

# International Practice

# NEWS

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## Letter from the Chair

**Jerry Okarma, Chair**

Since our last Section Newsletter, a number of things have happened that I'd like to report to you on. As we've reported to date, the efforts of your Section leadership are focused on our major initiatives for the year: our program at the State Bar Convention in May; developing our Section Web site; and finding ways to bring our expertise and build bridges between our Section and our two "hometown" law schools, Marquette and University of Wisconsin-Madison.

First, on the program the Section will be sponsoring at the Annual State Bar Convention, a number of twists and turns have taken place since our last Newsletter. Because of conflicts with other programs by other Sections, we chose to move our program to Friday, May 17, from 10:45-12:35. It was the only way to assure that the Convention did not feature similar programs at conflicting times, precluding membership from attending all programs they valued. Please note this change in your calendar for planning purposes, because it is a different date than we originally reported to you. The original topic, the Cybercrime Treaty, has also been broadened in light of the legislation adopted since the events of September 11th. Further details of our program are included in a separate article in this Newsletter.

Our revamped Section Web site has been unleashed and is now fully-operational. We've heard that it's being touted by the State Bar as a model Web site to the other Sections and Committees. I'd like to thank Terry Peppard (Madison) for his leadership here. Now that it's up-and-running, the next challenge is to expand it and make it even more valuable to our membership. Anyone interested in working with Terry on this project (or even a small piece of it!), should contact Terry.

Some major developments are occurring on the law school partnering front. On November 14th, a program was held at UW-Madison Law School for their international law students, sponsored by the Section. This informal pizza lunch featured brief presentations by members of our Section, followed by an informal question and answer session. Many thanks to Gina Carter (Madison), Jim Lucke (Madison) and Kevin Makowski (Milwaukee), who did an excellent job in providing the students with practical and helpful insights into what's involved in an international law practice. Work is being done to stage similar interchanges in the future.

I hope all is well with you, and strongly encourage you to get in-

involved in our Section's activities. This can take any number of shapes, whether it's becoming involved on our Board, helping on one of our major initiatives, or attending programs we're sponsoring...all is welcome. The old adage is true: the more you put into your membership, the more you'll get out of it. Let us know if you'd like to discuss how you might become more involved.

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# Effective Representation of Clients in International Arbitration and Mediation – An Insider’s View

**Lorraine Brennan, J.D.**

THIS PROGRAM WILL BE HELD FROM 3:00 - 4:30 P.M. ON APRIL 9, 2002 AT MARQUETTE UNIVERSITY LAW SCHOOL, 1103 WEST WISCONSIN AVENUE, MILWAUKEE, WISCONSIN. THERE WILL BE A COCKTAIL RECEPTION FOLLOWING THE PROGRAM.

THE PROGRAM IS FREE TO MEMBERS OF THE STATE BAR OF WISCONSIN, LAW STUDENTS AND GUESTS. PLEASE CALL (800) 728-7788 TO LET US KNOW THAT YOU WILL ATTEND.

Clauses in transnational contracts calling for the resolution of disputes through international commercial arbitration and mediation have become common. The exponential growth of these clauses has made it essential for lawyers and business executives to be prepared for international dispute resolution. Ms. Brennan will address a set of significant current issues, including: the ICC Guidelines for ensuring trustworthy digital transactions over the internet (e-business); the increasing importance of mediation in international disputes; insights about the transnational transfer of intellectual property; and, other relevant topics.

Ms. Brennan is Director of Arbitration and ADR, North America, International Chamber of Commerce (ICC) International Court of Arbitration. She serves as the American advisor to the International Court of Arbitration of the ICC in Paris, France. Ms. Brennan advises North American

attorneys and companies on all phases of ICC arbitration, including: negotiation of arbitration clauses, requests for arbitration, procedural issues and enforcement of arbitration awards. She is one of eight U.S. members of the NAFTA 2002 Advisory Committee on Private Commercial Disputes. Prior to assuming this Ms. Brennan served as the Director of Arbitration and Intellectual Property and Legal Counsel at the USCIB, the U.S. affiliate of the ICC. In her role as Director of Intellectual Property, she assisted in formulating and implementing U.S. policy with respect to intellectual property issues and advised U.S. companies on the latest developments in the intellectual property rights field. Ms. Brennan is Co-Chair of the International Litigation Section of the American Bar Association.

