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AMENDMENTS TO JAPAN'S FOREIGN DIRECT INVESTMENT LAW: HEIGHTENED REVIEW OF INBOUND INVESTMENTS

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From June 7, 2020, overseas investors may no longer be able to purchase shares of certain Japanese companies. The Japanese government passed amendments to its foreign direct investment laws that lower the government approval threshold from 10% to a mere 1% for share acquisitions of publicly-traded companies that engage in a broad range of business activities deemed critical to national security, public safety, public infrastructure, or Japan's economy (the "FDI Amendments"). The Japanese government claimed that its foreign direct investment laws required a major overhaul because it lacked legislation to effectively screen foreign direct investment to the same recent extent as other developed countries. In particular, Japan's Ministry of Finance noted the 2018 passage of the Foreign Investment Risk Review Modernization Act in the United States and European Union regulations adopted in 2019 establishing a framework for monitoring foreign direct investments as examples of how Japan's foreign direct investment regime lagged behind international standards. As a result, practically every share acquisition by an overseas investor of a publicly-traded company now deemed critical to Japan will require government approval, unless an exemption applies.

This article outlines the broad reach of the FDI Amendments and the exemptions that curtail its application, and then proceeds to highlight issues that prospective overseas investors should consider through a question and answer format. Given the complexity of the FDI Amendments, decision tree diagrams are included at the end of the article to provide a visual

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flow of how the FDI Amendments apply to a transaction.

Prior Foreign Investment Review Regime

The principal statute regulating foreign direct investment into Japan is the Foreign Exchange and Foreign Trade Act (the "FDI Act"). Prior to the FDI Amendments, generally speaking when an overseas investor acquired (either directly or along with its affiliates) any shares of a Japanese privately-owned company or 10% or more of the outstanding voting rights in a Japanese publicly-traded company, then after the closing the investor was required to file a post-acquisition notice report with Japan's Ministry of Finance and the Japanese economic ministry overseeing the industry in which the target company operates (which report provided notice of the closing of the transaction and did not require the Japanese government to consent to the purchase). However, an overseas investor was required to obtain Japanese government approval prior to the closing for its share purchase if the public- or privately-owned target company or any of its subsidiaries engaged in a business that the Japanese government deemed critical to Japan's national security (which was a finite list primarily limited to weapons, aircraft, and nuclear power) or engaged in certain protected industries (another finite list primarily limited to agriculture, petroleum, and leather).

To date, only one proposed foreign investment has been blocked pursuant to the rubric of the FDI Act—the proposed acquisition in 2008 by the Children's Investment Fund (a British hedge fund) to increase its holdings in J-Power, a Japanese electric wholesale company, from 9.9% to more than 20%. Japan's Ministry of Economy, Trade, and Industry objected to the ownership increase based on the argument that the purpose of the Children's Investment Fund was to maximize profits, which was incompatible with J-Power's function as an energy provider to Japan.

Amended Foreign Investment Review Regime

Effective May 8, 2020 (but applying to pur-

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chase transactions only after the expiration of a 30-day grace period), a "Foreign Investor" (as explained below under "Key Defined Terms") is required to obtain a Japanese government approval to acquire as low as 1% of the outstanding voting rights or the issued shares in a publicly-traded "Designated Company" (as explained below under "Key Defined Terms"), unless a newly established exemption applies (as explained below under "Share Purchase Exemptions"). By changing the approval threshold from 10% to a mere 1%, the FDI Amendments will require a Foreign Investor to comparatively submit more filings to the Japanese government to acquire equity of a Designated Company. The FDI Amendments also modify the post-acquisition notice reporting requirements for certain purchases of a publicly-owned Designated Company. The FDI Amendments do not alter the notice and approval thresholds in connection with the purchase by a Foreign Investor of shares of a privately-owned Designated Company, which remain the same at one share or more, unless a newly established exemption applies that eliminates the need for Japanese government approval for the purchase (as explained below under "Share Purchase Exemptions").

The FDI Amendments also require a Foreign Investor to obtain Japanese government approval post-acquisition if it desires to (i) appoint directors and statutory auditors to the Designated Company, or (ii) propose to transfer or dispose of a "Designated Business Sector." Accordingly, the FDI Amendments require Foreign Investors not only to obtain Japanese government clearance for acquisitions, but also for exercising shareholder rights. The contours of obtaining Japanese government approval for the post-acquisition exercise of such shareholders rights is not covered by this article.

