

# MARKET ENTRY: RAISING VC MONEY IN THE US

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*Ambitious Chinese start-ups in need of funding are advised to look to the US, where venture capital firms are increasingly willing to make investments.*

China is increasingly a centre of innovation, driven by entrepreneurs and their start-up companies. Those companies need funding. The largest pool of venture capital money, and still the world's centre for innovation, is 6,000 miles away in Silicon Valley. Should your company reach out to Silicon Valley? If so, what do you need to know?

## Pitching to Silicon Valley

Not all money is the same. A good start-up should have no problem finding someone to invest money. It is much more challenging to find money which can add value beyond financing—validation, expertise, mentoring and introductions to further funding and to business partners.

There are deep pools of money around the world. However, nowhere outside of Silicon Valley are venture capitalists themselves more deeply immersed in the world of high technology and better connected to other financiers and to the users and accelerators of technology.

Some start-ups in China never need to look beyond China. For them, Silicon Valley may not make sense. Nevertheless, for start-ups that are focused on the global marketplace, Silicon Valley venture capital money should be a target for a tech company's investor base.

## The Basics

Silicon Valley venture capital firms (VCs) are increasingly willing to invest directly into a PRC start-up company. However, the pool of capital is much larger if the start-up is organised as an offshore company with an operating subsidiary in the PRC. Hong Kong, the British Virgin Islands (BVI) and the Cayman Islands are familiar jurisdictions for offshore holding companies. It is important to pay attention to PRC laws and regulations when setting up your offshore holding company.

The most important facets from the VCs' point of view regarding the international structure of a start-up, all of which are "better" with an offshore holding company, are:

- Corporate law and comfort with the home country legal system
- Comfort with the home country legal system's ability to protect IP
- Accessibility to exits, especially public equity capital markets
- International tax considerations, particularly with regard to licensing of IP and transfer taxes

At least for now, it is a fact of life that Silicon Valley VCs are especially worried about the protection of

intellectual property in China. Entrepreneurs in the PRC need to be prepared to answer challenging questions on this topic. It will help if the company's IP is held by an offshore affiliate of the start-up; this is easy to do if the entrepreneurs plan for it at the beginning. Naturally, start-ups should make sure that all IP developed by founders and early-period employees is properly assigned to their companies.

### Immigration

If a non-US entrepreneur feels a need to spend extended periods of time in the US, the question of a non-immigrant visa must be faced. The "L-1" visa program is frequently used in these cases.

PRC entrepreneurs often look to the L-1 visa program to allow them to spend long periods of time in the US building their businesses and working with VCs. The L-1 program is available for management and technical personnel who are sent to a US affiliate of a foreign company. Using this program requires the establishment of a US subsidiary. The entrepreneur can then be "assigned" to the US entity for a total of seven years in the case of management, and five years in the case of technical personnel.

### Corporate Basics

The basic corporate form in the United States is the "corporation", designated by the letters "Inc" or "Co" after the company name. Corporations have shareholders, whose liability is limited to their investment in the entities. Corporations are taxed on their net income, at both the federal and state levels.

In these basic above aspects, the process is similar to the PRC. Nonetheless, beyond these items, forming a US corporation is different and easier than in China. In most American states, a new corporation can be formed in a matter of days. There is no minimum capitalisation set by law, but the corporation should be capitalised to an extent sufficient to meet its obligations. There can be one or more shareholders. There is no residency or citizenship requirement for shareholders, or for directors or officers. Unlike China, there is no concept of a "legal representative" in US corporations; the most important officer is the president or the CEO. The officers answer to the Board; the Board answers to the shareholders.

The one negative aspect of US corporations, as compared to Chinese companies, is that after-profit dividends are taxed as income to the shareholder when received. This is the infamous "double taxation" problem in the US.

### Venture Capital Funding

A venture capital funding starts with a pitch and then, if successful, moves to a term sheet. The term sheet is usually not binding, but once it is accepted and signed, it is unusual for either party to "shop around" without first breaking off discussions.

After the term sheet is agreed, the VC will engage in careful due diligence of the international company. The more the company's affairs are organised and in good order, the better this process will go.

Venture capital funds will typically look for the following in any investment:

- Ensuring the founders will stay with the company by imposing a vesting schedule on the shares held by the founders
- A liquidation preference of 1X to 2X—this ensures that upon a "liquidity event" (the sale of the company or a public offering), the investors have the right to receive their money or a multiple of their money before anyone else
- Anti-dilution rights, or "price protection"
- Board representation and special voting rights
- Registration rights
- Rights of first refusal and tag-along rights

It is not common in the US for investors to have a "put right" clause—a right to require the company to buy back their shares.

Venture capital investments are invariably into the "preferred stock" of the respective companies. This is completely different from the case in China, where there is only one class or type of equity in a private company. In the US, a company may establish any number of different classes or series of stock, each with different rights and privileges -- Series A, Series B, Series C, etc. The Series Preferred stock is invariably convertible into common stock at the election of the investor or upon certain events, such as an IPO.

## US Securities Laws

A final important difference between the US and China is that any issuance of stock or other securities to persons in the US requires either registration with the US Securities and Exchange Commission, or an exemption from registration. The most important exemptions for international start-ups are:

- Regulation D, which permits the offer and sale of securities to “accredited investors” (higher net-worth individuals and entities)
- Regulation S, which permits the offer and sale to investors outside the US

There are also state securities laws which must be complied with. It is important to document your compliance with these securities laws, because later-round investors will insist on a clear record of compliance as a condition for future investments.