This program is sponsored by the International Practice Section of the State Bar of Wisconsin, the Wisconsin World Trade Center and the International Law Society of Marquette University Law School.

## Section Program at State Bar Convention

In order to accommodate conflicting schedules with other Sections at the upcoming State Bar Convention in Madison this May, the International Practice Section has agreed to move its program to the morning of Friday, May 17. We will now begin at 10:45 and conclude at 12:35. In addition, the program’s focus has been broadened from its original subject matter to include a discussion of the major legislation impacting Cybercrime since the events of September 11th. The title of the program is “New Developments in Surveillance Law: Anti-Terrorism Legislation and the Council of Europe Cybercrime Convention.” We hope this will broaden the appeal to our Section members, as well as other State Bar members who are looking for an excellent presentation on the new regulatory scheme put in place.

While the date and title have changed to some extent, some things remain the same. The presentation will still be lead by two very knowledgeable attorneys on the topic: Jim Halpert, a partner in the D.C. office of Piper Marbury Rudnick & Wolfe and Betty Schaive, an attorney with the U.S. Department of Justice. The program will also be co-sponsored by the Intellectual Property Section, which has a broad membership base that will benefit from the presentations, as well.

Look for further details as we get closer to the Convention. Until then, please mark this date and time in your calendar.

# A Primer on U.S. Transfer Pricing for Foreign Companies Operating in the U.S.

By Robert J. Misesy, Jr.

As a result of the strong U.S. dollar, foreign produced goods are inexpensive, resulting in many foreign companies selling their goods in the U.S. Forming U.S. subsidiaries as buy-sell distributors, these related companies will engage in intercompany transactions.

The U.S. transfer pricing rules should concern foreign companies who will ultimately want to keep the profits from these intercompany transactions in their own countries. By charging the highest price possible, these foreign companies can retain the greatest amount of cash possible, without incurring a withholding tax on repatriation. Even if repatriation of cash to the foreign country is not a priority, the foreign companies should want their U.S. subsidiaries to avoid a costly transfer pricing audit by the IRS.

The concept of transfer pricing focuses on the price charged for these intercompany transactions. The principles of I.R.C. section 482 require pricing intercompany transactions at arm's length. Although ostensibly a simple concept, the arm's length standard has spawned hundreds of pages of regulations and case law.

Transfer pricing continues to be a hot issue for U.S. subsidiaries of foreign companies. This author has learned informally from former colleagues at the IRS that U.S. subsidiaries with intercompany purchases totaling more than \$10 million can expect to have an IRS economist review their intercompany transactions. Key to this issue is determining the amount of intercompany transactions.

For example, suppose a foreign company (ForCo) manufactures and sells widgets. Due to increased widget orders from U.S. customers, ForCo decides to form a U.S. distribution subsidiary (USSub). Although USSub does not have any manufacturing functions, USSub employs its own administrative and sales staff while using ForCo's unique distribution software to ensure that there are not any distribution problems. In an effort to ensure that USSub is financially solvent, USSub enjoys generous payment terms to ForCo of six months and, if USSub's customers do not pay, USSub has the use of ForCo's collection staff.

This ostensibly simple scenario results in ForCo and USSub having four intercompany transactions covered by the U.S. transfer pricing regulations.

- The sale of widgets is a transfer of tangible property;
- The provision of the unique distribution software is a transfer of intangible property for which USSub may deduct a deemed royalty, but incur a withholding tax;
- The six month payment terms are a loan for which USSub may deduct imputed interest, but incur a withholding tax;
- The use of ForCo's collection staff constitutes a service for which USSub may deduct an arm's length fee.