Key Defined Terms

As the need to obtain Japanese government approval for an inbound investment will partly depend on the type of investor and the business activities engaged in by the Japanese target company, it is essential to understand the following key terms under the FDI Amendments:

- **Designated Company** means an entity engaged in any Designated Business Sector, including a Core Sector.
- **Designated Business Sector** means any of the general business activities listed under this caption in Annex I (see end of this article).
- **Core Sector** is a subset of a Designated Business Sector as listed under this caption in Annex I and are activities for which the Japanese government considers of great significance to national security (so subject to higher government scrutiny). A company engaged in a Core Sector always will be considered to engage in a Designated Business Sector too, but not always vice versa.
- **Foreign Investor** means an individual or entity that is a non-resident of Japan, and a Japanese-organized company for which 50% or more of the voting rights are directly or indirectly owned or controlled by a non-resident of Japan.

Business activities captured by the FDI Amendments. Deal practitioners may find it difficult to independently determine if a target Designated Company is engaged in a Designated

Business Sector or Core Sector given the expansive definitions of these terms. To reduce ambiguity, all Japanese publicly-traded companies have been given a rebuttable classification as to whether (i) an investment in such an entity is subject only to a post-acquisition notice report, (ii) the entity conducts business in a Designated Business Sector (but not a Core Sector), or (iii) the entity conducts business in a Core Sector. The assigned classification is not conclusive, so if a company is misclassified and actually engages in a Designated Business Sector, then the Japanese government may request the Foreign Investor to undertake remedial measures (so due diligence with the assistance of management over the target company's business operations remains critical). Japanese privately-owned companies do not receive similar public classifications, so an acquirer is required to ascertain business status through due diligence (also with the assistance of the target company's management as it should know whether its goods and services are subject to government controls due to prior communications with local regulators).

Deal practitioners should note that a company's designation is subject to change as its business activities evolve and depending on the developing national security concerns of the Japanese government. For example, the Japanese government recently announced that later this year (the exact date is not known, but is expected to be this summer) companies operating in the fields of vaccines (including applicable raw materials, serums and formulation), medicines that treat and prevent infectious diseases, and advanced medical equipment that is difficult to manufacture or for which few alternatives would be available when an infectious disease spreads globally (such as ventilators, infusion pumps and artificial dialyzers) will be classified as a Core Sector under a new Designated Business Sector "Medical." The new designation is clearly in response to the COVID-19 pandemic.

Expanded scope of Foreign Investors. Prior to the FDI Amendments, to determine the ownership of non-residents of Japan, only the direct voting right ownership of a Japanese company in which foreign entities and individuals directly owned 50% or more voting rights was considered. The FDI Amendments expand the scope of what constitutes a Foreign Investor by stipulating that any ownership of voting rights held by an entity in which a non-resident of Japan owns 50% or more of the voting rights and such entity's "subsidiaries" (as defined under Japanese corporate law) also should be considered to determine Foreign Investor status. By taking into consideration a subsidiary's ownership, the reach of the Foreign Investor definition has significantly expanded. Annex II provides an example of the broad breadth of the definition of a Foreign Investor under the FDI Amendments. The definition of a Foreign Investor under the FDI Act has not been fully replaced by the FDI Amendments. Therefore, pursuant to the FDI Act a Foreign Investor continues to include an individual who is a non-resident of Japan, an entity established under non-Japanese law, an organization that has its headquarters outside of Japan, and an entity (even if formed under Japanese law) for which a majority of its directors (or equivalent) are non-residents of Japan. Given the complexity of the definition of a Foreign Investor, legal counsel should be contacted at the outset of a transaction if the proposed investor may be under the direct or indirect control of a non-Japanese person or entity.

Share Purchase Exemptions

A Japanese government approval for a share acquisition may not be required depending on a complex analysis of (i) the number of shares being acquired, (ii) the type of Foreign Investor, (iii) whether the Foreign Investor agrees to curb its shareholder rights, (iv) the business activities of the target Japanese company, and (v) the history of regulatory compliance by the Foreign Investor. The resulting analysis may lead to the availability of either a "Blanket Exemption" or a "Regular Exemption" that partially or fully avoids the requirement to obtain a Japanese government approval for share purchases. Each is discussed below.

Blanket Exemption

A Blanket Exemption is available only to certain Foreign Investors. Namely, "foreign financial institutions" (defined as high-frequency traders who are registered with Japan's Financial Services Agency, securities firms, banks, insurance companies, asset management companies, trust companies, and registered investment trusts) that are subject to supervision under financial regulatory laws in Japan or other jurisdictions, so long as these Foreign Investors agree to the following (the "General Exemption Conditions"):

- it (along with its "closely related persons") will not become board members of the Designated Company;
- it will not propose at a shareholders' meeting the transfer or disposition of business activities undertaken in relation to a Designated Business Sector; and
- it will not access non-public information about the Designated Company's technology used in a Designated Business Sector.

