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Legal Considerations for Establishing Operations in the United States (Pennsylvania)

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I. Introduction – Business and Legal Climate in the United States.

The business climate in the United States, though subject to business cycles, is the largest, most dynamic and durable in the world. The freedom to compete gives would be entrants the greatest opportunity to succeed and entrenched players the greatest risk of failure. Central to the business climate is the virtual absence of political risk and the stability and predictability of the legal system.

Although stories of run-away punitive damage verdicts give many business executives pause about investing or doing business in the U.S., the fact is that during the period 1989-1995, plaintiffs actually prevailed less than half the time and succeeded in getting a punitive damage award in fewer than 3 percent of those cases. In 1997, two-thirds of cases where plaintiffs won were overturned on appeal. On the other hand, courts follow prior decisions in determining the outcome of a lawsuit and that gives businesses the ability to predict the likely outcome of a particular course of conduct and give businesses comfort in the sanctity of contracts.

The U.S. tax system, although very complex, is generally less burdensome than most countries when you consider income, VAT, employment and property taxes combined. Moreover, the U.S. is party to myriad multilateral and bilateral tax treaties that reduce or eliminate many of the duplicate tax burdens between countries.

II. Limitations on Conducting Business in U.S.

A. Restrictions on Foreign Investment & Control.

Generally the U.S. has proven to be a desirable location for foreign investment. Few controls are posed on investment by foreign entities that are not imposed on domestic entities. However, federal law does restrict and regulate permissible levels of foreign ownership and control in certain key industries.

1. *National Security & Defense*: The Exon-Florio amendment to the Omnibus Trade and Competitiveness Act of 1988 gives the President the power to suspend, prohibit or dismantle mergers, acquisitions and takeovers of American companies by foreign investment that threaten national security. While there is no formal definition of foreign control that would “threaten” national security, the evaluation process criteria differs where the foreign entity is owned or controlled by a foreign government. Additionally, it must be clear that other provisions of the law do not provide adequate safeguards. The President may consider several factors in evaluating national security concerns; the primary factor is domestic capacity to meet national defense requirements in view of any potential

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takeover. The President also may consider the potential for the proliferation of terrorism, missiles, nuclear as well as biological weapons and any potential effect of the transaction on American technological leadership in areas affecting national security.[1]

2. *Nuclear Power*: The Nuclear Regulatory Commission (NRC) issues licenses for the use of nuclear material for medical, industrial and commercial purposes, including research and development. The NRC is prohibited from issuing licenses for the production and handling of atomic energy to any individual, corporation or entity that is owned, controlled or dominated by a foreign corporation or foreign government. The policy rationale behind this is the protection of domestic defense, security, health and safety. The NRC may enter any nuclear facility to recapture nuclear material and operate the facility to assure proper use, preservation and safeguarding of such material in order to promote the common defense and security of the U.S. Generally, foreign investors may participate in NRC-licensed activities if the foreign entity does not hold a majority interest in the venture and the licensed activities are controlled by U.S. citizens. In the past, the NRC has imposed the following licensing conditions on foreign participation in the applicant's licensed activities: (1) the foreign entity cannot hold more than a 50 percent ownership interest in the venture, (2) the directors, officers, and managers of the licensed entity must be U.S. citizens who are not controlled by, or under the influence of, a foreign entity or person, (3) officers and employees of the venture responsible for the custody and control of nuclear materials must be U.S. citizens and (4) only persons with security clearances and permits may have access to restricted data involving plant technology. These factors may not be the only conditions the NRC will impose on a foreign investors seeking to own a portion of a U.S. domestic nuclear power plant. In addition, the NRC always considers the form of the venture and the nature and extent of foreign participation.

3. *Public Utilities*: the Public Utility Holding Company Act of 1935 (PUHCA) states that, unless exempted, any entity owning over 10 percent of the voting securities of a public utility is considered a "holding company." Holding companies are subject to the provisions and restrictions of this act and must register with the Securities and Exchange Commission. However, foreign entities seeking to acquire an interest in a U.S. utility may be able to avoid the requirement of SEC approval by qualifying as a Foreign Utility Company. The exemptions to the PUHCA requirements are available to small domestic utilities.

4. *Maritime Industries*: Based on the same national security rationale, federal law requires that all merchant marine vessels must be owned and operated privately by citizens of the U.S. The merchant marine fleet serves as a military auxiliary in times of war and national emergency and is essential to foreign and domestic commerce. Accordingly, all merchandise to be transported by water, or by land and water, between points in the U.S. must be carried by vessels built in and documented under the laws of the U.S., and owned by U.S. citizens. Additionally, a U.S. owner is prohibited from selling any interest in a vessel to a non-U.S. citizen without the approval of the Department of Transportation. (This does not apply to certain pleasure and fishing vessels).

B. **Federal Regulation of Foreign Investment & Control.**

Federal law limits or regulates foreign ownership and investment in the following industries:

1. *Airlines*: U.S. citizens must own 75 percent of the voting shares of an air carrier, as well as constitute at least two-thirds of the board of directors and managing officers. In addition, the president of the air carrier must be a U.S. citizen. The Department of Transportation is primarily concerned with voting equity, but extensive foreign

equity ownership absent voting power may result in a denial of participation. A foreign airline is permitted to own up to 49 percent of the total equity, but the limit of 25 percent of the voting equity remains.

