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*Legal Framework for
Investment In Business Opportunities
in the United States*

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UNITED STATES – LEGAL FRAMEWORK FOR INVESTMENT IN BUSINESS OPPORTUNITIES

Contents

1. *Public Company Investment*
2. *Private Company Investment*
3. *Private Corporation Investment*
4. *Investment in a Partnership*
5. *Limited Liability Investments*
6. *Limited Partnerships*
7. *Limited Liability Companies*
8. *Contract Provisions Governing Investments*
9. *Choice of Law*
10. *Investment in the Wine Industry*
11. *Investment in the Entertainment Industry*
12. *Investment in U.S. Banks*
13. *Real Property Investments and the Foreign Investor*
14. *Risks of Fraud*

1. Public Company Investment. The most common method of investment in American business is by purchase of stock in publicly-traded companies through stock exchanges such as NYSE, AMEX or NASDAQ. All of the financial information about a publicly-traded company is public and the dissemination of this information is well regulated by the Securities and Exchange Commission, an agency of the United States government.

2. Private Company Investment. Investors are often attracted to presumed higher yield of investment in privately-held companies. Privately-held companies are owned by a small number of people and are not regularly listed for sale on a secondary market. Investment in private companies is less liquid than

investment in public companies, even in the case of private companies with hundreds of shareholders.

3. Private Corporation Investment. Private corporations are either S corporations or C corporations. This designation relates primarily to the manner in which corporate profits are taxed. C corporations pay taxes on their profits and may distribute remaining profits in the form of dividends to shareholders. S corporations are not taxed and pass all profits and losses through to shareholders who are then taxed on an individual basis.

4. Investment in a Partnership. One can also invest in a private business opportunity by means of the purchase of a partnership interest in a general partnership or a partnership interest in a joint venture. These investment vehicles do not provide any limitation on potential liability and a partner has complete liability for the misdeeds of any other partner, even if the investing partner had no knowledge of and did not participate in the activity which created the liability. Obviously, it would be unwise to invest a general partner unless one is on-site and active in the business or has a very trusted agent who is on-site and active in the business to protect one's interests.

5. Limited Liability Investments. Limited partnerships and limited liability companies each provide an opportunity to earn a share of the business's profits while limiting the investor's liability in the event that the business is sued. Although the amount invested will be at risk in the event of a lawsuit against the business, the investor's assets are protected by the shield of limited liability in most cases. The opportunities to invest in limited partnerships have largely been replaced by the opportunity to invest in limited liability companies.

6. Limited Partnerships. Limited partnerships are still used in connection with some types of real estate investment. In such investments, the general partner has broad discretion and may have little accountability to the

limited partners. Typically, a limited partnership investment is functionally illiquid. In other words, ownership is non-transferable, if not by contract, by all practical effect since it is difficult to find someone willing to purchase a limited partnership interest outside of the general partner's circle of friends and family.

7. Limited Liability Companies. Limited liability companies ("LLCs") have existed as creatures of statute in the United States since 1988. Without question, limited liability companies are considered the preferred vehicle for private investment in many industries, including the entertainment industry. However, before investing by means of membership in a limited liability company, one should have a basic understanding of the rules and laws that govern LLCs.

LLCs combine the tax benefits of a partnership (pass-through taxation) with the full limited liability of a corporation. LLCs have fewer formalities than a corporation, and typically have a single-level of management (the Managers) making decisions for the owners (the Members). LLCs can be easily formed by filing a single document with the appropriate state agency, and detailed provisions can be left to an operating agreement governing the relations of members.

8. Contract Provisions Governing Investments. Standard provisions will usually appear in contracts in the United States that govern disputes that may develop regarding an investment. Among other things, these provisions typically address the manner in which and location where any disputes will be resolved. Contract provisions may even determine the law which will be applied to resolve disputes. The contract may stipulate that the parties will submit disputes to binding arbitration as an alternative to litigation in state or federal court. Alternatively, the contract may include a provision which requires that any litigation be brought in a specific state or federal court. Further, the contract may stipulate that the laws of a particular jurisdiction, such as California, will be

applied to determine the rights and obligations of the parties. Finally, the contract may contain a provision requiring the investor to submit to the jurisdiction of a state or federal court in the United States. These types of provisions are binding on the parties and foreign investors should consider carefully the true cost and risk that such provisions represent.

9. Choice of Law. Because of the overlap of federal and state legal structure in the United States, the choice of law dictated by state law and in the operating agreement can have many different consequences. One may choose the law of any of 50 states and many territories to form your business entity.

Businesses are generally governed by state law, with some limited federal oversight of areas such as selling securities. Currently, Delaware is the most popular jurisdiction for LLCs offered to foreign investors. This is because Delaware has a well-developed body of business law, and is known to be a “business-friendly” state. For minority investors, this means that they may have little to no say in the management and affairs of the company. Delaware law clearly provides for freedom of contract, and that contract can include limited disclosure of information, removal of voting rights, and indemnification for managerial misconduct.

