Paul|Weiss

Private Equity Digest

October 2016, Issue 17

China-U.S. Crossborder Deal Risks and Mechanics

Overview

The last twelve months have seen a marked increase in the total volume of China-sourced, U.S.-inbound transactions. China's outbound M&A volume for 2016 surpassed the 2015 full-year total by early June, and Chinese buyers are on pace to acquire more than $30.0 billion in U.S. targets by year's end. According to Dealogic, as of October 2016, Chinese buyers had completed 99 deals this year with a total value of $20.38 billion.

Growth in China-U.S. deal volume is likely to continue as government policies and market pressures encourage Chinese firms to look to foreign targets. The government's "Go Out" policy, for example, under which the state has gradually relaxed certain controls on outbound deals since 1999, is a driving force in liberalization, and the "Made in China 2025" policy is a recent example of initiatives designed to increase the quality and reach of Chinese brands in foreign markets. In addition, local growth has slowed in China in recent years, and firms are seeking opportunities to invest in growth markets abroad.

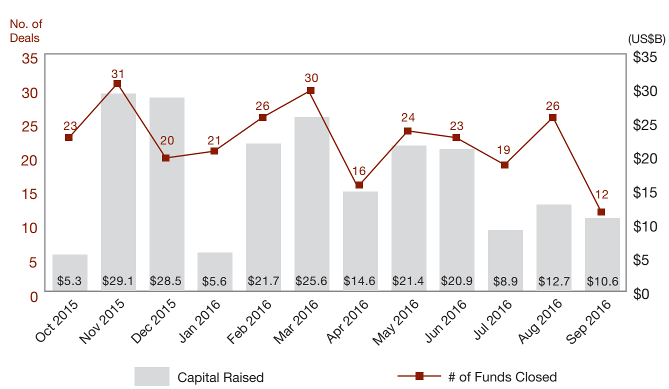
Given the rising volume and importance of Chinese buyers to the M&A market, potential U.S. sellers should familiarize themselves with the risks and market practices common to these deals. Crossborder transactions often feature specific risks resulting from U.S. and source country regulation and review, as well as general deal issues heightened or augmented by the crossborder context. Sellers can address these through early and focused due diligence and advanced planning, and by using deal mechanics, including reverse break fees, non-refundable deposits and hell-or-high-water provisions.

Discussion

U.S. Regulation

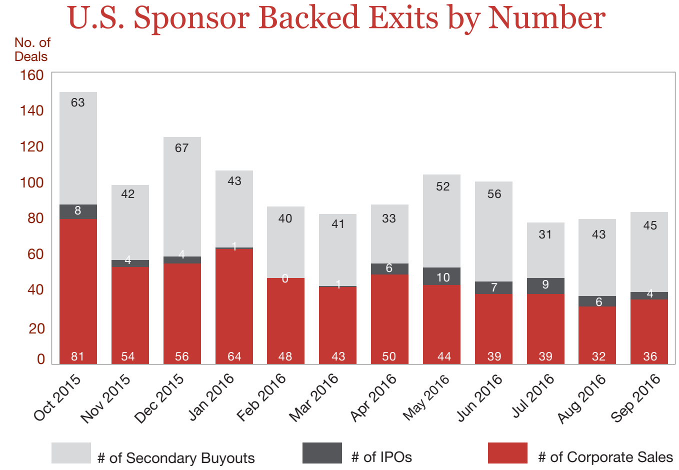
The main U.S. regulatory concern unique to U.S.-inbound transactions is possible review and/or investigation by the Committee on Foreign Investment in the United States (CFIUS). CFIUS has the authority to review any proposed transaction that could result in foreign control of a U.S. business to assess whether it creates a risk to critical infrastructure or national security. Parties may voluntarily inform CFIUS of the details of a deal, including data regarding the acquirer and the target businesses, or alternatively, CFIUS can initiate its own review. During the initial review period, which can last for up to 30 days, CFIUS typically requests additional information to identify any national security concerns created by the transaction. While most transactions are approved during this phase, a significant percentage face further scrutiny in a follow-up 45-day investigation. Following the second stage investigation, CFIUS may approve a deal with or without mitigation measures, or recommend that a deal be blocked entirely. CFIUS employs a wide variety of mitigation measures, including solutions designed to limit non-U.S. citizens' access to sensitive technology and key facilities, or to facilitate ongoing CFIUS monitoring of company operations. Of all foreign investors, Chinese investors have appeared most often before CFIUS in recent years.