2. *Media & Communications*: The laws governing the communication industry are the key area of federal foreign investment regulation. These laws are intended to promote competition and reduce regulation to encourage quality services at low prices and rapid development of new technology. The Telecommunications Act of 1996 gives the Federal Communications Commission (FCC) the discretion to refuse to license (television, radio, common carrier, broadcasting, aeronautical services, cellular & microwave and satellite communication) any corporation directly or indirectly controlled by any other corporation of which more than 25 percent of the capital stock is owned of record or voted by foreign persons, their representatives, a foreign government or by any corporation organized under the laws of a foreign country. Generally, the FCC would refuse the license because the public interest and national security would be served by the refusal or revocation of such license. The purpose of these regulations is to guard against foreign control. Additionally, under this act a four-prong Effective Competitive Opportunities (ECO) analysis applies to authorizations of foreign investors seeking to acquire either a controlling interest or more than a 25 percent interest in a U.S. communications carrier. The ECO test examines whether a foreign market is open by considering: (1) the presence of legal barriers to market entry by entities foreign to that market, (2) whether interconnection is permitted under reasonable and non-discriminatory charges, terms and conditions, (3) the presence of competitive safeguards (i.e. rules against cross-subsidization) and (4) the existence of a regulatory agency to protect the competitor.

3. *Banking*: The Foreign Bank Supervision Enhancement Act of 1991 mandated that the Federal Reserve must approve the establishment of U.S. offices by foreign banks if the bank is under comprehensive and consolidated regulation by its home country's authority.

4. *Mineral Leases and Timber Rights*: Deposits of natural resources and the lands containing them owned in the U.S. are available for exploitation by U.S. citizens, but not to foreigners unless their home country grants comparable rights to Americans. Foreigners may hold mineral leases through their interests in U.S. corporations provided that their home country does not deny similar rights to Americans. Aliens who are bona fide residents of the U.S. may obtain access to timber on federal lands.

5. *Outer Continental Shelf Activities*: Federal regulations govern the outer continental shelf and off shore leases. Foreign access is not prohibited because there is no citizenship requirement. Statutory provisions limit manning outer continental shelf rigs, vessels and platforms to U.S. citizens, with some exceptions.

III. State Restrictions on Foreign Ownership & Control.

A. Agricultural Lands. Under Pennsylvania law, an alien who is not a resident of a state or territory of the U.S. or of the District of Columbia, or a foreign government cannot acquire an interest in agricultural land exceeding 100 acres, except such as may be acquired by devise or inheritance, and such as may be held as security for indebtedness. This law does not apply to citizens, foreign governments or subjects of a foreign country whose rights to hold land are secured by treaty.

IV. Choice of Form of Business Enterprise.

Business entities in Pennsylvania are governed by statutory civil laws. In particular, the application of the Pennsylvania Business Corporation Law of 1988 (PABCL) is vital. When deciding to conduct business in the U.S., particularly in Pennsylvania, the nonresident individual or corporation needs to decide which method of conducting business and which business form best meets its needs and objectives.

The choice of the state in which to organize or incorporate an entity is similarly important. Business entities are creatures of state law, not federal law. A business entity can incorporate or form in any state it chooses and its internal affairs are governed by the law of that state, even if the entity does not do business in that state. Federal laws, however, are uniformly applicable to business entities throughout the U.S.

Many different legal vehicles are used to conduct business in Pennsylvania. The business can (1) form a joint venture with an existing Pennsylvania business enterprise; (2) create an enterprise in Pennsylvania owned by the foreign investor's company, such as a new Pennsylvania subsidiary, a more informal structure such as a liaison office or branch office of the foreign investor's company; or (3) acquire an existing Pennsylvania enterprise or Pennsylvania subsidiary of another corporation.

A. Joint Venture With a U.S. Business Enterprise.

While Pennsylvania law provides no legal definition of a joint venture (JV), it is generally defined as an agreement between independent parties who venture into a common objective and negotiate as equals. In the U.S., JVs generally take one of the three following types, but they may take the form of any legal vehicle.

a. A simple contractual relationship

b. A partnership agreement

c. A joint corporation or other legal vehicle.

These forms are all contractual in nature, but the first form is distinguishable from the other two. The first form does not result in a common entity, while the second form results in a quasi-common entity and the third results in a common entity. Numerous factors must be considered when deciding which form is appropriate for a particular JV.

1. *Factors Affecting Choice of Form.* The following factors should be considered when deciding on the appropriate structure for the JV:

a. *Size and Complexity of the Proposed JV.* Is a common entity justified or is a simple contractual JV sufficient to accomplish the goals of the deal?

b. *Anticipated Length of the Contemplated JV.* A contractual JV is often only a first step, which, if successful, will give rise to a common entity.

c. *Relationship Between the Joint Venturers.* What problems are anticipated concerning management/control, compatibility of the parties' interests, relative size and commercial weight of the parties?

d. *Use of Tax Benefits.* If an immediate deduction of start-up expenses for the JV is a significant factor, a partnership is likely to be the most appropriate structure.

e. *Cash Flow.* If income from the JV can be accumulated and distribution of profits deferred, a corporation would be preferable.

2. *Differences Between a Contractual JV and a Common Entity.* A common entity is usually a separate independent legal vehicle from the joint venturers, while a contractual JV is not. As a result:

a. The common entity can trade in its own name with third parties.

b. In principle, the common entity is not dissolved if a joint venturer goes bankrupt or enters into liquidation.

c. The common entity is an ideal vehicle for future expansion. It can merge, have subsidiaries, under certain conditions be traded publicly, etc.

d. The common entity can contract loans.

e. Arguably, the common entity is better able to establish a market presence and reputation as well as monitor and adapt to enduring market forces.

f. In the common entity, it is easier for joint venturers to transfer all or part of their interest in the common entity, so it is easier to bring in new joint venturers or investors.

3. Different Types and Forms of JV.

a. *Contractual JVs.* Several advantages as well as disadvantages are available in using contractual JVs. Most contractual JVs also share certain common characteristics.

