

# China America Legal Forum

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## Doing Business and Raising Capital Privately in the United States

Key Considerations for Chinese Businesses

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# Part I

## Doing Business and Setting up Business Operations in the US

# Key Formation and Management Issues

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- Subsidiary vs. Branch Office
  - Key Characteristics
  - Key Benefits
  - Management Structure
  - Limiting liability exposure
  - Governance

# Topics covered in our memo with the materials

- Tax considerations
  - Comparing the income tax treatment of corporations, LLCs and branch offices
  - Other Taxes: payroll, real estate, sales tax
  - Cross border tax planning for entity formation, M&A and transactions
- Duties of officers and directors, and independence requirements applicable to public companies
- Employment law legal landscape
- Basics of immigration law for management relocation
- Expanding into the US through Mergers and Acquisitions
  - Due Diligence process
  - Regulatory landscape
    - Hart Scott Rodino pre-merger notification and approval
    - National Security review under FINSA by CFIUS
  - Reverse Mergers

# Forming a Subsidiary

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Most typical vehicles used in international expansion and cross border transactions involving the US:

- Corporation (“C-Corp”)
- Limited Liability Company (“LLC”)
  - LLCs are often used in cross border joint venture transactions

# Comparing a Corporation and an LLC

- Formed in the same manner (simple regulatory filing)
- Management structure is different
  - Corporation has board of directors who appoint management
  - LLC can be managed by its owners (“Members”), or the members can appoint a manager
  - Often an LLC adopts a corporate management structure
- No criteria limiting who can own the entity or who can be on the board or in management
  - No citizenship or US residency requirement
  - Private companies - no board independence requirements
  - Parent and subsidiary can have same people serve on the board *but* it may leave the parent vulnerable to liability for subsidiary’s actions (“piercing the corporate veil”)

## Other Key Aspects of Entity Formation

- No minimum capital requirements \*
- No requirement for physical presence or address \*
  - ❖ Immigration law - adequate capitalization to cover the salary of relocated management, and cost of a physical address.
- No limitations on who can own a C-Corp or LLC: individual or another US or non-US entity
- Capital structure freedom: C-Corps are free to create many different share classes with different rights and terms (i.e. different voting rights, liquidation preferences)

# Key characteristics of a US corporation that differ from corporations formed in other jurisdictions

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- Privacy of owner
  - The identity of shareholders is not publicly filed with a state regulator in order to maintain corporate existence, however. . .
  - If a company is an Exchange Act Reporting Company, meaning it is subject to the reporting obligations under the Securities Laws (has sold securities in a public offering or is listed on a stock exchange) then a shareholder who acquires beneficial ownership of 5% or more must file a notice of ownership with the SEC (Form 13D).
- No “statutory accounts”
  - A private company is not obligated to file financial statements with any regulator to maintain existence
    - Exchange Act Reporting Companies must file periodic reports with the SEC

# Key benefits of a Corporation and an LLC

- Ability to have perpetual existence
- Limited Liability
  - Liability is typically limited to the value of its shares, or capital contribution to an LLC
  - Generally not liable for the debts of the C-Corp or LLC

*Unless . . .*

The “corporate veil” can be pierced.

# Piercing the Corporate Veil

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- The US subsidiary (C-Corp or LLC) must run its affairs in a manner that is indeed separate from the owner / parent.
- If parent exercises control over subsidiary's day to day business to the extent that subsidiary had no "separate mind" from the parent, and the control was used to commit fraud or some dishonest act, then parent can be held liable for the subsidiaries actions.

# Factors that Separate Subsidiary and Parent

- Adequate capitalization of the subsidiary
- Subsidiary follows good corporate governance practices
  - Convene board meetings
    - Duty of Loyalty and Duty of Care
  - Appoint officers with responsibility for making decisions
  - Keep adequate books and records of board and committee meetings and executive decision making process
- Subsidiary and parent money is not co-mingled
  - Keep separate bank accounts
- Parent otherwise refrains from exerting undue influence over day-to-day management

# Opting for a Branch

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## Doing Business without creating a US entity

- A non-US company can qualify to do business in a state simply by filing a form with the Secretary of State in the relevant state.
- It can conduct any business that would be lawful for an entity formed within the state.