Although many multi-nationals worry about the transfer pricing rules from a defensive perspective, a company may also employ transfer pricing rules to minimize taxes. For example,

suppose ForCo is a trading company in Hong Kong, where the highest corporate income tax rate is 16%. In addition to the U.S. corporate income tax rate of 35%, any dividend distributed by USSub to ForCo would be subject to a 30% withholding tax, resulting in an effective U.S. tax rate of 54.5% (i.e., after 35 cents of every dollar of income goes to the IRS, an additional 19.5% of the remaining 65 cents dividend is withheld). As a result, by aggressively pricing widgets from Hong Kong, the parties can save 38.5 cents for every dollar not subject to U.S. tax (54.5 cents compared to 16 cents).

## Best Method Rule

The best method rule in the section 482 regulations states that the transfer pricing method must result in the most reliable measure of an arm's length result. The application of the best method rule establishes an arm's length range of prices or financial returns with which to test the controlled transactions. The tested party must fall within the middle 50% of that range, known as the inter-quartile range.

The IRS's regulations list the following potential methods to determine the arm's length pricing:

- The comparable uncontrolled price method;
- The cost plus method;
- The resale price method;
- The comparable profit split method;
- The residual profit split method; and
- The comparable profits method.

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# A Primer on U.S. Transfer Pricing for Foreign Companies Operating in the U.S.

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In determining the best method, USSub should consider the degree of comparability between controlled and uncontrolled transactions by analyzing the functions, contractual terms, risks, economic conditions, and the nature of goods and services supplied. If this analysis requires numerous or sizeable adjustments to meet comparability, the unreliability of this comparable may result in its exclusion.

Because of these stringent comparability requirements, the best method is often the comparable profits method (CPM). The CPM compare the profitability of the less complex party (USSub) to that of comparable distribution companies. In applying the CPM, the international attorney must choose a financial ratio for USSub and determine if USSub's ratio is in the middle 50% for all comparable distributors. Two factors make the CPM easy to use: (1) comparability is based on functions performed and risks assumed, as opposed to comparability of product, and (2) financial information is easily derived from information that public companies disclose.

ForCo and USSub should also be aware of increased U.S. coordination between the Customs Service and the IRS. In fact, I.R.C. section 1059A requires a U.S. company, such as USSub, to claim a cost of goods sold that is no greater than the dutiable

value placed upon the imported goods for customs purposes. For example, USSub cannot claim a value of only \$50 a widget for customs purposes and then claim a cost of goods sold of \$100 a widget for income tax purposes.

## Penalties

If the IRS determines that (1) an intercompany transfer price is less than 50% or more than 200% of the arm's length price or (2) the transfer pricing adjustment increases taxable income by \$5 million or more, USSub must pay a penalty equal to 20% of the additional tax. The penalty can increase for even more aggressive transfer pricing practices.

USSub can protect itself against the penalty through either documenting its transfer pricing practices or entering an Advance Pricing Agreement (APA).

The documentation must state the reasons for believing the prices are at arm's length and must be in place when the return is filed, but does not have to be provided to the IRS until requested on audit. More specifically, the documentation must provide a business description, a thorough analysis of intercompany transactions, a detailed functional analysis of the relevant parties, a review of the transfer pricing methods resulting in the method chosen and an economic analysis showing the arm's length nature of the transfer pricing.

In the APA program, the taxpayer and the IRS prospectively agree to the taxpayer's facts, transfer pricing methodology, and an arm's length range of results. Although APAs have traditionally been the purview of large companies, the IRS recently issued streamlined procedures to make the process more cost efficient for small companies.

## Conclusion

When advising clients, the international attorney must be able to identify all the intercompany transactions. After choosing the best method, the international attorney must decide whether the amount of exposure requires preparing documentation or filing for an APA.

Robert J. Misey, Jr. is an attorney in the International and Tax Departments at Reinhart Boerner Van Deuren s.c. Mr. Misey previously worked with the IRS Chief Counsel (International) in Washington, D.C. He received his LL.M. (taxation) from Georgetown University and his J.D. from Vanderbilt University. Mr. Misey can be reached at either 414-298-8135 or [rmisey@reinhartlaw.com](mailto:rmisey@reinhartlaw.com).