(1) Advantages

(a) *Flexibility.* Contractual JVs are flexible, as the restraining effects of setting up a legal entity are avoided. In addition, contractual JVs allow all types of individual initiatives, such as leases, loans or supply of services. The parties can insert conflict of law provisions, subject only to Pennsylvania’s or the law of the situs’s public policy exceptions.

(b) *Absence of Predetermined Structure.* Contractual JVs do not constitute a legal category, so on the whole are not subject to any specific rules as are sales agreements, loans, etc. They are only governed by Pennsylvania contract law, and subject to public policy exceptions, such as competition and labor concerns.

(c) *Ease of Termination.* Unless the parties specify a certain duration, contractual JVs can normally be canceled at any time without liability with proper and reasonable notice.

(d) *Secrecy.* If the parties wish, a contractual JV can remain far more secret than a common entity JV.

(2) Disadvantages

(a) A contractual JV must be carefully drafted as no legal structure helps to implement the contract.

(b) A court might hold the contractual JV to be a de facto partnership, imputing the duties and obligations of a partnership onto the joint venturers.

(3) *Common Characteristics of Contractual JVs.* A contractual JV is created through a direct contractual relationship among joint venturers through one or several contracts. These contracts state the objectives and means of achieving the objectives of the venture, as well as precisely describing who does what in the venture. The venturers thus undergo contractual obligations. In general, most contractual JVs reflect some common features, including:

(a) The concern of the parties to foresee a maximum of potential future opportunities and problems.

(b) Provisions on automatic modification of certain aspects of the contractual JV, particularly financial aspects where a change in circumstances upsets the commercial balance of the arrangement.

(c) Provisions addressing the balance of power between the joint venturers in respect to decisions concerning the JV.

(d) Detailed provisions concerning the settlement of disputes.

(4) *Deciding Whether to Use a Contractual JV.* Contractual JVs should generally be used for specific operations or for ancillary activities of a previous JV. They should be used when a common entity structure is not justified because of the short-term activities of the venture, its experimental basis, lack of complex financing or need for secrecy. The classic example is the contractual JV between two companies to collaborate on the development of specific services or products, for which they agree to share in the profits and losses.

b. *Partnerships*. Partnerships are generally characterized by unlimited joint and several liability of the partners and restrictions on the assignment of partnership interest, particularly to nonpartners. There are three types of partnership agreements: (1) General Partnerships; (2) Limited Partnerships; and (3) Limited Liability Partnerships.

(1) When to Select a Particular Type of Partnership

(a) *General and Limited Liability Partnerships.* The considerations for using General and Limited Liability Partnerships are essentially the same in the JV context. These entities are often chosen as the JV vehicle for commercial real estate activities, particularly management and operation of real estate assets (i.e., vineyards, farms) or construction activities. They also are advisable in JVs where a small number of trusting and familiar partners are involved who wish to gain the benefit of tax transparency.

(b) *Limited Partnership.* The limited partnership is a hybrid of a partnership and a corporation. The limited partnership is rarely used as the entity for the JV because they are usually structured with one entity serving as a general partner and several investors as limited partners; however, a limited partnership may be an ideal choice in

the situation where one joint venturer wishes to have total control over the venture and the other joint venturers wish only to share in the profits.

c. *Joint Corporations and Other Legal Vehicles.* A jointly owned corporation is the standard form of JV used when the venture has any economic significance and when the joint venturers want the JV to be disclosed to the public. The preferred corporate form is the business corporation or the limited liability company.

(1) *When to Select an Business Corporation.* A business corporation often represents the ultimate step for a successful JV that started as another form. Also, business corporations are often used by companies that want the venture to be publicly listed on a stock exchange, to acquire more shareholders and then progress independently from its shareholders. In large-scale JVs, particularly industrial JVs, a business corporation is often the only suitable vehicle. Finally, JVs using a business corporation vehicle are often precursors to a merger of the companies involved in the JV, especially where the companies are contemplating a merger and in the interim wish to work together in a given field of activity.

(2) *When to Select an LLC*. A limited liability company is not usually used by entities that desire to become a publicly listed entity on a stock exchange. Rather, LLCs are for investments or operations that will grow organically and are not generally used as acquisition vehicles, although they may be used as such. LLCs allow for "pass-through" taxation where the revenues of the LLC are not taxed at the company level; rather, profits are passed through and taxed at the member level while providing the level of liability protection commensurate to a limited partnership.

B. Acquisition of an Existing Pennsylvania Business Enterprise or Pennsylvania Subsidiary of Another Foreign Corporation.

A foreign investor can acquire an existing Pennsylvania enterprise or Pennsylvania subsidiary of another corporation in one of two methods: (1) acquire the assets of an existing enterprise or subsidiary; or (2) acquire sufficient stock in an existing enterprise or subsidiary to acquire de facto control.

1. *Asset Acquisition.* There are two types of asset acquisitions. First, the foreign investor can acquire assets of the type necessary to start a new business, where the business will develop its own clientele. This type of asset acquisition is important only in that it is part of the process of creating a new business entity. All other asset acquisitions involve going concerns, the transfer of which raises a number of legal and tax issues.

a. *Going Concern.* A going concern consists of the whole business enterprise, "fonds de commerce," including tangible and intangible business assets, such as inventory or supplies, a right to a lease or license of the business, or the most important factor that determines the existence of a going concern, a *clientele* attached to a particular group of assets. It is important to be aware of the going concern, "fonds de commerce," because an acquisition of a going concern triggers certain tax and legal consequences.

