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A Strategy for Chinese Investment in America

by J. F. KARCH

There are a myriad of fundamental considerations for Chinese businesses, entrepreneurs, or businesspersons seeking to establish business in the United States. This article provides an outline of some basic choices to be made. The recommended strategy is to mirror the proven low-profile strategy of Chinese investors such as CIC (China Investment Corp.) who pick the existing ripe, low hanging fruit and stay under the radar by seeking smaller parts of businesses in need of financing in non-threatening industries with high potential for future growth.

This strategy creates a window of opportunity for Chinese investors as never before seen in American history and avoids traditional protectionist and security arguments against foreign investment.

Breaking into American Markets

Success stories abound. A few examples demonstrate a powerful, mutually profitable trend at work. Solar Power Inc. of Roseville, California received an infusion of $33 million from LDK Solar, a Chinese solar cell manufacturer, to install solar energy capacity in the Los Angeles Staples Center and 20th Century Fox studios. MVP RV of Riverside, California received an investment totaling $300 million over time, plus order contracts of approximately one billion dollars per year over three years, for recreational vehicles from Winston Battery of Shenzhen, China. Synthesis Energy Systems of Houston, Texas received an $84 million investment from Zhongjixuan Investment Management of Beijing to assist in developing new technology involving Synthesis' proprietary coal-burning technology for evolving Chinese companies. Pansun's, a California corporation distributing sportswear and fashion apparel, joined with Shanghai Tiqiao Textile and Yarn Dyeing to help fund clothing designers, thereby ensuring availability of long-term, affordable merchandise to leading retailers such as Saks Fifth Avenue, Bloomingdale's, Dillard's, and Nordstrom.[1]

The most effective ways to enter the business community in the United States include buying into an existing business, merging with an existing business, starting a joint venture with an existing business, or starting a new business from scratch. Buying or venturing with an existing business is generally termed "Foreign Direct Investment" (FDI), while starting up a new business is often referred to as "Greenfield Investment." Additionally, indirect investment by "non-resident aliens" is possible through off-shore entities created for specific investment opportunities.

Each investment type has unique characteristics and consequences over time. When properly structured in advance, there can be significant federal, state, and local tax benefits to non-resident investors. Moreover, currently there is unprecedented general receptivity, since much of today's governmental policy in the United States favors foreign investment, particularly under existing economic conditions. The current perception is that foreign investment fosters job creation, which enhances the overall taxable base of both businesses and individual workers, helping federal, state, and local governments balance their deficit budgets.

The initial considerations for any investor are: (1) identifying the target business or industry selected, (2) choice of entity and choice of laws, (3) the amount of capital to be invested and the form of funding, (4) the ownership structure in terms of investor participation and management positions held, if any, and (5) statutory regulation and tax regimes. As examined below, many of these considerations are interrelated.

Target Business or Industry

Target businesses or industries are almost unlimited in the United States, due to its diverse economy. However, it would be prudent for foreign investors to act with forethought to avoid government challenges, primarily due to a perceived threat to United States' national security. Such challenges are distinct possibilities in certain industries, such as the electronics-manufacturing sector, government contracted aerospace or weaponry, particularly sensitive software platform development programs, valuable natural resources, and contracted security enforcement service companies. Nevertheless, outside investment brings added value to companies and products by developing and implementing perceptive product changes, creative marketing, and other innovative strategies, all of which enhance the return on investment.

However, some investment plans may be precluded for reasons other than national security. Some potential investments are taboo because they are simply sacrosanct. For example, recall how Japanese investors sought to purchase Pebble Beach, home to one of the world's pristine golf courses, in the late 1980s with plans to develop the property's lodging facilities for worldwide resale as condominiums. After initial success, the plan collapsed for several reasons, one of which was the California Coastal Commission's refusal to permit property use changes (undoubtedly, protectionism) of that international golfing bastion's traditional status on California's Monterey Peninsula.

Choice of Entity and Choice of Laws

Any business may be owned by an individual as a "sole proprietorship," but the most formally recognized types of businesses are corporations, limited liability companies (LLC), or partnerships. These are governed by corporate or business laws of the particular state in which the entity is formed. Each entity has certain rights, obligations, and liabilities based on those laws. Accordingly, it is important to make an informed decision when choosing in which state to locate one's business. And, if an entity seeks to do business in states other than its state of formation, it is required to register with that state, and to pay state taxes.

> **This is a sound investment strategy of picking the "ripe, low-hanging fruit," while avoiding any "protectionism."**

A joint venture (JV) is another popular form of business entity, generally governed by a contract between or among the participating parties (individuals or entities), which sets forth the financial and/or property contributions, rights, obligations, and liabilities of the participants. However, it is important to remember that where a JV participant is an entity, the entity's state of formation's laws will govern aspects of that participant's conduct.

Invested Capital and Form of Funding

When money is invested, it can be exchanged for some form of ownership in the business, generally represented by an instrument or "security" such as equity, debt, or a hybrid. Equity is stock in a corporation, membership interest (managing or non-managing) in an LLC, or partnership interest (general or limited) in a partnership. Securities are strictly regulated at both the state and federal levels in the United States, but there are sweeping exceptions, which may be utilized to minimize the impact and implications of the applicable securities laws. Next, debt takes a form of an obligation to repay money, most commonly as a loan or bond. Finally, hybrid securities involve combinations of equity and debt, such as stock with a "warrant" for subsequent options to purchase additional shares, or a "debenture," which is a loan with a right to convert to equity under particular circumstances.