Receipt of non-public information does not include employment terms, remuneration of board members and financial information. In addition, the third prong of the General Exemption Conditions is not breached if the Designated Company voluntarily provides such non-public information to the Foreign Investor. This qualification prevents a Designated Company from thwarting the acquisition intentions of a Foreign Investor by sharing confidential information for the purpose of preventing the application of a Blanket Exemption.

Purchase of 1% or more of a publicly-traded Designated Company. With a Blanket Exemption, a Foreign Investor can acquire shares with no upper limit in a publicly-traded Designated Company without having to obtain Japanese government approval, even if the publicly-traded Designated Company engages in a Core Sector. However, a Foreign Investor relying on the Blanket Exemption for the purchase of more than 10% of the voting rights or the issued shares in a publicly-traded Designated Company is required to file a post-acquisition notice report with the Ministry of Finance and the Japanese economic ministry overseeing the industry in which the Designated Company operates. The notification allows the Japanese government to monitor foreign investment but is not a method for the Japanese government to unwind a share purchase *ex post facto*.

Purchase of a privately-owned Designated Company. The Blanket Exemption does not fully extend to the purchase of shares in privately-owned companies. A Foreign Investor acquiring as little as one share and as many as all of the

shares of a privately-owned company is subject to the following filing requirements for each share purchase transaction depending on the business activities of the target company:

- if it is a Designated Company that engages in a Core Sector, then the Foreign Investor is required to obtain Japanese government approval and file a post-acquisition notice report with the Ministry of Finance and the Japanese economic ministry overseeing the industry in which the Designated Company operates;
- if it is a Designated Company that does not engage in a Core Sector, then the Foreign Investor is not required to obtain Japanese government approval so long as it (i) agrees to the General Exemption Conditions, and (ii) files a post-acquisition notice report with the Ministry of Finance and the Japanese economic ministry overseeing the industry in which the Designated Company operates; or
- if it is not a Designated Company, then the Foreign Investor is required only to file a post-acquisition notice report with the Ministry of Finance if it will acquire 10% or more of the outstanding voting rights or the issued shares in the target company, and for every equity purchase above such threshold thereafter.

Regular Exemption

A Regular Exemption is available to all Foreign Investors (except for those who are *persona non grata*, as explained below) and provides varying degrees of relief depending on whether the Designated Company engages in a Core Sector. High-frequency traders who have not registered with Japan's Financial Services Agency can utilize a Regular Exemption. In addition, sovereign wealth funds and public pension funds can utilize a Regular Exemption so long as such Foreign Investor has entered into a memorandum of understanding with the Ministry of Finance confirming that its investments are only for economic returns and made without their government's intervention. These memoranda are not publicly available, so a Designated Company undertaking a transaction with this type of Foreign Investor will need to directly obtain comfort from the Foreign Investor that the proposed transaction does not require Japanese government approval.

Purchase of 1% or more of a publicly-traded Designated Company—Non-Core Sector only. For publicly-traded Designated Companies that do not conduct any business in a Core Sector, then the Regular Exemption allows a Foreign Investor to acquire up to 100% of such Designated Company without having to obtain Japanese government approval, so long as the Foreign Investor agrees to all of the General Exemption Conditions. However, a Foreign Investor relying on the Regular Exemption in this context is required to file a post-acquisition notice report with the Ministry of Finance and the Japanese economic ministry overseeing the industry in which the Designated Company operates when (i) its ownership interest in the Designated Company's outstanding voting rights or issued shares reaches 1% for the first time or 3% for the first time, or (ii) the purchase involves 10% or more of the outstanding voting rights or the issued shares in the Designated Company. Accordingly, a post-acquisition notice report is not required when a Foreign Investor's ownership interest falls below 1% or 3% and subsequently returns

to a level above 1% or 3% (so long as the transaction returning to these thresholds did not involve the purchase of 10% or more of the outstanding voting rights or the issued shares in the Designated Company).

Purchase of 1% or more of a publicly-traded Designated Company—Core Sector. For publicly-traded Designated Companies that conduct business in a Core Sector, then the Regular Exemption allows a Foreign Investor to acquire less than 10% of such Designated Company without having to obtain Japanese government approval, so long as the Foreign Investor agrees to all of the General Exemption Conditions, plus the following further conditions:

- it will not become members of any committee of the Designated Company that makes important decisions with respect to the business activities involving the Core Sector; and
- it will not make written proposals that require a response or action by a certain deadline to the board of directors of the Designated Company (or any member thereof) or any committee of the Designated Company regarding the business activities of a Core Sector.

On its face, a Foreign Investor would be able to make verbal suggestions concerning the business activities of a Core Sector without violating the FDI Amendments; however, a Foreign Investor adopting this approach should consult with legal counsel to evaluate whether such verbal suggestions violate the spirit of the FDI Amendments in light of the facts and circumstances.