## What Do You Know?

Do you have a brief article you would like to see published in our Newsletter? Do you have a practice pointer you could share with other lawyers in our section? Have you learned of a recent case, treaty or event in which other Section members might be interested? Please direct your ideas to [cdavies@reinhartlaw.com](mailto:cdavies@reinhartlaw.com).

## Technology Update

Work is being conducted on the Section's Web site links. If you have any ideas or suggestions, please contact Terry Peppard at [tpeppard@execpc.com](mailto:tpeppard@execpc.com).

# WTO Rules Against US Foreign Sales Corporations

By Erik W. Ibele

The World Trade Organization has ruled in favor of a complaint by the European Union that the tax treatment afforded US Foreign Sales Corporations (FSCs) violates the global trade rules established by the WTO. In a report issued January 14, 2002, the appellate body of the WTO ruled that Sections 921-927 of the US Internal Revenue Code (IRC) and related regulations providing for special tax treatment for FSCs are inconsistent with the US's obligations under the WTO agreements. The report determines that the tax treatment accorded FSCs represents a "hidden export subsidy," and calls upon the US "to withdraw the export subsidies without delay."

The tax legislation and regulation permitting the establishment of FSCs and their predecessors, Domestic International Sales Corporations (DISCs) was drafted in response to a feature of the US income taxation which was perceived to put US corporations at a disadvantage relative to their foreign competitors. US corporations are in principle subject to tax in the US on their worldwide income. The US does not generally tax income earned by foreign corporations outside the US. However, foreign source income of a foreign corporation is subject to US taxation if it is "effectively connected" with the conduct of a US trade or business. In principle, the determination of whether a foreign corporation's foreign source income is "effectively connected" with a US trade or business is the result of factual inquiries by the tax authorities. Generally, a US corporation is subject to taxation on the income earned by a foreign subsidiary only when the

subsidiary's income is repatriated to the US in the form of dividends. Taxation of such income is, however, deferred until the income is transferred to the US parent. Because of a concern that US corporations could defer tax indefinitely on foreign source income, the US has enacted a variety of anti-tax avoidance measures, including Subpart F of the IRC. Subpart F limits the deferral of certain types of income earned by certain controlled foreign subsidiaries of US corporations. Sec. 951 IRC. Under Subpart F, certain income earned by a foreign subsidiary of a US corporation can be imputed to its US parent even though it has not yet been transferred to the parent as dividends. A US corporation can thus become subject to taxation in the US on income which it has not in fact received

The Foreign Sales Corporations provision of Sections 921-927 of the Code provide a partial exemption from the imputation rules of Subpart F. FSCs are foreign corporations responsible for certain activities related to the sale or lease of goods produced in the US for export outside the US. The FSC provisions essentially exempt a portion of an FSC's export-related foreign-source income from US income tax. A corporation must satisfy several criteria to qualify as an FSC. In particular, an FSC must be organized in a "qualified country;" i.e., a country that has a reciprocity agreement with the US Treasury with respect to the exchange of tax information. Sections 922(a)(1) and 927(d)(3) IRC. It must also satisfy various requirements with respect to foreign presence, recordkeeping, shareholders and directors. Sec. 922(a) IRC. The Code does not

require that an FSC be affiliated with or controlled by a US corporation. Many FSCs are, however, in fact controlled foreign subsidiaries of US corporations. A large number of FSCs are formed in the US Virgin Islands, as for most US corporations, this seems to be the most convenient "qualified country" location.

The foreign-source income of an FSC may be broadly divided into "foreign trade income" and all other foreign source income. Sec. 923(1)(b) IRC. "Foreign trade income" is essentially the foreign source income attributable to an FSC from qualifying transactions involving the export of goods from the US. Other foreign source income of an FSC may include interest, dividends, and active business income not arising out of qualified export transactions. Foreign trade income is in turn divided into exempt foreign trade income and non-exempt foreign trade income. Sec. 923(a) IRC.

Sections 921-927 of the Code exempt the foreign-source income of an FSC in three ways.

(1) The exempt portion of an FSC's foreign trade income is deemed "foreign source income which is not effectively connected with the conduct of a trade or business within the United States" Sec. 921(a) IRC. As noted above, the determination of whether foreign source income is "effectively connected" with a US trade or business is usually the result of a factual inquiry.