b. *Tax Issues.* When purchasing assets, the purchase price of the assets becomes the new tax basis of those assets. This usually results in a higher tax basis and higher tax depreciation deductions than for the purchase of shares of stock of a business corporation. By purchasing assets, the purchaser can usually avoid most liabilities of the seller, including any liabilities for back taxes. Numerous other tax issues regarding the purchase of a going

concern are beyond the scope of this discussion. For example, if one of the assets being sold is real property and the seller is a foreign entity, the U.S. government imposes a tax on any amount realized by such foreign entity in addition to other transfer, income or capital gains taxes which may be applicable to such a transaction

c. *Labor Issues.* A sale of a going concern usually triggers certain labor law obligations. Within certain limits, the sale of assets provides a buyer with options regarding the assumption of a collective bargaining agreement. The buyer in an asset sale is not obliged to assume the seller's collective bargaining agreement unless the buyer evidences an intent to be bound by the agreement or the buyer is an alter ego or considered a "single employer" with the seller. A buyer may establish initial terms and conditions of employment to offer the seller's employees. This ability, however, is limited in circumstances where the buyer clearly intends to hire all of the seller's employees or where the buyer unlawfully refuses to hire the seller's employees because of their union affiliation. A buyer who is a successor employer must bargain in good faith with the seller employee's union if the buyer hires a substantial and representative complement of the unionized workers, a majority of whom were formerly employed by the seller.

2. *Stock Acquisition.* A variety of transactions are available to a would-be stock acquirer, and many tax and labor issues are involved.

a. *Types of Transactions.* First, and simplest, is where the acquirer simply buys the shares from the seller. Second, an acquirer can obtain, with the agreement of all existing shareholders, a controlling interest in the company by subscribing to an increase in the target company's capital which has been reserved for the acquirer in the agreement. It is important to note that where a publicly traded company is involved the acquisition must be done in compliance with the rules and regulations contained in the federal securities laws and of the relevant stock exchange on which such stock is listed.

b. *Tax Issues.* By purchasing the equity interest in a business corporation or other entity, the purchaser inherits all of the tax attributes (e.g. basis) of the purchased equity. The purchaser also inherits all liabilities, including tax liabilities. Once again, this type of transaction involves significant other tax issues, which must be considered when deciding whether to make such a transaction.

c. *Labor Issues.* In a stock sale, the buyer does not have the same flexibility as an asset sale, and must assume any pre-existing collective bargaining agreements. Unlike an asset sale, the nature of a stock sale does not involve a break or hiatus between two legal entities, but is the continuation of a legal entity under new ownership.

3. *Merger*. A third way to acquire a going concern is through merger. A merger occurs through the combination or fusion of two entities to become one entity. As with the acquisition of stock or assets, a number of legal, tax and labor issues are involved in the merger of two entities.

a. *Types of Transactions*. Presumably, to effect a merger to begin operations in Pennsylvania or any other state in the U.S., a foreign entity would incorporate a U.S. wholly-owned Pennsylvania subsidiary which would own no assets and be incorporated solely for purposes of the merger. In the merger, the subsidiary would merge with the target business entity and the target entity would be the "surviving" business entity of the merger. The foreign entity would own all of the stock of this surviving target entity. The surviving target entity would keep all of its assets and liabilities and maintain its separate corporate existence from the foreign entity.

b. *Tax Issues*. Certain mergers may be completed on a tax-free basis, depending on the amount of voting stock, cash and other consideration exchanged as part of the merger. This type of transaction requires analysis of possibly significant tax filing and payment requirements, as well as significant other tax issues, which must be considered when deciding whether to make such a transaction.

c. *Labor Issues*. A merger presents the same set of issues as a stock sale where the buyer must assume any pre-existing collective bargaining agreements.

4. *U.S. Foreign Investment Controls.* Investment controls are mainly governed by federal law. The U.S. has two types of investment controls. First, the U.S. has complex laws and regulations related to the trading of securities by domestic or foreign persons or entities, which are triggered when an individual or entity acquires securities of an U.S. company, either on the open market or through an acquisition of a U.S. company. Second, the U.S. has special acquisition review procedures where the acquisition affects a certain share of the U.S. market. Third, Pennsylvania has certain "anti-takeover" provisions which are available for corporations to ensure the stability of ownership and governance of business entities organized in Pennsylvania.

a. *U.S. Securities Laws.* The U.S. Securities and Exchange Commission is principally responsible for enforcing laws that regulate the public issuance and later exchange of securities of U.S. corporations.

(1) *Purchase of More that 5 Percent of Business Entity's Publicly Traded Stock*. The Exchange Act of 1934 provides that any person who acquires more than 5 percent of a publicly traded U.S. company must file Schedule 13-D, which provides certain personal and financial information of the acquiring person to the business entity and the public.

(2) *Tender Offers*. A tender offer is the public announcement by a person or entity that it is offering to pay a certain price over the current market price for publicly traded shares of a business entity that the person wishes to control. Tender offers are regulated by the Exchange Act of 1934. A few key guidelines in the law are summarized below.

(a) *Commencement of Offer*. Before, or within five days of, the commencement of the tender offer, the offeror must file Schedule 14D-1, which contains certain background information on the offeror, its transactional history with the target company and the purpose of the tender offer.

(b) *Minimum Offer Period*. All tender offers must remain open for no less than 20 days. If the offeror changes the amount of securities that it has offered to purchase by more than 2 percent, the offer must remain open for at least 10 days from the date of such change.

(c) *Target's Response to Securities Offer*. The board of the target must provide a recommendation to the shareholders within 10 days of the commencement of the tender offer.

b. *Review of Acquisitions Substantially Affecting the U.S. Market.* The Hart-Scott-Rodino Antitrust Improvements Act requires review of certain corporate combinations or purchase of business assets that would have an anticompetitive effect on interstate commerce. When certain market share thresholds are exceeded by the entities engaging in the corporate combination or asset purchase, the involved enterprises may choose to file their acquisition plan with the Federal Trade Commission for review. If the FTC has not objected to the transaction

within two months after the filing, it can no longer object to the transaction. However, if there is no filing with the administration, the acquisition can be investigated and canceled at any time after consummation.