Similar to a non-Core Sector transaction, a Foreign Investor relying on the Regular Exemption is required to file a post-acquisition notice report with the Ministry of Finance and the Japanese economic ministry overseeing the industry in which the Designated Company operates when (i) its ownership interest in the Designated Company's outstanding voting rights or issued shares reaches 1% for the first time or 3% for the first time, or (ii) the purchase involves 10% or more of the outstanding voting rights or the issued shares in the Designated Company.

Purchase of a privately-owned Designated Company. The FDI Amendments do not differentiate between the treatment of financial institutional investors versus regular investors in relation to purchases of privately-owned company shares, so the discussion under the Blanket Exemption for share purchases of privately-owned companies applies equally in the context of the Regular Exemption.

Persona Non Grata

The FDI Amendments stipulate that no exemptive relief is available to entities under the control of a foreign government, including sovereign wealth funds and public pension funds (unless such entities have entered into a memorandum of understanding with the Ministry of Finance), so Japanese government approval is required for these Foreign Investors to purchase (i) 1% or more of the outstanding voting rights or the issued shares in a publicly-traded Designated Company or (ii) any amount of shares in a privately-owned Designated Company. In addition, any Foreign Investor with a record of being sanctioned due to violations of the FDI Act must obtain Japanese government approval for Japanese equity purchases in the amounts stated above (although the *persona non grata* status will

expire after five years from any sanctions imposed due to certain infractions).

Japanese Government Approval and Notification Filings

Approval filings. To obtain a requisite approval for an equity purchase of a Designated Company, an identical approval filing is submitted to the Ministry of Justice and the Japanese economic ministry overseeing the industry in which the Designated Company operates. The approval filing is required to be submitted within six months of the proposed acquisition, and the waiting period to decide whether the transaction can proceed is 30 days (which can be shortened to two weeks, or extended up to five months if additional information or time to review is requested). The approval filing consists of information concerning the (i) purpose of the acquisition, (ii) means of participation in management in connection with the acquisition, (iii) likelihood of the Designated Business Sector being transferred, wound-down or reduced in size or function, and (iv) ultimate parent company or other persons who have influence over the business decisions of the Foreign Investor. There is no filing fee and the filing is not publicly available. Despite the significance of the approval filing, the information required to complete the filing based on the face of the FDI Act is normally modest, but the Japanese government may make supplemental information requests that can be time consuming to complete and raise sensitivities (such as information about the Foreign Investor's business and its relationship with a governmental body). The Ministry of Justice and the Japanese economic ministry overseeing the industry in which the Designated Company operates will issue a joint opinion on the proposed equity purchase, so a Foreign Investor will not face a split decision. The Foreign Investor will be notified of the Japanese government's decision, but not the underlying rationale for the decision. An investment denial decision will not be directly publicly disclosed by the Japanese government, but meeting minutes of Japan's Foreign Exchange (FDI) Commission where investment denials are discussed are publicly available (so it is conceivable that some information could have probative value if the Foreign Investor seeks to appeal the Japanese government's decision, or could have predictive value for future transactions by other Foreign Investors).

Notice filings. An identical notice filing is submitted to the Ministry of Justice and the Japanese economic ministry overseeing the industry in which the Designated Company operates. The notice filing is required to be submitted within 45 days from the closing of the equity purchase, and does not elicit a Japanese government consent for the acquisition. The notice filing is a short-form document and typically takes only a few days to prepare. There is no filing fee and the filing is not publicly available.

Sanctions. Failure to comply with a Japanese government approval requirement under the FDI Act (including the FDI Amendments) can lead to members of the Foreign Investor's management team being subject to imprisonment for up to three years and/or the Foreign Investor being required to pay a monetary penalty of up to JPY1,000,000 (however, if the amount of the investment for the violative transaction exceeds JPY1,000,000, then the monetary fine can be increased to up to three times the amount of the investment). Failure to comply with a Japanese government notice requirement under the FDI

Act (including the FDI Amendments) can lead to members of the Foreign Investor's management team being subject to imprisonment for up to six months and/or the Foreign Investor being required to pay a monetary penalty of up to JPY500,000.

Frequently Asked Questions

Do the FDI Amendments apply only to share purchases, so transactions by Foreign Investors structured as either asset purchases or business transfers will not require Japanese government consent?

No. The FDI Amendments only amend the portions of the FDI Act that apply to share purchases. The FDI Act already stipulates certain requirements for acquisitions structured as asset purchases, business transfers, mergers, or spin-offs.

What regulations in relation to the implementation of the FDI Amendments still need to be published?

All of the regulations with respect to the FDI Amendments have been published. As noted above, industries classified as a Designated Business Sector will evolve over time depending on the concerns of the Japanese government, so the list should be confirmed at the outset of a transaction.

