

**NACUA 2013 ANNUAL CONFERENCE
JUNE 19-22, 2013**

**KEY OPERATIONAL RISKS IN INTERNATIONAL VENTURES: WHAT UNIVERSITY LAWYERS
NEED TO TELL THEIR CFOs**

Part I: Operating Foreign On-Ground Programs through Separate Corporate Structures

**William Ferreira
Hogan Lovells US LLP
Washington, DC**

Higher education institutions, increasingly innovative, operate on-the-ground internationally in advancement of their research and teaching missions. International service and education ventures are ever more numerous, complex, and challenging. A fundamental step in any foreign program—although by no means the only step—is to appraise the sometimes stupefying “rules of the road” relative to host country activity. (This is not to imply that rules or roads properly exist in some of the far-flung locales of university endeavors.) Informed by these and many other considerations, colleges and universities operate abroad through a remarkable variety and number of corporate and organizational structures, some which entail formation of a separate legal entity in the United States or overseas. The CFO’s question--Is there value to operation through a separate affiliated entity?--merits reflection by universities and lawyers. Counsel increasingly is called upon to illuminate this query for faculty and administrators who pursue foreign programs.

To that end, this paper presents, through a series of questions and answers, various concepts that figure in the corporate structure of foreign on-ground initiatives. This paper is not intended to be a definitive discussion of the topics addressed; indeed, many of the individual topics themselves merit a paper. Rather, the aim is to remind and inform the reader, and offer concise talking points, on threshold issues and risks that could influence the corporate structure of a physical university outpost abroad.

A. How has the risk profile changed in recent years?

In years past, many university projects overseas progressed without official “legal status” in the host country—i.e., without registrations, licenses, or other permissions for the institution to conduct programs there. For example, it was not uncommon for colleges to offer on-ground educational programs, employ foreign nationals, post U.S. citizens to foreign positions, conduct scientific research, and pursue various service projects, without official consent from the host country to conduct these programs. Resource-constrained foreign regulators scarcely aspired to monitor a foreign institution’s nonprofit activities.

Today, counsel’s enquiry into host country legal status requirements and related “permanent establishment” issues is among the threshold diligence points in any university overseas endeavor. Several institutions already have learned from experience that foreign governments—even third world developing countries—are more proficient; regulators there are surprisingly sophisticated and no longer overlook foreign universities that “set up shop” without authorized legal presence. Host country corporate registration obligations and related tax and employment conditions are enforced

through administrative, civil, and criminal penalties that these governments enforce with confidence. Gradually CFOs and administrators have become sensitive to this dynamic, and to the legal, practical, business, reputational, and other implications of the institution's omission to obtain appropriate legal presence in a host country.

B. How do we demonstrate to CFOs and administrators that these risks are not immaterial?

Consider two actual scenarios, modified slightly:

1. Recently an institution learned that a tenured professor hired two dozen foreign nationals to work on a service project in Country X. Documentation confirmed that the workers were assumed as "independent contractors" to avoid entanglement with host country employment law, payroll, and income tax withholding. In substance, however, the workers were employees. (Country X, like most countries, elevated substance over form and disregarded the independent contractor designation.) Upon knowledge of these workers, the general counsel engaged Country X counsel and learned that, under Country X law, to employ workers without a corporate affiliate in-country (which this university did not have) was a civil and criminal offense. What ensued was a hectic scramble to obtain proper legal status, to understand why it was omitted, and to articulate an uncomfortable corrective action plan to the university's fiduciaries.
2. Recently an institution encountered a dispute in a foreign country with an employee based there. The dispute focused on terms and conditions of employment. Under normal circumstances, it would have been resolved quickly. However, the disgruntled employee gained dangerous leverage when she threatened to divulge to host country authorities the institution's omission to register a formal legal status or obtain official permission to operate there despite long-running programs.

Such scenarios make for indigestion among CFOs and counsel.

C. What kinds of activities merit advance appraisal of host country legal status requirements?

Various activities trigger requirements for registration, licenses, permissions, and other forms of official legal status in the host country. The following activities, among others, are illustrative triggers:

- Providing on-ground educational or assistance services in the host country, regardless of whether a host country "partner" is involved in the program.
- Opening an institutional bank account in the host country.
- Employing local nationals or third country nationals in the host country, or posting U.S. employees to positions in the country.
- Enrolling subjects into a clinical trial, or conducting scientific or medical research programs in the host country.
- Executing a lease for host country office space, or owning land and other real property there.