(1) For pre-transaction notifications to be required, each of the following tests must be met:

(a) *Commerce Test*. Are either of the entities engaged in activity affecting commerce?

(b) *Size of the Person Test*. Either the acquiring entity or the target entity must have either assets or annual net sales in excess of $100 million and the other party must have assets or annual net sales of $10 million.

(c) *Size of the Transaction Test*. Either (i) $15 million or more in assets or equity are acquired in the transaction or (ii) 15 percent or more of the voting securities of the target are being acquired and the acquiring entity gains control of an entity with annual net sales of $25 million or more.

(d) In addition, acquisitions that result in holdings valued at $200 million or more are reportable regardless of the size of the parties.

(2) *Exempt Transactions*. Transactions that result in holdings of voting securities and/or assets of $50 million or less are exempt from pre-transaction notification filing.

(3) *Fees*. Pre-transaction notification filings have large filing fees.

(a) For acquisitions valued at less than $100 million, the filing fee remains $45,000.

(b) The fee is increased to $125,000 for acquisitions valued at $100 million or more but less than $500 million, and to $280,000 for acquisitions valued at $500 million or more.

(4) The size-of-transaction thresholds and the filing fees will be annually adjusted for changes in gross national product, beginning in 2005.

c. *Reporting Obligations to the Bureau of Economic Analysis.* Under the International Investment and Trade in Services Survey Act, all foreign investment in U.S. business enterprises in which a foreign person owns a 10 percent or more voting interest (or the equivalent) are subject to reporting. This includes investment in real property, other than for personal use. A number of types of forms must be filed:

(1) *Initial Investment Report (Form BE-13)*: An Initial Investment Report is required for new investment transactions in which a foreign entity, or the U.S. affiliate of a foreign entity, acquires at least a 10 percent ownership of a U.S. business enterprise that has total assets of more than $3 million or involves the acquisition of 200 or more acres of U.S. real property.

(2) *Report by U.S. Person Assisting in the Acquisition of a U.S. Business Enterprise (Form BE-14)*. U.S. entities assisting a foreign entity in the type of acquisition described above may file a Report by a U.S. Person Assisting in an Acquisition as an alternative to filing Form BE-13.

(3) *Annual Report (Form BE-15)*. An Annual Report must be filed for any non-bank U.S. business, more than 10 percent of which is owned or controlled, directly or indirectly, by a foreign entity.

(4) *Other Forms*. The International Investment and Trade in Services Survey Act requires certain other forms to be filed, depending on the type of business which is owned or controlled by the U.S. entity.

d. *Pennsylvania Anti-Takeover Provisions*. Under Pennsylvania law, certain anti-takeover rights are available to business corporations that have a class of stock that is publicly traded pursuant to the Exchange Act of 1934. These rights are optional as business corporations may "opt-out" of having these laws be applicable to such corporation. Each of the rights is summarized below.

(1) *Control Transactions*. This subchapter deters hostile bids by imposing a fair price provision that gives shareholders the right to receive "fair value" for their stock in the event of an acquisition by a person with 20 percent voting power. Fair value is basically a value not less than the highest price paid per share by the controlling person in the 90-day period prior to the acquisition.

(2) *Business Combinations*. Under this subchapter, a publicly held company shall not engage in a business combination with an interested shareholder (*i.e.,* generally, the beneficial owner of at least 20 percent of the outstanding stock) other than a combination approved:

(a) by the board prior to the date the interested shareholders became a 20 percent owner;

(b) by majority vote of disinterested shareholders at a meeting called no earlier than three months after the interested shareholder becomes an 80 percent beneficial owner if the combination meets certain other conditions;

(c) by majority vote of disinterested shareholders at a meeting called no earlier than five years after the interested shareholder became a 20 percent owner; or

(d) by a majority of votes cast by shareholders at a meeting called no earlier than five years after the interested shareholder became a 20 percent owner if the combination meets certain other conditions.

(3) *Control Share Acquisitions*. Under this subchapter, if any person or group acquires voting power of a publicly held company, which would raise their aggregate voting power for the first time to within a range (i) between 20 percent and 33-1/3 percent, (ii) between 33-1/3 percent and 50 percent; or (iii) 50 percent and above, the shares acquired in such transaction and in certain related transactions will be deprived of voting rights, unless such voting rights are restored upon the consent of the independent shareholders. Some uncertainty exists as to restrictions imposed by the federal securities laws on a corporation's ability to opt back into a control share acquisition statute such as this one.

(4) *Disgorgement of Certain Controlling Shareholders Following Attempts to Acquire Control*. This subchapter is designed to discourage manipulation of a publicly held company's stock prices by putting the issuer "in play." The statute provides for the disgorgement of profits realized by a controlling party through the sale of equity securities of the corporation within 18 months of becoming a controlling person where the equity security was acquired either within 24 months before or 18 months after the party became a controlling person. In this case, a controlling

person is defined to include “[a] person or group who has acquired, offered to acquire or, directly or indirectly, publicly disclosed . . . the intention of acquiring voting power over … 20 percent of the votes” or has publicly disclosed that it may seek to acquire control … through any means.” The subchapter effectively prevents a party from putting a company “in play” and then gaining a profit from having its interest bought out either by a third party or by the target itself.

C. Creation of a Pennsylvania Enterprise Owned by the Foreign Investor’s Company.

Instead of acquiring an existing Pennsylvania business enterprise, an investor may choose to create or establish an enterprise owned by the investor’s company, such as a new Pennsylvania subsidiary, or a more informal structure such as a liaison office or branch office of a foreign investor’s company.

