture. Differences in cultures can involve variations in manners, body language, religion, family life and gender roles, and many other aspects of culture.

For example, business travelers should consider interactions between business and family when planning business meetings and business socializing in some countries. Whether it is appropriate to invite a spouse to a business dinner or a family to a sporting event can vary by culture.

Time Differences

Time differences between countries can make conducting international business challenging. For example, when it is 3:00 p.m.—an appropriate time for a conference call—in Philadelphia, it is 8:00 p.m. in London. Further, for companies communicating across the International Date Line, it can be Monday in London and Tuesday in Sydney.

Additionally, different countries and cultures perceive time differently, and those perceptions can affect interactions within a business transaction. In many northern European countries, along with the U.S., people perceive time in a linear fashion. People at a business meeting in the U.S. might have a set agenda they follow closely, moving from one item to the next. In another country, such as Spain, people may perceive time less linearly and may tend to do many tasks at the same time. Some countries value the use, or quality expenditure, of time more highly than the quantity of time spent on any endeavor.

Distance and Space

The physical distance between locations limits contact between individuals and influences the culture of both individuals and companies.

New travel and communication technologies have helped to reduce some of the physical distance barriers to international transactions and have helped to unify the world into a single international market. Technology makes it possible to conduct international business around the world twenty-four hours a day.

Space also affects individuals and cultures. Each individual has a preferred personal space, and the size of a person's preferred personal space varies by culture. How people interact, as well as the circumstances under which they touch others, also differs within each culture. A kiss on the cheek is an appropriate greeting in some cultures, a handshake in others, and a bow in others.

Types of Government

Government structure is important to consider in all international business dealings. Changes in government can result in changes to the business and legal environment within a country. These changes can occur quickly or slowly, depending on the type of government in a country. Most countries have one of six basic systems of government:

- Democratic
- Military
- Monarchal
- Single-party
- Theocratic

Democracy takes many diverse forms, and the name of a government can be deceiving. For example, the Democratic People's Republic of Korea is the name of North Korea, a single-party communist dictatorship, and is not the name of South Korea, a democracy.

Democratic rule is rule by the people through elected representatives. Modern democratic governments take these forms:

- A **nonparty democracy** is a form of government in which elected representatives have no political party affiliation.
- A **parliamentary democracy** is ruled by a prime minister and an elected parliament. Approximately sixty countries have had parliamentary democracies in recent years.
- A **presidential democracy** is governed by a president directly elected by the citizens. Approximately sixty countries have had presidential democracies recently.
- A **multiparty democracy** is a form of government in which representatives may be elected from several or many political parties. Many multiparty democracies have balancing roles of a prime minister and a president. Approximately thirty-five countries have had multiparty democracies in recent years.

Military forms of government have occurred throughout history. Another term for these governments is **junta.** Military rule is commonly associated with single-party or transitional forms of government. **Martial law** is the means by which the military assumes control of a country, often because of a perceived need for military security or public safety.

A **monarchy** may be a kingdom or dynasty over which one person rules for life. Individual monarchs can have titles such as king, queen, prince, emperor, czar, or sultan, among others.

Two common forms of monarchy are absolute and constitutional. In an **absolute monarchy**, the leader rules alone and selects advisers for assistance. In a **constitutional monarchy**, a parliament, or democratic legislative body, replaces absolute monarchical rule.

Many of the world's remaining monarchical governments had ended by the mid-20th century. Some countries, such as Great Britain, the Netherlands, Sweden, and Spain, still have monarchs, but their powers are limited and often ceremonial, and democratically elected legislative bodies have the real power to govern.

A **single-party government** usually has a constitutional requirement that only a specific political party can exist. Although these governments are not military, theocratic, or monarchical, most arose from those forms of government.

Democratic rule
A form of government by the people through elected representatives.

Nonparty democracy
A form of government in which elected representatives have no political party affiliation.

Parliamentary democracy
A form of government involving rule by a prime minister and an elected parliament.

Presidential democracy
A form of government in which the citizens directly elect a president.

Multiparty democracy
A form of government in which representatives may be elected from several or many political parties.

Junta
A form of government by a group of military officers governing a country after seizing power.

Martial law
The assumption of control of a country by the military.

Monarchy
A form of government led by a hereditary chief of state with powers varying from absolute to ceremonial.

Absolute monarchy
A form of government led by a single ruler who selects advisers for assistance.

Constitutional monarchy
A form of government with a parliament, or a democratic legislative body, but with a monarch as a formal or ceremonial head of state.

Single-party government
A form of government that constitutionally permits only one specific political party.

Theocratic government
A form of government based on a religious doctrine and often led by religious leaders.

Transitional government
A temporary form of government used when a country is rebuilding its government, usually as a result of war.

A **theocratic government** is based on religious doctrine, and religious leaders may govern. Throughout history, theocratic governments have ruled countries such as Tibet and China and the Aztec, Incan, and Mayan empires in Latin America, as well as many Islamic countries. Examples of theocratic governments today include Iran and the Vatican City.

A country has a **transitional government** when it is rebuilding its government, usually as a result of war.

SUMMARY

Companies can engage in international business through foreign trade, foreign contractual relationships, or foreign direct investment. Foreign trade involves the import and/or export of goods. Foreign contractual relationships include product licensing and franchising. Direct foreign investment can occur through the use of subsidiaries or joint ventures.

Countries share legal approaches and concepts, which can be grouped into predominant families of law. In general, countries adopt legal systems that are either civil-law systems or common-law systems.

International law comprises public international law, which governs the interaction of nation states; and private international law, which governs disputes between individuals or corporations in different countries.

Practically all international business dealings are affected by these multinational organizations and agreements:

- The United Nations
- The World Trade Organization
- The North American Free Trade Agreement
- European Union
- Association of Southeast Asian Nations
- Asia-Pacific Economic Cooperation

Important examples of U.S. federal laws influencing international business and foreign investment are the Internal Revenue Code, the Foreign Corrupt Practices Act, and the U.S. Patriot Act.

A business operating in the international market must consider both currency and foreign exchange markets because sales, profits, or investment can increase or decrease in value based merely on the change in the value of the other country's currency. Expropriation is a government's lawful acquisition of property without the owner's consent. High-quality accounting standards are a necessary element of a sound capital-market system. Corporations involved in international business must deal with issues of taxation in their home country jurisdictions as well as in the foreign country in which they conduct business or invest. Many multinational corporations use offshore tax havens to reduce their taxes and increase their information privacy.

Any organization conducting international business must weigh potential challenges and barriers of such ventures according to the types of transactions the organization requires. These challenges and barriers include language, culture, time, distance and space, and types of government.

ASSIGNMENT NOTES

1. Additional information can be found at www.ustreas.gov/offices/enforcement/ofac/faq/answer.shtml#global1.
2. U.S.C., Section 26 et seq.
3. U.S.C., Section 15 et seq.