**Liability is not limited** - The branch office is not a separate legal entity, therefore does not insulate the parent from liability for its actions.

Income tax status is different from a subsidiary entity

## Part II

# Raising Capital Privately in the US

# What does it mean to raise money privately?

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- Means that the company is not offering or selling securities – debt or equity – in a manner that triggers the requirement to file a registration statement with the Securities and Exchange Commission, which further subjects the company to ongoing periodic disclosure obligations.

# Characteristics of the Private Capital Markets

- US and non-US welcome - A Chinese company can raise money in the US capital markets even if it does not do business in the US
- Open to all businesses: Both privately held (non-public) and public companies can raise money privately.
- Private capital markets in the US are huge
  - According to recent SEC estimates, over \$1 trillion annually, more than double the size of the public markets
  - Median offering size being \$1 million, making it a viable source of capital for small and medium size businesses as well as large multinationals

# Why raise money privately rather than use the public capital markets?

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Public markets offer liquidity, but there are many advantages to raising money privately:

## Ease and lower costs

- ❑ No SEC registration of securities, a time-consuming and expensive process
- ❑ Avoid public disclosure of company information and personal information about officers and directors
- ❑ Avoid being subject to ongoing disclosure requirements (burdensome, costly)
- ❑ Avoid being subject to the enhanced corporate governance requirements of Sarbanes-Oxley and Stock Exchange Rules

*But, the process is still regulated . . .*

# “Private” does not mean “Unregulated”

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Statutory exemption for offers and sales of securities *not involving any public offering* (Section 4(a)(2) of the Securities Act of 1933)

## Regulation D – Safe Harbor Exemptions

- Most capital raised privately relies on one of the **safe harbor exemptions** under a set of rules referred to as **Regulation D**, which is made up of several rules (Rule 504, 505 and 506) each with different criteria for the exemption. Rule 506 accounts for over 90% of total money raised privately.
- 2 overriding concepts apply to safe harbor exemptions:
  - Who may invest: Many exemptions limit sales to “**Accredited Investors**” (high net worth individuals who meet certain income and net worth tests and certain institutions)
  - Manner of sale and the regulated use of **general solicitation and general advertising**

# Rule 506(b) of Regulation D is The Primary Exemption Relied Upon in the Private Market.

A Chinese company, or its US subsidiary, can raise

- unlimited amount of money
- from an unlimited number of accredited investors and up to 35 non-accredited investors
- However, use of general solicitation and general advertising is prohibited.

# Chinese companies recently using Reg D Rule 506(b) to raise money

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***General Steel Holdings, Inc.*** privately placed 5 million shares for approximately \$7.5 million.

***China Mobile Games and Entertainment Group Limited*** sold American Depositary Shares\* in a private placement that raised US\$16.4 Million

\* Note an American Depositary Share (“ADR”) is a negotiable certificate that evidences ownership of American Depositary Shares (“ADSs”) which, in turn, represent an interest in a specified number (or fraction) of a foreign company’s shares that are deposited with a Depositary Bank.

# Regulation S: Offshore Offers and Sales and “Side-by-Side” offerings

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Regulation S provides that offers and sales of securities occurring outside of the US are not subject to the registration requirements of the Securities Act if two conditions are met:

- the offer and sale is made in an “**offshore transaction**” to a person who is not in the US when the offer was made or the buy order was placed; and
- there are **no “directed selling efforts” in the US**, which means no activities that could be deemed to “condition the market” in the US for the securities that are being sold overseas -- be careful what you say on a website that is accessible in the US.

For issuers that do not have “**substantial US market interest**” (“SUSMI”), it may be possible to make offshore offers and sales to US persons (rules are very complicated and require analysis of issuer’s US and worldwide trading history).

Global Offerings often combine Regulation S with a “**side-by-side**” offer and sale in the US under Regulation D Rule 506(b).