1. *Subsidiary.* A Pennsylvania subsidiary can be created by a foreign investor by acquiring an existing enterprise in Pennsylvania or a Pennsylvania subsidiary (as described above), or by creating a new company which becomes a Pennsylvania subsidiary to the foreign investor’s company. The subsidiary owned may be any type of entity. The ownership of a subsidiary triggers certain legal and tax obligations.

a. *Legal Obligations.* A party must comply with various formalities to validly create a subsidiary. For purposes of our discussion we will assume that the subsidiary formed will be a business corporation.

(1) *Articles of Incorporation.* The articles of incorporation are used to establish the name of the business corporation, its domicile, ownership rights and voting rights of certain classes of stock, and special dissolution arrangements, if applicable, not in accordance with the rules as set forth in the PABCL. The business corporation is officially formed upon the filing of the articles of incorporation with the Secretary of State of the Commonwealth of Pennsylvania.

(2) *Bylaws*. The bylaws function as the management document of the corporation. The bylaws set forth provisions for managing the business and regulating the affairs of the corporation, such as the terms, conditions and scope of the power of the board of directors and officers of the corporation, provisions governing notice of the date a time for meetings of the board and shareholders, indemnification of directors and officers. The bylaws cannot be inconsistent with the articles of incorporation.

(3) *Board of Directors.* All business corporations organized under the laws of Pennsylvania are managed by a board of directors. Directors are elected by the shareholders of the corporation. The board of directors must consist of one or more directors. The number of directors is usually set forth in the bylaws or in the articles. If no number is stated, the PABCL provides that the business corporation will have three directors. Generally, directors of Pennsylvania business corporations must be natural persons of full age (more than 18 years of age) and need not be shareholders of the corporation or residents of Pennsylvania. The bylaws may set forth more qualifications for directors.

(a) *Classified Board of Directors.* In addition, the board of directors may be split into different classes to increase the time upon which each director serves on the board. For example, if a board of directors consists of nine members, divided into three classes, only one class would stand for election each year. Consequently, each director would serve for three years. Pennsylvania law requires that each class be nearly as equal as possible in

number of directors. Additionally, the term of office of at least one class must expire each year and the members of a class may not be elected for a period longer than four years.

(b) *Cumulative Voting.* Pennsylvania law also allows shareholders to cumulate their votes in the election of directors to protect minority shareholders from being unable to elect any directors to the board. Cumulative voting allows every voting shareholder to multiply the number of votes they are entitled to cast by the total number of directors to be elected in the same election by the holders of the class or classes of shares of which his shares are a part. Ultimately, the shareholder may cast the whole number of his votes for one candidate or he may distribute them among any two or more candidates. Pennsylvania law also allows business corporations to "opt out" of statutory provisions providing for cumulative voting. Often business corporations opt-out of cumulative voting and don't permit their shareholders to cumulate their votes.

(4) *Officers*. Every business corporation in Pennsylvania must have a president, secretary and treasurer. The bylaws may prescribe special qualifications for the officers. The president and secretary must be natural persons of full age. The treasurer may be a corporation, but if a natural person, he or she must be of full age. Unless otherwise restricted in the bylaws, it is not be necessary for the officers to be directors. Any number of offices may be held by the same person. The way officers are selected and the length of their tenure in office is typically set forth in the bylaws. In most cases, however, the bylaws provide that board has the power to select officers and such officers serve for one year.

(5) *Shareholders Agreement.* Where the investor will not be the 100 percent owner of the Pennsylvania subsidiary, it is advisable to have a shareholders agreement. This agreement will establish the various restrictions regarding the ownership and transferability of the shares of stock of each of the corporation's shareholders. The agreement should then be signed by all shareholders of the subsidiary. The goal of the shareholders agreement is to protect the investor from problems that may result from dissension or disagreement between shareholders regarding the management of the corporation.

(6) *Choice of Name.* The corporate name may be in any language and must contain the word "corporation," "company," "incorporated," "limited," "association," "fund" or "syndicate," or an abbreviation of the appropriate word. The name must be distinguishable from the name of any other Pennsylvania corporation or any foreign corporation authorized to do business in Pennsylvania. Before filing the articles of incorporation, the investor may apply to the Pennsylvania Department of State to reserve the name chosen for the subsidiary. Such reservation will remain in effect for 120 days.

(7) *Intellectual Property.* The company also should consult the U.S. Patent and Trademark Office where the new company wishes to use any types of intellectual property (i.e., patents, trademarks, etc.) potentially already registered in the U.S..

b. *Tax Obligations.* Creating a subsidiary also gives rise to a quantity of tax issues. The business corporation or other entity has the option of reporting its tax activity as well as that of the subsidiary in a consolidated federal tax return. In such a case, the business corporation and its subsidiary are a "consolidated group." The consolidated income tax return allows income from one member of the consolidated group to be offset by losses of another member. Pennsylvania does not allow consolidated state income tax reporting. This regime provides many planning opportunities. Through careful planning, taxpayers can minimize and sometimes avoid entirely

Pennsylvania corporate net income, capital stock and franchise tax.

2. *Branch of a Foreign Company.* For legal and tax purposes, a branch is not an independent entity. Rather, it is treated as part of the same company as its head office. To form a branch office of a foreign corporation in Pennsylvania, the foreign corporation must file an application to transact business in Pennsylvania. The costs and time involved to form a branch may be less than the costs and time involved in forming a Pennsylvania business corporation. The branch does not need to produce any board or shareholders' minutes or reports. The foreign corporation would simply apply for certificate of authority to transact business. Once approved, the foreign corporation will have to file an annual report with the Secretary of State identifying the outstanding capital and its current officers and directors. The foreign corporation also must pay an annual franchise tax.