- Dispensing medications or other controlled substances.
- Purchasing equipment or motor vehicles in the host country, titling these assets in the name of the institution, or buying insurance for these assets in the host country.

Though far afield from what may be claimed as “higher education law” in the host country, it would be hazardous to assume that universities enjoy “grace periods” or “benefit of the doubt” for noncompliance with legal status and registration requirements triggered by the foregoing activities.

D. How is host country legal status obtained?

A country-specific inquiry is warranted. To apply for host country registration and licenses may involve, for example, submission of forms, proposals, resolutions, curriculum, and other materials sufficient to put regulators on notice of the university’s intentions and activities there. The application for legal status is not always a formal process or a process that entails formation of a separate legal entity. Various countries permit operation by foreign universities via a collaboration or affiliation agreement with a local entity, or a memorandum of understanding with the appropriate government ministry. Some countries permit foreign research institutions to “piggyback” on a research sponsor’s legal presence (e.g., operation pursuant to USAID’s bilateral agreements with the host country). In still other countries, the institution could be subject to civil or criminal penalties for operation of any program prior to registration of a specific in-country business entity and licensure of that entity.

Certain countries are notoriously slow to approve a registration, and it is not uncommon for several months or even a year to pass before the registration process is completed. Because registration may entail several levels of protracted bureaucratic scrutiny by foreign authorities, institutions often explore some form of “interim” authorization to commence activity pending registration.

E. What motivates the formation of a separate but affiliated special purpose entity for operation abroad?

Increasingly, public and private institutions structure foreign on-ground activity through the incorporation of a wholly-controlled affiliated legal entity -- i.e., a special purpose vehicle (SPV). Many considerations inform such a decision, and creation of a SPV is not workable in every situation.¹ Experience with and observation of these SPVs suggests that (a) various factors motivate their establishment, including legal, business, organizational, administrative, social, cultural, and diplomatic considerations, and (b) the weight afforded to any particular consideration may vary depending on the nature of the international program (e.g., research versus degree programs) and the risk entailed. A few examples of risk considerations and other factors follow.

i. Legal considerations

In various jurisdictions the only viable approach to proper legal status and local employment is to incorporate a new business vehicle there. This vehicle could be, for instance, a branch office; a

¹ Special state-specific considerations apply to a public university’s formation of a separate corporate entity in the U.S. or abroad.

representative office; a nongovernmental organization; a company limited by guarantee; a proprietary company; a joint venture; or some other form of university “affiliate” or “subsidiary”.

As an example, various U.S. institutions that operate federally sponsored projects in Nigeria have formed a “company limited by guarantee” (CLG) under the law of Nigeria. The CLG essentially is a nonprofit company in which the liability of its members for debts and obligations of the company is limited to an amount specified in its formative documents. Formation of a CLG in Nigeria often is viewed as the only available approach to proper legal status because the strings attached to other forms of legal status there are extensive and agonizingly ambiguous.

In other countries, tax and commercial issues may motivate the creation of a separate entity. Institutions that seek to generate revenue in India may contemplate formation of a SPV in a jurisdiction with which India has a favorable tax treaty (e.g., Mauritius or Singapore, also known as a “gateway countries”). To have an entity in these countries may facilitate tax-efficient movement of money into and out of India. Institutions that operate on-ground in China often find that the only feasible mode of lawful operation in China is to establish in the U.S. a separate legal entity to serve as the holding company for a Chinese “wholly foreign owned enterprise” or WFOE. Indeed when a new entity or subsidiary must be established in a foreign country, many universities will first establish a U.S. SPV to serve as the parent, or the member, of the new foreign entity.