U.S. Private Equity Fundraising



Source: Pitchbook

U.S. Sponsor Backed Exits by Number



Source: Pitchbook

It is increasingly difficult to predict which transactions will run into major CFIUS problems, as the areas of CFIUS interest continue to expand and CFIUS does not reveal the outcomes of specific transactions or the reasons for those outcomes. The 2014 CFIUS Annual Report to Congress illustrates the wide range of businesses and industry sectors that were examined under a review and/or investigation for national security reasons. For example, observers may not have supposed that pork – the subject of Shanghui International Holdings Limited's successful $7.1 billion acquisition of U.S. processor, Smithfield Foods Inc. – would be a national security concern, yet that transaction was the subject of intense congressional scrutiny, as political concerns for food security and safety emerged. CFIUS eventually approved the acquisition, but only after undertaking a second-round, 45-day investigation.

Moreover, it remains to be seen whether there will be a future broadening of the types of deals CFIUS reviews to include areas attracting greater foreign investment, for example, U.S. media assets. After a Chinese buyer bought Legendary Entertainment, one of Hollywood's biggest production companies, in January of this year, 16 members of Congress questioned whether the definition of national security should be broadened to address concerns about foreign control of media and other "soft power institutions." There is also a sense among market observers that CFIUS scrutiny is heightened when the target is a widely recognized American brand, due to political headwinds against foreign acquisitions of popular, U.S. household brands.

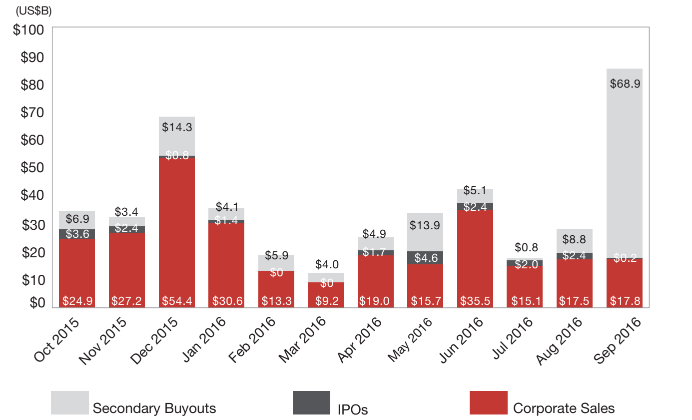
CFIUS risk has been attracting heightened attention in connection with U.S. acquisitions generally, and especially in the context of proposed acquisitions by Chinese entities (or Chinese owned/controlled entities). For example, Fairchild Semiconductor, an American company, rejected China Resources Microelectronics' recent $2.5 billion bid and embraced a smaller bid from an American company in part out of a concern that CFIUS might reject the Chinese deal.

We note that in addition to CFIUS review, other federal and state regulatory regimes (including export control requirements and regulations related to conducting classified business) may also raise U.S. national security issues and, to some degree, political issues as well.