3. *Additional Types of Legal Vehicles Used to Conduct Business in Pennsylvania.* The vehicles discussed below are either additions to or further discussions of the vehicles mentioned previously in connection with acquisitions and subsidiaries.

a. *Business Corporation.* There are two types of corporations, registered and unregistered. A registered corporation publicly traded. It consists of negotiable shares or debentures that are quoted on a stock exchange, such as the New York Stock Exchange, the NASDAQ or AMEX. These shares are offered to the general public and then publicly traded. An unregistered corporation obviously is not publicly traded. Special additional rules apply to registered corporations that do not apply to unregistered corporations. This section will discuss applicable corporate law for unregistered corporations, which also is generally applicable to registered corporations.

(1) *Formation.* As previously discussed with regard to subsidiaries, business corporations must be formed in accordance with PABCL. The legal status of a business corporation does not begin until it receives a registration number from the Office of the Secretary of State of the Commonwealth of Pennsylvania. That number will typically be issued on the same day as the filing of the articles of incorporation of the corporation. Incorporation expenses, excluding any counseling fees, are composed mainly of the filing fee and legal fees for preparing the appropriate documentation.

(a) *Steps Necessary to Commence Operations.* Before beginning operations, generally the proposed corporation must take the following steps:

i) Drafting of the articles of incorporation and bylaws.

ii) Capitalization of the company.

iii) Signature of the articles.

iv) Formation of the Board of Directors. The articles of incorporation may name the initial directors. If the directors are not named in the articles, an organizational meeting of the incorporator(s) must be held once the corporate existence begins. All directors other than those constituting the first board are then elected by the stockholders.

v) File the articles of incorporation in the office of the Secretary of State.

vi) Commence operations.

Any subsequent modifications to the incorporation documents must also be filed with the Secretary of State. Upon formation, the corporation's existence is perpetual unless a specific term of existence is specified in the articles of incorporation.

(2) Capital Structure

(a) *Shareholders.* Corporations consist of shareholders as the owners of the equity interests. The law defines shareholder as a record holder or owner of shares of a corporation, including a subscriber to shares. Every corporation shall have the power to create and issue the number of shares stated in its articles. Shareholders may be either natural persons, corporations or any other legal entity or as otherwise defined in the articles.

(b) *Authorized Shares.* The articles of incorporation must set forth the amount of authorized capital stock. A business corporation may have more stock authorized that is actually issued to shareholders. Typically, business corporations do not authorize an excessive number of shares of stock to avoid concern among investors that additional shares would dilute the investor's equity interest in the company. Notwithstanding that concern, business corporations typically have additional shares authorized over what is planned to be issued to plan for unexpected circumstances.

(c) *Share Capital*. In Pennsylvania, the business corporation also must set forth the "par value" of the shares of common stock authorized or a statement that the shares are "without par value." In some states, if the authorized stock of a business corporation has a par value, the price paid by an investor for such stock must be in excess of par value. As such, in cases where stock has a designated par value, the drafters of the articles of incorporation will identify nominal par value, such as $.01 per share of stock. In Pennsylvania, however, there is no requirement that the authorized shares have a par value, and as such, the shares of stock of a business corporation in Pennsylvania may be issued at a price determined by the board of directors.

(d) *Types of Share Classes.* The articles of incorporation may initially divide the corporation's shares into classes and/or series within those classes. These distinctions can also be made through an amendment to the articles. Any particular voting rights, preferences, limitations and special rights of the shares of a class or series can be established in the articles or through an amendment to the articles of incorporation made by the board of directors. Unless otherwise specified in the articles, every shareholder is entitled to one vote for every share standing in his name. However, the articles may restrict the number of votes that either a single shareholder or a group of shareholders, a beneficial owner or group of beneficial owners of shares may cast in the aggregate for the election of directors or any other matter being voted on. This applies to shares of any class or series and the restriction must be based on circumstances that are not "manifestly unreasonable." These circumstances might be based on: (1) the number of shares of any class or series held by either a single or group of shareholders or a single or group of beneficial owners; or (2) the length of time shares of any class or series have been held. Types of shares typically issued are summarized below:

i) *Common Shares.* This class is the most frequently used class of shares in a corporation.

ii) *Preferred Shares.* Typically issued to a major investor. This class of shares is usually given voting, dividend,

and/or a liquidation preference.

iii) *Nonvoting Shares.* The holders of non-voting stock do not have the right to vote on matters upon which shareholders have the right to vote, such as election of directors and fundamental changes (discussed below). Typically non-voting stock is issued to investors who do want to have control over the corporation's business affairs, such as a bank or another lender.

(e) *Share Ownership and Transferability.* Ownership of shares of stock in a business corporation is typically evidenced by an entry on the corporation's share transfer register and with a share certificate executed in the name of the shareholder. Subject to restrictions in the federal securities laws, shares in a Pennsylvania business corporation are freely transferable. Typically a shareholder wishing to transfer his or her sharers will notify the corporation so the corporation is able to note such transfer on its records and issue a new share certificate to the transferee.

(f) *Treasury Shares.* Corporations have the power to acquire their own shares. Such reacquired shares are typically referred to as treasury shares. If the articles provide that the shares acquired by the corporation are not to be reissued, the authorized shares of the class are reduced by the number of shares acquired. In all other instances the shares are considered to be issued, but not outstanding, unless it is provided in the bylaws that the board may, by a resolution restore the previously issued shares it owns to the status of authorized but unissued shares.

(g) *Shareholder Liability.* Shareholder liability is limited to the size of the shareholder's investment in the business corporation's shares; however, a court may "pierce the corporate veil" of the business corporation and attach further liability if the court finds that the shareholder corporate form caused fraud or similar injustice. The remedy of piercing is available only if the corporation's affairs and personnel were manipulated to such an extent that it became nothing more than a sham used to disguise the shareholder's use of its assets to its own benefit in fraud of its creditors.