A SPV also may act as a corporate veil, potentially to insulate from exposure to uninsured legal liability abroad, which may be a concern in certain types of projects, such as clinical trials. Analysis in various jurisdictions suggests that there is a meaningful chance that operation through a SPV that is affiliated with the university would protect the university from liability, because the conditions necessary to the preservation of the corporate veil largely are within the university’s control. There can be no advance assurance, however, that this corporate boundary will survive attack in the event of catastrophic liability for which the SPV is unable to answer. Moreover, there may be practical and reputational constraints on the university’s ability to establish and maintain sufficient separation for liability limitation purposes.

ii. Practical and organizational considerations

To operate directly in a host country—without a SPV as the operating vehicle—can be uncomfortable and unworkable. For example, direct operation by the home institution in certain countries may involve disclosure of highly personal information about the institution’s trustees and executive officers, inflict foreign tax and audit requirements on the home campus or its officers, and prompt submission of reports to the host country on home country activity. To avoid these requirements, several institutions have established a U.S. SPV which in turn is used to obtain legal status—such as corporate registration and licenses—abroad.

A U.S. SPV also could help to centralize operational control, guidance, and tools for overseas endeavors. Some SPVs serve as the university’s organizational lead for global support services, and to provide the U.S.-based logistical and administrative infrastructure associated with these projects, such as international travel assistance, visa and passport services, maintenance of travel registries, umbrella contracts for global payroll and international health/safety services, and certain back-office functions to facilitate and advance international programs.

If and when appropriate, SPVs also have been used to streamline certain home institution procedures that may be too difficult or too inefficient to apply abroad (e.g., procurement policies).

iii. Social, cultural, and diplomatic considerations

A SPV incorporated and registered in the host country may speedily obtain certain in-country privileges and exemptions, such as tax relief, import-export privileges, and immigration and visa privileges. Such in-country SPVs also may attract funds from host government or regional sources. The entity could help to signal the foreign institution's long-term commitment to the host country, and help to alleviate suspicion that American and western organizations have short-range or exploitative intentions.

On the other hand, foreign "partner" organizations, vendors, and employees may pause at the idea of an agreement with, or working with, the SPV affiliate of a U.S. university as opposed to the university itself. Such expectations of foreign parties should not be taken lightly; various institutions have struggled to operate through their SPVs and still retain ability to capitalize on the name and reputation of the home institution.

F. What questions merit CFO input in formation of a SPV?

As noted above, a SPV may serve many functions. It could serve as the controlling member of an institution's foreign legal entity; as an entry vehicle into a particular country (e.g., to spare the home campus from the watchful eye of foreign regulators); as an administrative or organizational clearinghouse for international operation resources; and as a corporate shield, among other functions.

Some universities have formed single member LLCs in their home states to serve as the SPV. Others have formed nonprofit corporations in states like Delaware and New York. Federal and state tax law must be considered. The following interrogatories often attract risk management dissection by the CFO in consultation with counsel:

- What will be the university's formal relationship with the SPV?
- Who will comprise the members, directors, and staff of the SPV?
- Will the SPV have employees and what will be their status?
- Will the SPV and the university consolidate their financials?
- What authority does the SPV have to act for the university?
- What transactional records will document the flow of funds or property between the SPV and the university?
- What policies and procedures of the university flow to the SPV?
- How to recover the SPV's costs?
- Does the SPV have an independent identity relative to research and other funding sponsors?
- Does the SPV have fundraising authority?

These and similar questions are addressed extensively in related NACUA materials on university affiliates.²

G. Can we operate federally sponsored projects overseas through our SPV?

Operation through a SPV entity raises complex issues of federal grants and contracts compliance. Take for the example the question -- How does the grantee institution define and characterize its sponsored projects relationship with the affiliate? The characterization has significant implications for cost recovery, including recovery of direct and indirect costs under the federal cost accounting principles.

If the university chose to treat its SPV as a “subawardee,” it may force the SPV to have its own federal cost accounting system and its own indirect cost rate. (This indirect cost rate may be severely limited by federal policies that deny or limit indirect cost recovery to foreign awardees and foreign subawardees.) Importantly, the university’s own indirect cost recovery would be limited: under OMB Circular A-21, the university would be permitted to apply its indirect cost rate *only* to the first \$25,000 of the subaward agreement with the SPV; this rule by itself prompts research universities to avoid bestowing on its SPV the “subawardee” designation.

There does not appear to be written federal guidance for a situation in which a grantee operates through a SPV. USAID, HHS, and NIH often award grants and cooperative agreements that involve substantial work overseas, but no apparent guidelines address the operation or involvement of a grantee’s wholly controlled entity (apart from largely inapposite guidance on affiliated state research foundations). The NIH has suggested that arrangements of this nature are “often complex and each situation is unique” and may require NIH approval. See Sec. 2.3.6., *NIH Grants Policy Statement* (Oct. 1, 2011).