Chinese Regulation

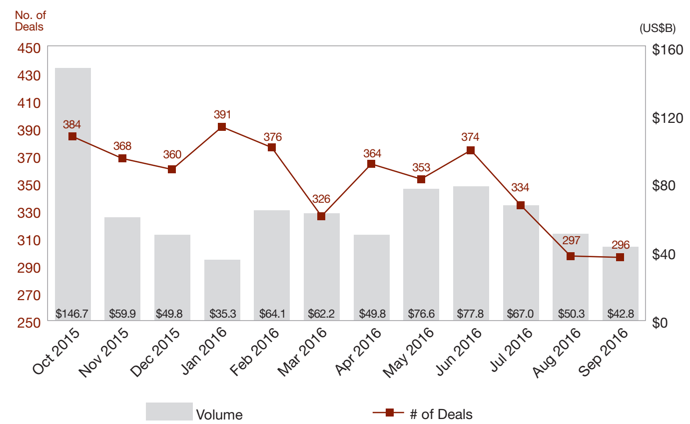
Another set of risks particular to the Asian crossborder deal context is source country regulation. In China, proposed acquisitions of foreign targets may require approval by the National Development and Reform Commission (NDRC), the regulator of outbound investment; the Ministry of Commerce (MOFCOM), the general commerce regulator; and the State Administration of Foreign Exchange (SAFE), the overseer of currency exchange for acquisitions, as well as local regulators and industry-specific regulators. State-owned enterprises and Chinese public companies have additional filing requirements.

U.S. Sponsor Backed Exits by Dollar Volume



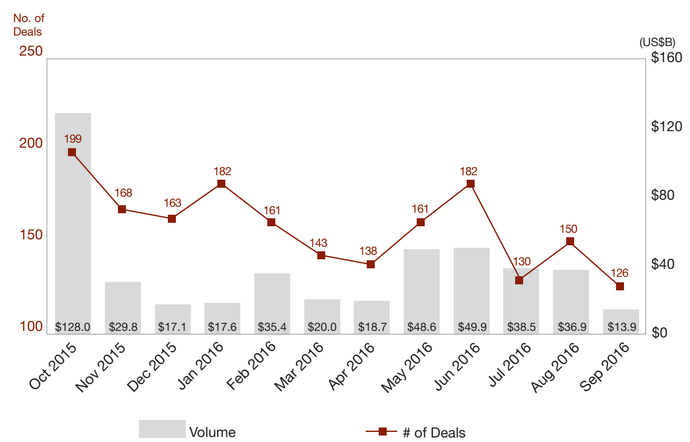
Source: Pitchbook

Global Sponsor-Related M&A Activity



Source: Dealogic

U.S. Sponsor-Related M&A Activity



Source: Dealogic

In recent years, a number of regulations governing outbound investment in China have been loosened pursuant to the "Go Out" policy. Where MOFCOM, for example, previously required all transactions over $100 million to be submitted for approval – a process that could take up to several months – the majority of deals now only require a filing, with approvals limited to financial sector acquisitions and investments that involve sensitive countries or regions (the United States is currently not on the sensitive list) or industries. SAFE has also relaxed its requirements in recent years by allowing Chinese companies and individuals to provide a guarantee in relation to the debt of an unrelated foreign debtor without prior approval, and by delegating the authority to approve certain foreign exchange matters to domestic banks. However, our experience has been that despite these changes in legislation, banks are often required as a matter of practice to consult with or receive approval from SAFE for many foreign exchange matters. As well, the NDRC has announced that it will remove the requirement to obtain State Council approval for acquisitions of targets in sensitive countries, regions or industries with consideration over $2.0 billion.

Heightened Crossborder Deal Risk

Crossborder transactions often entail increased execution risks that need to be considered when structuring the deal. For example, U.S. sellers should consider that debt financing for Chinese buyers is often provided on non-customary terms and/or by local banks that do not have an international presence, or that are not familiar with deal terms common in the United States. In the China-outbound deals we have seen, financing even for large projects is generally obtained from a single local bank, thus focusing the risk of a potential funding failure on one institution.

Also novel to the China-U.S. crossborder context are issues related to recognition and collection of court judgments. Risk mitigation mechanics (for example, reverse break fees) may require bespoke features when the assets of the seller are held locally, as not all countries have treaties providing for the enforcement of U.S. court judgments (including China). However, because China is a signatory to a treaty with the United States and other countries on the recognition of arbitration awards, such dispute resolution procedures may be a practical solution to the risks around enforcement of court judgments.

Finally, some proposed transactions may create negative public opinion and optics concerns necessitating a proactive public relations approach, such as when a popular American brand is sold to a non-U.S. firm.