Could a hedge fund qualify as a "foreign financial institution" and utilize the Blanket Exemption?

Yes. A hedge fund could utilize the Blanket Exemption. For example, the following are considered "foreign financial institutions" that can utilize a Blanket Exemption: an investment advisor that is registered under the U.S. Investment Advisers Act of 1940; an authorized fund manager and an alternative investment fund manager that are subject to license and supervision under the U.K. Financial Conduct Authority; a person who is granted a Type 9 license under the Hong Kong Securities and Futures Ordinance and subject to the supervision of the Securities & Futures Commission of Hong Kong; and a registered fund management company or a licensed fund management company under Singapore's Securities and Futures Act and subject to the supervision of the Monetary Authority of Singapore.

Does the ownership of non-voting equity shares count towards the determination of Foreign Investor status?

The determination of Foreign Investor status (in particular, a resident Foreign Investor) is dependent only on the relationship of voting equity shares. However, both the acquisition of non-voting equity shares and voting equity shares by a Foreign Investor are considered foreign direct investments and subject to a Japanese government prior approval and/or filing a post-acquisition notice report pursuant to the rules stated above.

Do the FDI Amendments only examine the share ownership of the Foreign Investor for purposes of determining whether the Blanket Exemption or the Regular Exemption apply?

No. Shares owned by the Foreign Investor's "closely related persons" are also attributed to the ownership of the Foreign Investor. The term "closely related persons" has a broad and lengthy definition under the FDI Amendments and includes more than what is commonly captured by the terms "affiliate" and "group."

Does the FDI Act apply to a Japanese company that has an overseas subsidiary that is engaged in a Designated Business Sector or Core Sector but its products are not sold in Japan?

The FDI Act (including the FDI Amendments) does not apply to a scenario where the Designated Business Sector is housed exclusively in an overseas subsidiary and there are no business activities in Japan. However, the FDI Act (including the FDI Amendments) would apply if the Japanese company has certain business connections with the overseas subsidiary (*e.g.*, the overseas subsidiary licenses technology from or to a Japanese company and the Japanese company is subject to the acquisition).

Is it possible to hold pre-transaction consultations with the Japanese government to determine whether it will object to a proposed investment by a Foreign Investor?

Yes. It is possible and common to preview a transaction with Japan's Ministry of Economy, Trade and Industry or the Japanese economic ministry overseeing the industry in which the target Designated Company operates to "test the waters" and develop a suitable operating plan.

Can a Foreign Investor qualify for a Blanket Exemption or a Regular Exemption that has a subsidiary or a less than wholly owned affiliate that is classified as persona non grata?

On its face, the *persona non grata* portion of the FDI Amendments applies only if the acquirer is subject to a Japanese government sanction. However, we will need to watch how the FDI Amendments evolve since it would be relatively easy to circumvent the *persona non grata* disqualification if only the record holder of the shares is examined.

What happens if a Foreign Investor who purchased shares of a Designated Company by relying on a Blanket Exemption or a Regular Exemption is subsequently acquired by a person who is classified as persona non grata?

The precise consequences are difficult to determine given the nascent stage of the FDI Amendments. Since ownership and management changes involving a Foreign Investor who purchased shares of a Designated Company by relying on a Blanket Exemption or Regular Exemption are required to report such changes to the Japanese government, it is conceivable that a remedial order could be issued depending on the circumstances.

In addition to the persona non grata exemption disqualification, are there any other provisions that prevent a Foreign Investor from relying on a Blanket Exemption or a Regular Exemption?

As with many statutes, the FDI Amendments include a general "catch-all" clause to deny exemption reliance. A Foreign Investor is not allowed to rely on a Blanket Exemption or a Regular Exemption if its underlying purpose for completing the share purchase is to make it difficult to operate the Designated Business Sector in a stable and continuous manner. For example, the "catch-all" could apply if the Foreign Investor plans to expend comparatively more resources on the target company's non-Designated Business Sector activities to the detriment of certain Designated Business Sector activities, or even withdraw from the Designated Business Sector. The catch-all also could apply if the Foreign Investor plans to undertake a recapitalization of the Designated Company that could lead to the Designated Company having difficulties continuing

to conduct the Designated Business Sector in a manner consistent with past practices. It is difficult to predict how often the catch-all clause will be used given its broad underpinnings, but it could prove useful to the Japanese government if it has concerns with the business practices or reputation of a Foreign Investor.

Are the General Exemption Conditions to which a Foreign Investor must agree under the Blanket Exemption and the Regular Exemption documented in an agreement between the Foreign Investor and the Ministry of Finance, and what happens if there is a breach by the Foreign Investor of a General Exemption Condition post-acquisition?