H. What alternate in-country operation structures may be available short of registration and/or SPV formation?

Where the avoidance of in-country registration and SPVs is desired, other possible models may be as follows:

1. Where lawful, some institutions contract with a host country “professional employment organization” (PEO) which operates like a temporary staffing agency. The PEO (a) engages local staff as employees of the PEO; (b) serves as “employer of record” for each local employee; (c) handles all local withholdings and payroll; (d) assumes liability for employment-related claims under local law; and (e) posts the employees to the university’s project. Under this model, the university would lead the project but would not directly employ foreign nationals, and the PEO would serve as a “vendor” to the university. A contract with the PEO would be drafted with careful attention to various issues including intellectual property, termination, employment standards, and liability.
2. Some institutions may engage the services of a local NGO to serve in the capacity of a PEO,

² See http://www.nacua.org/lrs/NACUA_Resources_Page/FoundationsAffiliatedEntities.asp

even though PEO-type services are not among the NGO's typical line of business. Under this model, again the foreign university would lead the project but would not directly employ foreign nationals, and the NGO would serve as a "vendor" to the university.

3. In federally sponsored projects, some institutions engage a local organization (such as an NGO, university, hospital) as a new federal "subawardee" to perform a large portion of the institution's scope of work. The local organization would be a full federal subawardee, contribute measurable effort to the project, and would become subject to all the same federal funding instrument terms and conditions as the prime institution (including cost accounting requirements). The local organization would not be a mere "vendor" and hence this model may require prior approval from the federal sponsor.
4. Some institutions will continue to engage in-country staff as employees or independent contractors—and essentially operate as if it has a permanent establishment in the host country—on the basis of a negotiated memorandum of understanding or other agreement with the host country government that permits such operation.

There are pros and cons to each approach. Any proposed PEO or "best friend organization" should undergo due diligence. Too, there must be sensitivity to the effect that these structures have on the project and its employees (i.e., some employees have made claims on the basis that restructuring entails adverse results for them).

I. Can you offer a hypothetical table of host country issues and risk considerations entailed in registration and corporate structure?

The following hypothetical scenario illustrates knotty risk management considerations that can be fraught with tension.

Hypothetical Country X Considerations

Upon review of the scope and substance of the university's proposed on-ground project, Country X counsel advises that the institution must register a corporate presence in Country X. Such registration must occur within 21 days of "establishing a place of business" in Country X. With respect to foreign nonprofit organizations, registration in Country X generally takes one of two forms:

1. Registration of a nonprofit "branch office" of the foreign organization, or
2. Registration of a new nonprofit subsidiary, incorporated in Country X.

The table below identifies hypothetical Country X considerations within seven broad categories. The categories are representative, not exhaustive. The comments and issues identified here are unique to Country X; local law guidance in each country is crucial.

Table

Category	Branch Office in Country X	Subsidiary in Country X	Country X Risk Considerations/Comments
<p>1. Country X Corporate Registration Process</p>	<p>Documents to submit:</p> <ul style="list-style-type: none"> ▪ University's founding documents. ▪ Branch office address. ▪ Name of Country X auditor. ▪ Notice of financial year. ▪ List of university's trustees and their addresses. ▪ Local manager. ▪ Local agent for service of process. <p>Founding documents: Certified copies of the university's U.S. formation papers must be submitted.</p> <p>Directors: The "particulars" of the university's trustees must be disclosed. "Particulars" include full name, nationality, occupation, address (residential and business), and identification number.</p> <p>De-registration: Termination or "winding up" activity is achieved quickly.</p> <p>Time period: Registration normally occurs 2-4 weeks after papers are filed.</p>	<p>Documents to submit:</p> <ul style="list-style-type: none"> ▪ Subsidiary's founding documents. ▪ Subsidiary's foreign office address. ▪ Name of Country X auditor. ▪ Subsidiary's financial year. ▪ List of subsidiary's members, local officers, and directors. <p>Founding documents: Draft new formation documents for the Country X subsidiary (Articles of Incorporation and Bylaws) that comply with the Country X Companies Act; the documents must address basic organizational issues that pertain to the subsidiary's directors, officers, members (at least 7 members are required), company meetings, bookkeeping, assets, etc.</p> <p>Directors: Opportunity to name new directors and officers for the subsidiary and avoid disclosure of trustee information.</p> <p>De-registration: The "wind up" process is significantly more</p>	<p>The fundamental legal distinction between the two forms of registration is that the branch office is considered to be one and the same as the foreign organization -- the branch office registration merely qualifies the foreign organization to operate in Country X in accordance with Country X law. A subsidiary, however, is a separate, distinct, and new legal entity established and organized under Country X law.</p> <p>Delays and inquiries by Country X regulators may extend the registration process by 3-6 months upon submission of all documents; must explore interim authorization or license to operate if in-country activity must proceed swiftly.</p> <p>Consider engagement of an in-country "professional employment organization" to serve as the local "employer of record" for foreign nationals while the appropriate corporate structure is established.</p> <p>What purpose is served in branch registration by submission of trustee "particulars"? Will there be direct communication from Country X to such individuals?</p>