Addressing the Risks

Early and Proactive Due Diligence

To mitigate the CFIUS risks, parties should try to identify as early as possible the real and perceived national security threats created by the proposed transaction. Early due diligence of the target and purchaser companies' assets, technology and links to both the U.S. government (including contracting, grant-making, and licensing arrangements) and relevant foreign governments is important. Moreover, if parties can detect CFIUS concerns early, they can make an early decision about whether to submit the transaction for CFIUS review and, if so, begin the laborious process as soon as feasible.

The CFIUS risk profile will also affect the structuring of the acquisition agreement. If a CFIUS filing will be made, the buyer will typically require a closing condition tied to a successful outcome of the CFIUS review process. Moreover, if the CFIUS risk appears to be high, the seller is likely to require a significant reverse break fee in the event that the outcome of the CFIUS review process prevents completion of the transaction.

Work with Regulators

Deal parties should work with U.S. and Chinese regulators to ensure that they will meet all requirements for approvals and reviews. Proactive and frank discussions with the regulators may also have the effect of quelling negative public perception for potential acquisitions of U.S. popular brands or targets in politically sensitive industries.

Sellers should be mindful of any regulatory review timelines that need to be taken into account. Deal teams should consult with local experts on expected processes and other domestic market requirements or practices during the early stages of a transaction. For example, Chinese companies generally have lengthier internal decision-making processes than U.S. companies, and U.S. sellers would be wise to consider the likely longer time needed for internal review and approval when negotiating a transaction.

Bespoke Deal Mechanics

Reverse break fees.

To address regulatory risks and potential creditworthiness issues surrounding a Chinese buyer, U.S. sellers have frequently relied on reverse break fees. To alleviate enforcement concerns, escrow agreements or letters of credit may be used to backstop a reverse break fee. Examples of potential triggers of a reverse break fee include an unsuccessful CFIUS outcome and failure to secure other regulatory clearances (including any required outbound investment approvals from Chinese regulators). If this strategy is employed, it should be similarly reflected in the escrow agreement or letter of credit.

When backstopping a reverse break fee with an escrow agreement, deal parties should consider the need for certainty in negotiating the triggering events, as escrow agents want to be clear when and to whom funds should be released. Deals occasionally include tiered reverse break fees, each tier for a different dollar amount with different triggers.

The use of reverse break fees in China-U.S. crossborder deals has significantly increased over historical levels in the last two years, and some Chinese buyers are pushing back. As a recent example, two Chinese bidders for Ingram Micro refused to agree to reverse break fees during negotiations for the acquisition.

Non-refundable deposits.

Another risk-mitigating deal mechanic that can be used in this context is non-refundable deposits. While not very common, U.S. sellers may require Chinese buyers to make a "good faith deposit" or an "earnest deposit," which is non-refundable and may be required to begin the diligence process or even to enter into discussions. However, the payment of such a deposit may, in itself, trigger a requirement to obtain Chinese regulatory approval thereby creating additional timing concerns if the Chinese buyer does not have sufficient funds available offshore to pay the deposit in U.S. dollars.

Hell-or-high-water provisions.

The conditions imposed by CFIUS and by Chinese regulatory authorities can be quite difficult to predict, and U.S. sellers negotiating with a Chinese buyer will often push for a limitation on the buyer's walk-away rights through a hell-or-high-water provision. If the U.S. seller is successful, the contract may oblige a buyer to undertake all steps or measures necessary to achieve CFIUS or Chinese regulatory approvals, including divestitures. However, accepting any and all conditions imposed by CFIUS or applicable Chinese regulators can be onerous and buyers, at a minimum, will generally push to limit divestitures they are required to accept by reference to a threshold tied to EBITDA or another metric. For example, in 2015, Chinese-backed Zhongwang USA LLC agreed in its acquisition of Aleris Corp to accept divestment obligations up to 5% of Aleris Corp's 2015 net sales. Buyers and sellers can determine the best metric for the context of their deal and ensure that all regulatory requirements below a given threshold will not prevent a successful closing.

This publication is not intended to provide legal advice, and no legal or business decisions should be based on its content.
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