The General Exemption Conditions do not appear in a separate document, but appear as "check the box" agreements in the post-acquisition notice report a Foreign Investor is required to submit. If the Foreign Investor breaches a General Exemption Condition, then the minister of the Ministry of Finance and the minister of the Japanese economic ministry overseeing the industry in which the target Designated Company operates can issue a notice of breach and request the Foreign Investor to undertake certain corrective actions (*e.g.*, to file the requisite post-acquisition notice report). If the Foreign Investor fails to comply, then the applicable ministers can issue a remedial plan (such as the sale of the Designated Company's shares or assets), and the Foreign Investor will be classified as *persona non grata*.

Could a company that collects sensitive personal data be classified as a Designated Company?

Under the FDI Act, software and IT service companies that use software specifically designed to handle certain personally identifiable information (such as DNA and passport numbers) and certain personally sensitive information (such as health-related data) of one million or more persons are deemed to conduct business in a Core Business Sector. However, a company that just collects, stores and transmits personal information and personally sensitive information would not be classified as a Designated Company. As such, the social networking company, Grindr LLC, most likely would not be classified as a Designated Company under the FDI Amendments simply because it collects, stores, and transmits personal information and personally-sensitive information of dating preferences of certain users (unlike in the United States, where the U.S. government expressed national security concerns over the sale of the company to Beijing Kunlun Tech).

Would the purchase of a company that owns real estate in close geographical proximity to a business engaged in a Designated Business Sector or Core Sector be subject to the FDI Amendments?

Not currently, but we anticipate that legislation may be enacted if abuses are uncovered by the Japanese government.

Will the FDI Amendments impact shareholder activism in Japan?

Most likely, if the activist is a Foreign Investor. Since the FDI Amendments will require Japanese government approval for the purchase of as little as 1% of the outstanding voting rights or the issued shares of a publicly-traded Designated Company (unless an exemption applies), it may become more difficult for a Foreign Investor

shareholder activist to purchase a meaningful toehold position in a Designated Company since a Japanese government approval may be required and obtaining such approval itself could take substantial time and increase the risk of disclosure about the activist's interest in the Designated Company (which, if publicly known, could increase the trading price of the Designated Company). Furthermore, the FDI Amendments require a Foreign Investor to obtain Japanese government approval if it desires post-acquisition to (i) appoint directors to the board of the Designated Company or statutory auditors, or (ii) propose to transfer or dispose of a Designated Business Sector. The foregoing potential curtailments on shareholder rights could limit the playbook of a Foreign Investor shareholder activist, thereby reducing its investment interest in a Designated Company.

Piecing It All Together

The FDI Amendments present significant changes to the FDI Act and will require deal practitioners to carefully consider this new legislation in connection with any share purchase transaction by a non-Japanese investor.

To facilitate an understanding of the FDI Amendments, Annex III sets forth a decision tree diagram with respect to investments in publicly-traded Designated Companies and Annex IV applies with respect to investments in privately-owned Designated Companies.

In addition to restrictions under the FDI Act, a Foreign Investor also should bear in mind whether there are any industry-specific regulations or license requirements that could impact its ability to acquire an ownership interest in a Japanese company. For example, Japanese statutes restrict foreign direct investment exceeding 20% in broadcasters and foreign direct investment exceeding 33% in Nippon Telegraph and Telephone (Japan's former land-line monopoly telephone operator). Similarly, if a target Japanese company operates in a regulated industry, the Foreign Investor may need to obtain an acquisition approval or authorization from the relevant supervisory authority. For example, a person acquiring 20% or more (and in certain cases 15%) of an insurance company in Japan must obtain prior approval from Japan's Financial Services Agency, so it is conceivable that a Foreign Investor could be blocked even if the investment is permissible under the FDI Amendments.