# Resale Restrictions, and Rule 144A Resale Exemption

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- Securities that are not sold pursuant to a registered public offering are “restricted” from resale for a period of time, either 6 months or 1 year depending on whether the issuer is an Exchange Act reporting issuer and whether the purchaser is an affiliate.
  - “Restricted” means that the securities cannot be resold before the expiration of that period unless sold pursuant to an exemption from registration. Illiquid compared to listed securities.
- **Rule 144A** is an exemption for immediate resale in the US, by an initial purchaser from the issuer, to “Qualified Institutional Buyers” (“QIBs”), of securities that were originally sold by the issuer in a private offering.
  - Global offerings often combine a Reg S offshore sale with a Rule 144A resale by the banking syndicate in the US.

# Recent Notable Chinese Reg S and Rule 144A Offerings

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Examples of recent transactions that included an offshore Regulation S offering to non-US persons and an on-shore US offering to QIBs under Rule 144A.

**Qihoo 360 Technology Co. Ltd.** offering of nearly **US\$1 billion** (an aggregate US\$900 million principal amount) of convertible senior notes with staggered maturity dates, convertible into Qihoo's American Depositary Shares.

**51Job, Inc.** offering of **US\$150 million** convertible senior notes, convertible into 51Jobs American Depositary Shares.

# Managing the number of US holders of record: Don't become a “public” company accidentally

For non-public companies, it is important to manage the number of record holders to avoid triggering the periodic reporting requirements of the Securities Exchange Act of 1934, effectively becoming a US public company accidentally, without the benefit of raising any money.

Issuer (US or foreign) must register with the SEC within 120 days after the end of its fiscal year when:

- It has total assets in excess of \$10 million, and
- Either 2,000 or more US holders of record or 500 US holders who are not accredited investors. Tally excludes securities issued under an employee compensation plan, and securities sold under the proposed Regulation Crowdfunding, when effective.

# Periodic Reporting Obligations – How “Foreign Private Issuers” Can be Exempt

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What is a “foreign private issuer” (“FPI”)?

A foreign company that meets tests related to the relative degree of its US share ownership, and the level of its US business contacts.

A “FPI” is exempt from the Exchange Act reporting requirements if it makes available in its home jurisdiction, including information it has:

- made or is required to make public pursuant to the law of the country of its domicile or in which it is incorporated or organized;
- filed or is required to file with a stock exchange on which its securities are traded and that was made public by such exchange; and/or
- distributed or is required to distribute to its security holders. It does not require the reconciliation of financial information to US GAAP.

A few Chinese companies using the exemption include

***Angang Steel Company***

***Jiangxi Copper Co Ltd.***

***Shanghai Industrial Holdings Ltd.***

# Penalties for Non-compliance with Periodic Reporting Obligations

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- Failure to timely file required periodic reports will result in the SEC revoking the registration of the securities, and the ultimate de-listing of the securities, and may expose the company to shareholder litigation.
- Chinese companies recently de-listed (by default judgment because they did not respond to the SEC action) include
  - China Ruitai International Holdings Co. Ltd
  - FLM Minerals, Inc. (Beijing)
  - China Digital Animation Development, Inc.

## More information . . .

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Our paper in the conference materials provides detailed information on the topics discussed and more, including:

- New Rule 506(c) allowing general solicitation
- Crowdfunding – the “new capital market”
- Additional safe harbor exemptions
- Typical Disclosure in a private offering document
- Periodic reporting requirements
- Foreign Private Issuer exemption from periodic reporting requirements

# Conclusions

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The US welcomes foreign investment.

- Highly - developed body of corporate, contract and securities laws with clear and objective criteria regarding permitted and prohibited activities that bring certainty to the business environment.
- A generally objective enforcement system.
- Regulatory safeguards in place to protect investors by ensuring that they have access to accurate information in a timely manner, which provides the security needed to foster active capital markets.
- Relative freedom under US law to structure a business and its management procedures in a manner the company deems best, and good corporate governance practices can shield the parent from liability.

# At your disposal



For further information, or if you have any questions regarding the presentation or the content of this publication, please contact:

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