Category	Branch Office in Country X	Subsidiary in Country X	Country X Risk Considerations/Comments
		<p>onerous for subsidiaries due to local regulatory oversight.</p> <p>Time period: Registration normally occurs 1-2 weeks after papers are filed.</p>	<p>Is it permissible to repatriate funds and assets upon wind-up?</p> <p>Is there a minimum in-country capitalization requirement for branches and subsidiaries?</p> <p>Corporate registration is separate from the Ministry of Education licensure process for in-country educational activity.</p>
2. Management & Control	<p>A branch office serves as an extension of the foreign organization; the foreign entity is expected to exercise management and control over its Country X branch (i.e., typically there is no separate set of directors and officers for the branch office, but there may be local managers or administrators). The foreign entity's system of institutional policies and procedures often pass through to the branch office.</p>	<p>A subsidiary has a new and separate legal personality in Country X and is not necessarily under the management and control of a parent organization unless such control is established through the subsidiary's formation documents and through appointment of members, officers, and directors. A Country X subsidiary has the opportunity to (and sometimes must) develop new policies or procedures specifically tailored to local operations and applicable local law.</p>	<p>Regardless of the form of registration, the application of robust supervision is critical in foreign on-ground programs; oversight and control often is thought to be easier (but not substantially so, and not in every program) via operation through a branch registration.</p> <p>If a subsidiary is chosen, who to appoint as the trusted members, local officers, and directors? To whom are they accountable? Will they be covered by the university's D&O insurance?</p> <p>To what extent will exercise of control over a subsidiary debilitate the corporate shield or engender a principal-agent problem?</p>
3. Ongoing Requirements	<p>The foreign organization is required to annually report to the Country X government detailed information about itself in order to maintain a branch office.</p> <p>Financial Statements: Submit certified financial</p>	<p>A subsidiary reports information only about the subsidiary itself; the parent is ignored.</p> <p>Financial Statements: Submit the subsidiary's audited financial statement.</p>	<p>Failure to track and fulfill ongoing local obligations (such as local reporting requirements) is subject to financial penalty, corporate probation, and involuntary de-registration.</p> <p>Is the home campus exposed to audit and unwanted</p>

Category	Branch Office in Country X	Subsidiary in Country X	Country X Risk Considerations/Comments
	<p>statements for the foreign organization; such statements are made available in Country X for public review.</p> <p>Auditors: Name an auditor; the auditor must annually submit a report in regard to the financial position of the branch's Country X activities.</p> <p>Directors: Report to Country X regulators changes in trustees or other management of the foreign organization; the "particulars" of each new trustee or director must be made available to the public.</p> <p>Other:</p> <ul style="list-style-type: none"> ▪ Conspicuously exhibit the organization's name and country of incorporation on all letterheads, notices, and official publications, and on a signboard outside the Country X place of business. ▪ All letterheads and/or "trade circulars" in Country X must list the names of the foreign organization's trustees/directors (and their nationality), and the names of the branch's local managers (if any). 	<p>Auditors: Name a local Country X auditor that prepares and submits financial statements.</p> <p>Directors: Report changes in directors or other management of the subsidiary; the "particulars" of each director are made available to the public; the directors serve as the day-to-day officers of the organization.</p> <p>Other:</p> <ul style="list-style-type: none"> ▪ The Country X Companies Act regulates both the internal administration and the local obligations of Country X subsidiaries. For example, the Companies Act defines rights and duties of members and directors; company meetings and voting rights; various financial practices; etc. 	<p>scrutiny in the host country by virtue of a branch there?</p> <p>Auditors must be "licensed and qualified" in Country X in order to serve a subsidiary there.</p> <p>Possibly awkward and uncomfortable to report and display trustee information in the host country.</p>
4. Tax & Regulatory Matters	Income Tax: Exemption is available upon successful application.	Income Tax: (Same exemption is available, but it depends on the type of income that the	Tax counsel must advise on U.S. tax and information reporting relative to foreign bank accounts and cross