Each form of ownership has unique characteristics and, as a matter of law, a particular priority in recouping any residual investment in the event of failure of the business. Balanced with the rights associated with each such form of ownership, the amount of investment at risk is, of course, of paramount importance.

Recently publicized in the *New York Times*, CIC, controlling some $300 billion of funds (a fraction of Beijing's huge foreign reserves on the order of $3 trillion), wisely targets relatively small transactions, such as Visa Inc. ($350 million), Apple Inc. ($6.5 million), Coca-Cola Co. ($9 million), and Goodyear Tire & Rubber Co. ($1.5 million). But CIC sometimes invests very large sums, such as the $1.7 billion stake in Morgan Stanley, helping to finance its repayment of U.S. Government bailout funds received in June 2009.[2] Note how this investment was helping U.S. policymakers and contributing to United States' economic security. In general, CIC follows the strategy suggested here: a low-profile approach of investing in minority business interests in non-threatening industries. This is a sound investment strategy of picking the "ripe, low-hanging fruit," while avoiding any protectionism, which might arguably be raised disguised as national security.

In contrast to CIC, China's largest telecommunications network company, Huawei, has been excluded or impeded in a number of its investments, particularly by the Inter-agency (Treasury, Defense, State, Commerce, Homeland Security, and some twelve other U.S. government agencies) U.S. Committee on Foreign Investment.

The difference is, unlike CIC's relatively small, under-the-radar investments, Huawei sought to contract with or invest in national-security-sensitive telecommunications deals with Sprint-Nextel and 3Leaf. Indeed, as the U.S. telecommunications industry is a clear component of maintaining national security, it is certainly understandable that a Chinese company seeking to participate in that industry would undergo considerable scrutiny not only as a rival economic power, but also as a political adversary prospectively obtaining foothold controls in the U.S. military-industrial complex structure.[3]

Ownership Structure

The form of investment will usually dictate where the investor is positioned within the structure of the business, and the extent of influence or control, which might be exerted by the investor on the operations of the entity. As a general rule, equity holders who invest will appoint directors or managing members or partners to oversee the business. These, in turn, will select officers to conduct day-to-day operations. Unless otherwise formally modified, the business is controlled by a majority vote by percentage of interests held. So, the threshold issue is how much needs to be invested to gain the degree of control desired by the investor?

The appropriate amount of investment will be determined by the goals of the investors and the overall value of the business. For example, in investing in a corporation with a value of $10 million, would owning a "minority" interest of less than 50% (less than $5 million) of the voting common stock be acceptable? Or would controlling interests of greater than 50% (more than $5 million) be necessary? And, would the investment be required on the front end, or would it be acceptable to "earn-in" to a future greater percentage of control with future stock purchase options, dividends distributed as additional shares of stock, and so forth, based on benchmark criteria such as increased gross sales by a predetermined percentage or dollar amount?

Statutory Regulation and Tax Regimes

The tax regimes at all levels of U.S. government are complex and onerous, particularly when tax assessments arise after most transactions have concluded. Nevertheless, there are various tax incentives built in for foreign investment. If not outright exempted from tax consequences, there are a variety of structuring nuances that may be able to minimize tax liabilities. Among these techniques are reduction by credits and other offsets afforded by statute, deferral to later payment (with time value of money advantages), converting ordinary income to capital gains at lower tax rates, or diverting tax exposures to other taxpayers at lower tax rates. It is important to understand that the character of income (active from operations; or passive from rents, royalties, interest, etc.) triggers different tax consequences. Also, there are a variety of "hidden" taxes for gifts of property, and for property present in the U.S. for deceased alien investors, whether resident or non-resident, married or unmarried, and so forth.

In addition, foreign investors need to be aware that there are generally minimum "fees" for the right to transact business in a state, such as a franchise fee, even if there are no operations or taxable income *per se*; but these are minimal (*e.g.*, California assesses $800 per year regardless of entity type; Delaware $250 per year for LLC and partnership entities, with corporations taxed on amount of capital). Additionally, there are licensing fees to operate businesses at city and state levels on an annual basis (again nominal expenses of doing business). And, all of these are usually deductible against income generated.

Conclusion

It is important to consider the multitude of fundamental considerations for Chinese businesses, entrepreneurs, or persons seeking to establish business in the U.S. This article has outlined only the most basic options and choices. The recommended policy is to institute the proven low profile strategy of Chinese investors, such as CIC, to seek smaller parts of businesses in need of financing, in non-threatening industries with high potential future growth.

ENDNOTES

(1) James Flanigan, *A Wave of Chinese Money Gives a Lift to Companies Struggling in Tough Times*, N.Y. Times (July 6, 2011), http://www.nytimes.com/2011/07/07/business/smallbusiness/07sbiz.html?pagewanted=all.

(2) David Barboza, *As China Invests, U.S. Could Lose*, N.Y. Times (May 4, 2011), http://www.nytimes.com/2011/05/04/business/global/04yuan.html?pagewanted=all; and Associated Press, *China's Investment Arm Details $6.9B of Stakes in U.S. Companies*, Statesman.com (February 9, 2010), http://www.statesman.com/business/chinas-investment-arm-details-6-9chinas-investment-arm-details-6-9b-of-stakes-224317.html.

(3) Barboza, *supra* note 2.

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