(h) *Payment for Shares.* To be validly issued, shares in a Pennsylvania business corporation must be approved by the board of directors and the corporation must receive adequate consideration. The price of the shares is set by the board of directors and, unless otherwise restricted by the bylaws, such consideration may be in the form of cash, obligations, services performed, shares or other securities or obligations of the business corporation, or any other tangible or intangible property or benefit to the corporation.

(i) *Distributions to Shareholders.* Generally business corporations may make distributions out of the profits to the shareholders. Some states restrict distributions to shareholders based upon a stated par value of the authorized shares, however, in Pennsylvania, business corporations may make distributions to shareholders in excess of par value. Notwithstanding, under Pennsylvania law a business corporation may not make distributions to shareholders if, after doing so:

i) the corporation would be unable to pay its debts as they become due in the usual course of its business; or

ii) the total assets of the corporation would be less than the sum of its total liabilities plus (unless otherwise provided in the articles) the amount that would be needed, if the corporation were to be dissolved at the time as of

which the distribution is measured, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.

(3) Management

(a) *Board of Directors.* As discussed previously, all business corporations organized under the laws of Pennsylvania are managed by a board of directors. The board has broad discretionary power to manage the business affairs of the corporation.

i) *Election & Qualifications.* Directors are elected by the shareholders of the corporation. The board of directors must consist of one or more directors. The number of directors is usually set forth in the bylaws or in the articles. If no number is stated, the PABCL provides for three directors. Generally, directors of Pennsylvania business corporations must be natural persons who are at least 18 years old. The directors do not have to be shareholders of the corporation or residents of the Commonwealth of Pennsylvania. The bylaws may set forth additional qualifications for directors.

ii) *Term of Office of Directors*. Each director shall be selected for the term of office provided for in the bylaws, which is one year and until a successor has been selected and qualified or until the director's earlier death, resignation or removal, unless the board is classified. A director may resign at any time by submitting written notice to the corporation. A decrease in the number of directors does not shorten the term of any incumbent director.

iii) *Action by Written Consent.* Any action that is either required or permitted to be taken at a meeting of the board of directors may be taken without a meeting if all of the directors file their written consent with the secretary of the corporation. The directors' consent can be before or after the action is taken. This practice may be prohibited by the articles.

iv) *Removal of Directors.* One or more directors may be removed by either the shareholders, the remainder of the board of directors or a court of law.

a) *Removal by the shareholders*. Absent a bylaw adopted by the shareholders prohibiting removal, the shareholders can vote to remove a director, a class of directors, or the entire board of directors. New directors may be elected at the same meeting. Removal can be with or without cause. If the removal is for cause it must be based on a vote of the shareholders who are entitled to vote for cause, if such a classification has been effected by a bylaw adopted by the shareholders. These provisions do not apply to incumbent directors serving the balance of their term. If the shareholders vote cumulatively, a director will not be removed if sufficient votes are cast against his removal. The articles of incorporation cannot prohibit removal for cause.

b) *Removal by the board (Vacancy)*. Absent a bylaw adopted by the shareholders prohibiting removal, the board may fill the office of a vacant director if he or she has been judicially declared incompetent, has been convicted of an offense punishable by imprisonment for a term longer than one year or any other proper cause specified in the bylaws. A vacancy also may be declared if a selected director does not accept the position within 60 days or the time specified in the bylaws.

c) *Removal by a Court of Law*. Any shareholder or director may petition the court to remove a director from office in the case of fraud, dishonesty, gross abuse of discretion or any other proper cause.

v) *Reinstatement*. A director's reinstatement will not impinge acts of the board taken during the suspension or removal.

(b) *Officers*. As previously discussed, every business corporation in Pennsylvania also must have certain executive officers, such as a president, secretary and a treasurer. In most cases, however, the bylaws provide that the board has the power to select officers and such officers serve for one year. Officers and other agents of the business corporation may be removed by the board of directors with or without cause.

(c) Fiduciary Duties of Directors

i) *Standard of Care and Justifiable Reliance*. Directors of a business corporation have a fiduciary relationship with the corporation. As such, each director must perform his or her duties as a director in good faith, in a manner he or she reasonably believes to be in the best interest of the corporation and with such care, including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances. In performing such duties, each director is entitled to rely in good faith on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by any of the following:

a) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;

b) counsel, public accountants or other people on matters which the director reasonably believes to be within the professional or expert competence of such person;

c) a committee of the board upon which he or she does not serve, duly designated in accordance with law, as to matters within its designated authority, which committee the director reasonable believes to merit confidence.

ii) *Considerations in Determining the Best Interests of the Corporation*. In Pennsylvania, the board may consider the following factors in determining what is in best interests of the corporation:

a) The effects of any action upon any or all groups affected by such action, including shareholders, employees, suppliers, customers and creditors of the corporation, and upon communities in which offices or other establishments of the corporation are located.

b) The short-term and long-term interests of the corporation, including benefits that may accrue to the corporation from its long-term plans and the possibility that these interests may be best served by the continued independence of the corporation.

c) The resources, intent and conduct (past, present and potential) of any person seeking to acquire control of the corporation.

d) All other pertinent factors.

iii) *Challenges to Fiduciary Duties of Director: the Business Judgement Rule*. When a board action is challenged as a breach of fiduciary duty, the plaintiff challenging the board action bears the burden of proving the breach. Additionally, the directors are protected by the "business judgement rule," which presumes that in making business decisions the directors act on an informed basis, in good faith and in the genuine belief that the action taken was in the best interests of the corporation. When this rule