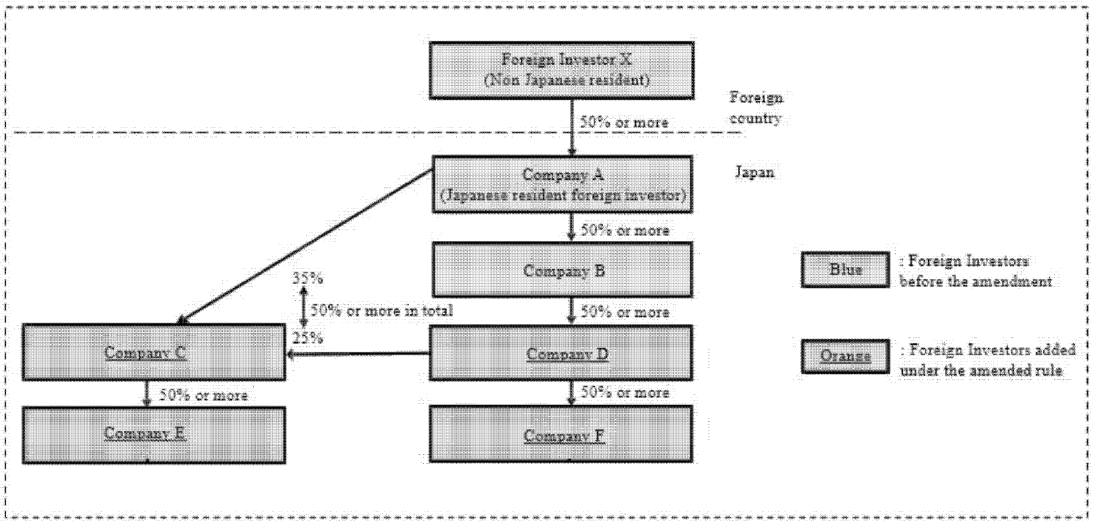
Annex I
Business Activities Subject to FDI Amendments

Designated Business Sectors	Core Sectors*
Weapons	All business activities
Aircraft (*i.e., the manufacturer of aircraft and rockets, and the parts thereof*)	All business activities
Nuclear facilities	All business activities
Space	All business activities
Dual-use technologies (*i.e., manufacturers, engineering service providers and software developers who deal with products and technologies that are subject to Japanese export control regulation*)	All business activities
Cybersecurity	• Cybersecurity-related services (e.g., network security monitoring, software) • Service providers of programs designed for critical infrastructure • Service providers of programs specifically designed to handle personal information and sensitive personal information of one million or more persons
Electricity	• General electricity transmission and distribution utilities • Electricity transmission utilities • Electricity generation utility companies that own a power plant with a maximum generation capacity of 50,000 KW or more
Gas	• General gas/specified gas pipeline service providers • Gas manufacturers • LP gas companies that own a storage facility or core cylinder filling station
Telecommunications	• Telecommunication carriers that provide service across multiple local municipalities
Water supply	• Water supply companies supplying to more than 50,000 people • Bulk water supply companies with a capacity to supply over 25,000m^3 of water per day
Railway	• Railway service companies operating public facilities/infrastructures that are stipulated under Japan's Armed Attack Situations Response Act
Oil	• Oil refineries • Oil storage facilities • Crude petroleum facilities • Natural gas production facilities
Heat supply	None
Broadcasting	None
Public transportation	None
Biological chemicals	None
Security services	None
Agriculture, forestry and fisheries	None
Leather manufacture	None
Air transportation (*i.e., air transportation service providers, such as Japan Airlines*)	None
Maritime transportation	None

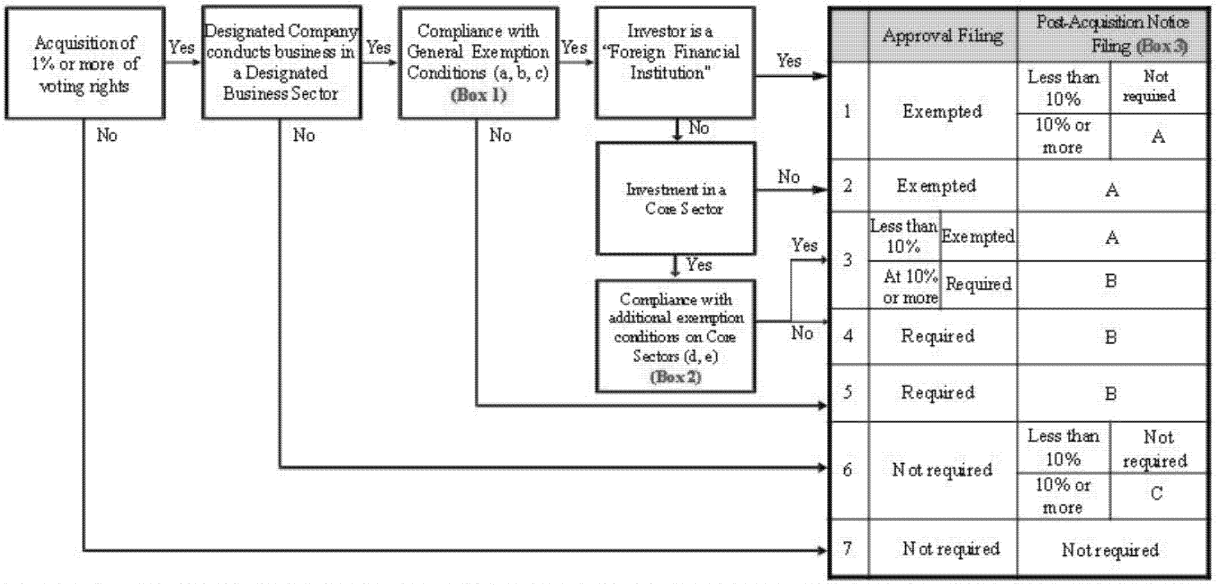
* Core Sectors are summarized herein, so this list should not be considered comprehensive.