(2) The foreign trade income of an FSC is generally exempted from Subpart F Sec. 951(e) IRC.

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# WTO Rules Against US Foreign Sales Corporations

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(3) US corporate shareholders of an FSC can generally deduct 100 percent of dividends received from distributions made out of the foreign trade income of an FSC SEC. 245(c) IRC.

An FSC's foreign trade income is its "foreign trading gross receipts" generated in qualifying transactions. Sec. 924 IRC. Qualifying transactions involve the sale or lease of "export property" or the related performance of services. "Export property" is property manufactured or produced in the US by a person other than an FSC for use, consumption or disposition outside the US, and of which no more than 50% of its value is attributable to imports. Sec. 927(a)(1) IRC. This supposed preference for domestic property is at the heart of the dispute between the EU and the US. The EU has taken the position that the favorable tax treatment accorded FSC, is contingent on the use of domestic US goods, rather than imports. This, the EU argues, represents a hidden export subsidy in violation of Section 3.1(b) of the Agreement on Subsidies and Countervailing Measures (SCM Agreement) under the WTO. The US has argued that the decisive factor in determining whether property is "export property" is the overall value of the property, not the relative foreign and domestic content. It has also relied on an interpretation of footnote 59 to Annex I of the SCM Agreement which, it claims, requires that the SCM Agreement be read to permit tax exemptions for foreign source income.

body is the latest chapter in a long-running dispute between the EU and the US over alleged export subsidies contained in US tax laws. In 1976, a panel of the General Agreement on Tariffs and Trade (GATT) found DISCs to constitute a prohibited export subsidy. In 1981, the GATT council adopted the panel findings and proposed a formula to settle this dispute. In 1984 the US congress replaced the DISC Act with the Foreign Sales Corporations Act. In 1988 a WTO panel ruled in favor of an EU complaint that FSCs also constitute a prohibited export subsidy; this ruling was upheld on appeal in February 2000. The US Congress enacted the Extraterritorial Income Exclusion (ETI) Act in 2000, to replace the FSC Act. Notwithstanding, a subsequent WTO panel upheld a subsequent EU complaint against the ETI Act. The January 14 ruling by the WTO appellate body was in response to this latest appeal.

The WTO must now determine the amount of the economic damage the EU has incurred as a result of the continued use of FSCs. The EU has claimed damages of \$4 billion dollars; the WTO is expected to set the figure at a lower level. ("US Faces Heavy Trade Sanctions;" *Financial Times*, 15 January 2002, page 1). Once that figure has been determined, the EU will have the right to request the WTO to authorize sanctions against US exports to the EU in that amount. The EU would then publish a preliminary list of US products targeted for sanctions. Most observers believe the EU will, however, suspend actual retaliation while it seeks a diplomatic resolution with the US. In addition, many European multinational corporations are not eager to see the EU press the issue; many have US subsidiaries that enjoy FSC tax benefits.

The WTO appellate body decision does not spell the imminent end of

FSCs. The US Congress does not seem disposed at present to revisit the issue of FSCs so soon after the enactment of the ETI Act. Some Republicans favor changing to a territorial tax system similar to those in the EU, as part of a broader reform of US tax laws. While such a reform might satisfy the WTO, it seems unlikely to win majority support in Congress at present. The prospect is that FSCs and their successors will continue to be at the center of the transatlantic discussion of export subsidies. (The WTO appellate body decisions are available on the WTO Web site at [www.wto.org](http://www.wto.org).)

**Erik Ibele is a partner at Neider & Boucher, S.C. in Madison, Wisconsin, where he practices in the areas of international business law, intellectual property, and corporate finance. He is also an instructor at the University of Wisconsin Law School, where he teaches International Business Transactions.**

## How do you measure up?

### **The State Bar of Wisconsin's Economics of Law Practice in Wisconsin – 2001 Survey Report**

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To view the report's introduction, visit: [www.wisbar.org/bar/reports/2001/econpr.html](http://www.wisbar.org/bar/reports/2001/econpr.html).