10. Investment in the Wine Industry. The wine industry has almost no regulatory oversight and no transparency. As such, investment in winery operations poses special risks. Also, because wineries are, for the most part, privately-held there are few opportunities for foreign investors to directly purchase an ownership interest in a specific winery. There are California wineries owned by publicly traded conglomerates (such as Constellation Brands or Pernod Ricard) but winery holdings are typically a small portion of corporate assets for those conglomerates.

Well-connected individuals can discover investment opportunities in the form of smaller wine groups such as Andretti or Chalone, but any potential investor should consider that a winery is an agriculture-based enterprise facing all the risks inherent in the agriculture business. Moreover, wineries are subject to state and federal law governing agriculture production and must comply with state and federal rules concerning the production and sale of alcoholic beverages. The line most often heard in the Sonoma-Napa region concerning investing in the wine business is, “[i]f you want to make a small fortune in the wine business, start with a large one.” While there no literal truth to this statement, it will serve a potential wine industry investor well to remember both the unique challenges and the opportunities present in the wine industry.

11. Investment in the Entertainment Industry. The classic Americana investment may be made in a company doing business in Hollywood. Motion picture, T.V. and music video production all require substantial investments of capital, making the entertainment industry a wide open area for investment. An investment in a Hollywood project will most likely involve cooperation with industry regulars, be they big, corporate distributors, production companies, behemoth record label companies, or the Screen Actors Guild. Investors should be aware that power players in Hollywood know how to make money on invested capital without paying any return to the investors. Vanity investment – where you invest your money with no real hope of a return, but with the right to have your name in the credits or the right to own a piece of a production -- is always an option. Investors should understand that copyright ownership comes with obligations and liabilities, many of which are not obvious to the Hollywood outsider. First, any lawsuits related to the production in any way are likely to involve the owner of the copyrighted material. Second, the owner of a copyright protected asset must diligently protect copyright and prosecute any infringements

or risk losing all rights of protection under copyright laws. Third, ownership of a copyright can create automatic obligations under collective bargaining agreements, regardless of whether the owner actually entered into the agreement. For example, the owner of a copyright for a motion picture may be obligated to pay residuals and royalties in perpetuity to union members who worked on the film, even if the rights to collect revenues from sales and distribution of the film were assigned to a third party.

12. Investment in U.S. Banks. Banks are organized as corporations and have become a very popular investment for foreign and domestic investors. Bank stocks are exempt from registration with the Securities and Exchange Commission and thus are more freely transferable. Banks are able to leverage capital better than companies doing business in other industries and it has not been uncommon to see ROE in excess of fifteen percent. Companies like Sandler O'Neill & Partners, L.P., can provide helpful information about bank investment prospects and many small bank stocks can be purchased Over The Counter.

13. Real Property Investments and the Foreign Investor. Limited liability companies are generally considered the best way for a foreign investor to indirectly own United States real property. While direct ownership of real property is allowable, significant tax disadvantages may result. The United States has a transfer tax imposed on gifts and transfers at death. United States citizens or permanent residents must own property in excess of \$2,000,000 before any estate tax is due under current law. Foreign individuals with real property in the United States are subject to the estate tax. Furthermore, absent treaty provisions to the contrary, a foreign individual's exclusion from the estate tax is only \$60,000. Since tax rates begin at 24% and go as high as 45%, this can be an expensive tax. In addition, a gift from a foreign individual of United States property doesn't get any exclusion (a U.S. citizen or resident has a \$1,000,000 lifetime exclusion) other

than an annual \$12,000 per year per person exclusion. As a result, it is almost always inadvisable for a foreign individual to directly own United States real property.

Instead, foreign individuals often own an LLC that in turn owns United States real property. The LLC interest is generally considered an intangible asset and, if the LLC is not organized in the United States, it will generally not be considered as United States property and therefore is not subject to United States gift or estate tax. Many practitioners believe the best way for a foreign individual to own United States real property is to have an LLC organized somewhere other than the United States owning LLC interests in a domestic LLC that in turn owns real property. This may be somewhat conservative and a bit complex, but, properly done, it provides the best chance of legally avoiding the United States gift and estate taxes. This technique is unlikely to work for income tax purposes.

14. Risks of Fraud. Fraud is a common peril for investors in private companies. The risks of criminal prosecution for fraud are low and obtaining redress by litigation can be a formidable expense for any investor, especially one located out of the area where the fraud occurs. The best solution is to invest in a company that exists in a heavily regulated environment (such as banking) or to conduct thorough due diligence. Unfortunately, due diligence can be difficult to conduct from a distance and some fraud risks cannot be found out by the best of due diligence. Well chosen local professionals can provide a significant measure of protection and should always be consulted prior to large investments.

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