Category	Branch Office in Country X	Subsidiary in Country X	Country X Risk Considerations/Comments
	<p>VAT Tax: Exemption is not available.</p> <p>Personal Income Tax:</p> <ul style="list-style-type: none"> ▪ Country X nationals are subject to Country X income tax for services rendered in Country X. ▪ U.S.-Country X Tax Treaty applies to US citizens. <p>Other:</p> <ul style="list-style-type: none"> ▪ Upon termination of activities in Country X, the assets of a branch office must be distributed to a local Country X tax exempt organization. 	<p>subsidiary derives from Country X sources.)</p> <p>VAT Tax: Exemption is available.</p> <p>Personal Income Tax:</p> <ul style="list-style-type: none"> ▪ (Same as a branch office.) <p>Other:</p> <ul style="list-style-type: none"> ▪ Country X subsidiaries may be subject to licensure and subject-matter regulation that depends on the nature of the subsidiary's activity; furthermore, the subsidiary is treated like any other Country X company (e.g., subject to the Country X labor code to the extent it employs any individuals). 	<p>border funds transfer. Note that IRS Form 990 (for federal tax exempt organizations) requires certain disclosures relative to overseas activity (Schedule F) and disclosure of "related organizations"-- e.g., subsidiaries (Schedule R).</p> <p>An entity that holds a bank account in Country X is subject to stringent currency exchange control requirements to the extent foreign currency is deposited into a Country X account (e.g., conversion of foreign currency to Country X currency must occur within a specified time period).</p> <p>Is the distribution of assets upon wind-up to other in-country tax exempt organizations consistent with obligations to project sponsors?</p>
5. Legal Liability	<p>There is no legal distinction between a branch office and the branch's home country organization; liability in Country X flows to the home country.</p>	<p>The Country X subsidiary is a distinct legal entity; liability generally does not flow to the subsidiary's parent organization, unless the "corporate veil is pierced".</p>	<p>The extent of exposure to local liability (e.g., labor and employment, contract, tax, malpractice, or other liability) will influence the branch/subsidiary choice.</p> <p>Would the home campus truly abandon its foreign subsidiary that cannot satisfy a liability?</p>
6. Local Public Perception	<p>Country X regulators are skeptical of branch offices but local employees and local "partners" are eager to affiliate with the home campus and to deem themselves as working in collaboration with the</p>	<p>Country X regulators welcome subsidiaries but local employees and local "partners" are skeptical of the corporate insulation offered though a subsidiary and of the</p>	<p>What are the expectations of our foreign "partner" organizations, vendors, and employees?</p> <p>Will we use our home campus name abroad? Or a variation of it?</p>

Category	Branch Office in Country X	Subsidiary in Country X	Country X Risk Considerations/Comments
	home institution (which a branch office permits).	formal separation from the home campus that subsidiaries may promote.	
7. Federal Funding Considerations	The branch office is an extension of the home university and typically may operate as one-and-the-same as the university for purposes of the university's sponsored projects.	A subsidiary is a separate legal entity and distinct from the university; therefore, consideration must be given to the precise relationship (contractual or otherwise) between the university and the subsidiary in order for the subsidiary to operate the university's federally-funded projects without sacrifice of cost recovery.	<p>Federal sponsors are increasingly inquisitive about separate but wholly-controlled subsidiary entities that fall with the university's organizational structure and assist a university to carry out its federal projects abroad. Sponsors have asked pointed questions about the affiliated entity's involvement and its associated costs. Consequently, thoughtful assessment must inform the decision to operate federal projects through a subsidiary.</p> <p>Who will oversee compliance with both U.S. and foreign research law and standards?</p>