The ruling by the WTO appellate

## Board Roster

Following is a list of the members of the Board of Directors of the International Practice Section. If you would be interested in becoming involved on the Board, please contact Jerry Okarma at [jerome.d.okarma@jci.com](mailto:jerome.d.okarma@jci.com) or 414-524-3400.

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# Cross-Border Technology Transfer

**By John D. Gatto**

Transatlantic Venture Solutions, LLC

I have spoken and written in the past about the growing need for the general practitioner and international lawyer alike to be aware of and be able to react to cross-cultural issues in today's business environment. The following is intended to illustrate how a steadily increasing deal flow involving technology transfer across international borders is impacting not only the business climate in Wisconsin but also the practice of law.

Globalization is no longer just a buzzword but is an actual reality that many of us face in our every-day personal and business dealings. This globalization not only brings us closer to the "outside" world, but also serves to contrast the different realities that exist in a seemingly smaller world. We all know that people in other parts of the world eat different things, dress differently, listen to different music, and speak different languages. However, it sometimes never occurs

to us that they also think differently. This means that in many cases they also conduct business differently. Being aware of and addressing these cross-cultural differences appropriately in specific international business situations can mean the difference between success and failure.

In line with the increase in international business our state is experiencing overall, I have found that my business consulting practice is encountering a growing number of cross-border business deals evolving around technology transfer. My clients typically hire me initially to help them find investment capital to finance their business deals. Most of these matters involve a new technology that has been developed into a prototype ready to be launched into the commercial marketplace. Due to the rapid pace of technological advancement, these new products frequently have very short shelf lives.

Unlike a traditional manufactured good, like a Harley-Davidson motorcycle, new technologies like medical devices and biotechnologies cannot be sold regionally for a period of time before it is decided to export them outside of a region. Consequently, more often than not, these new technologies immediately constitute global products.

Due to such developments, the practice of law in Wisconsin is becoming more sophisticated and capable of handling the more complex issues evolving around international transactions and technology transfer. Nonetheless, when my clients ask me about international legal counsel, many are surprised that firms qualified to handle international legal transactions can readily be found in Wisconsin. Many of my clients still tend to go outside of Wisconsin to firms in Chicago, New York or

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The **International Practice News** is published quarterly by the International Practice Law Section of the State Bar of Wisconsin. Questions and comments may be directed to:

**Catherine L. Davies**

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Individuals interested in joining the International Practice Section should contact the State Bar of Wisconsin, (608) 257-3838.

## Cross-Border Technology Transfer

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Washington, D.C. because of their belief that only these cities have firms capable of handling sophisticated international legal transactions. The reality is that with the shifting marketplace paradigm, the legal profession overall, but especially in our state, is slowly but surely becoming more in tune with the requirements of a global marketplace.

For example, I have been working with a new technology that allows for the manufacture of an airplane luggage container capable of containing a bomb explosion and significantly decreasing the likelihood of crash subsequent to a blast. I was first

brought into this project to help secure the investment capital necessary to launch this technology into the commercial marketplace. Over the past year, my role has evolved in that I am now responsible for putting together a strategic alliance consisting of not only the capital investment, but also matching the plastics/composite manufacturing capabilities with the necessary airline industry marketing and sales expertise. This product is one with an immediate need for global distribution because the domestic niche market is too small to warrant the resources required for this specific technology transfer. As the project develops, it requires on-going legal expertise in many complex areas such as project finance, import/export regulation, and domestic and international intellectual property protection, to name just a few. Various domestic and international transactional and contractual aspects have also emerged.

The above project is a prime example of one in which the Wisconsin legal community can and does shine. The steady increase in cross-border technology transfer and deal flow that I am experiencing in my practice results in the need for qualified legal counsel expert in the many aspects of international business right here at home in Wisconsin. Prior to and during the course of many of my projects, I seek to bring together the best financial and legal talent available, as suited to my clients' specific needs, in order to assure the success of each transaction. In networking the professional community to this end, I am finding that, contrary to popular belief, there is no need, in many cases, for companies to look outside of our state for these services. Firms need only open up to the possibilities of a global business and legal community and may often be surprised at what they are capable of achieving.