Annex II
Foreign Investor Status

- Before the FDI Amendments, a Foreign Investor included companies located in Japan for which 50% or more ownership of their voting shares were owned by foreign investors, as well as direct subsidiaries of such companies.
- After the FDI Amendments, all companies for which their voting shares are owned 50% or more by Company A and/or Company A's subsidiary companies (*as defined under Japanese corporate law*) are regarded as Foreign Investors.



Annex III:
Investments in Publicly Designated Companies



(Box 1)
General Exemption Conditions

Foreign Investor agrees to the following:

a. it (along with its "closely related persons") will not become board members of the Designated Company

b. it will not propose at a shareholders' meeting the transfer or disposition of business activities undertaken in relation to a Designated Business Sector; and

c. it will not access non-public information about the Designated Company's technology used in a Designated Business Sector.

(Box 2)
Exemption Conditions on Core Sectors' Business Activities

Foreign Investor agrees to the following:

d. it will not become members of any committee of the Designated Company that makes important decisions with respect to the business activities involving the Core Sector; and

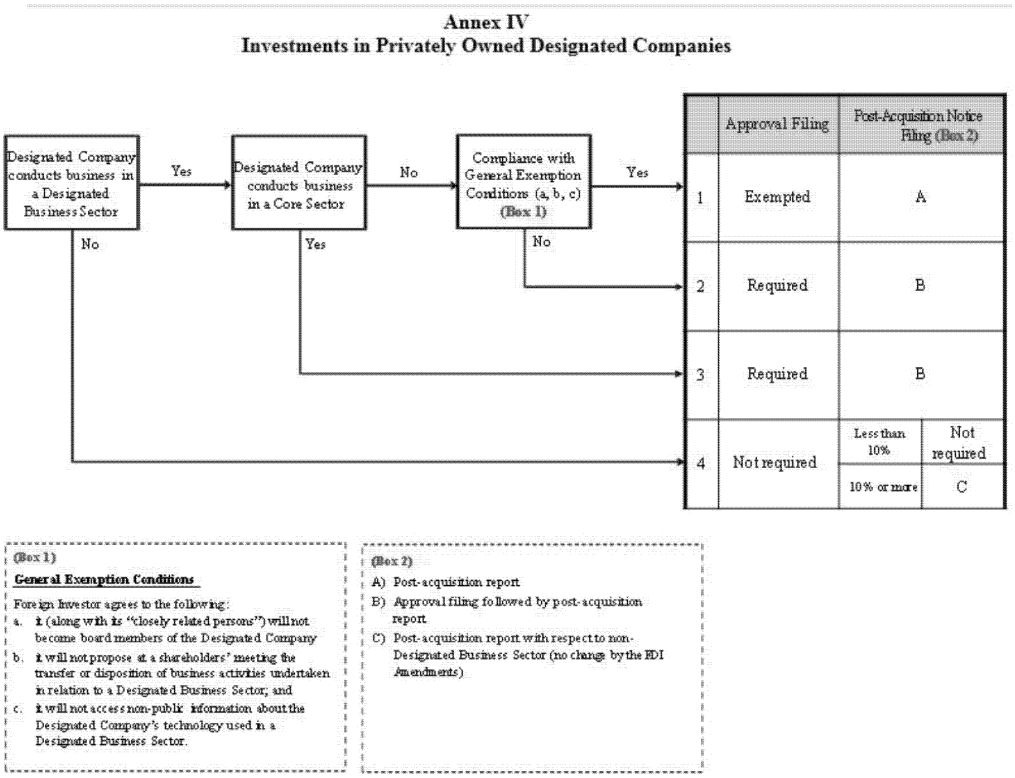
e. it will not make written proposals that require a response or action by a certain deadline to the board of directors of the Designated Company (or any member thereof) or any committee of the Designated Company regarding the business activities of a Core Sector.

(Box 3)

A) Post-acquisition report (1%/3%/10% rule)

B) Approval filing followed by post-acquisition report

C) Post-acquisition report with respect to non-Designated Business Sector (no change by the FDI Amendments)



REGULATORS AND M&A: TWO MONTHS INTO THE PANDEMIC

On May 29, 2020, ***The M&A Lawyer*** *spoke with Michael Knight and Michael Gleason, who are partners in the Washington, D.C. office of Jones Day, on the topic of antitrust and how dealings with the federal regulatory agencies have developed over the two months since the COVID-19 crisis began in the U.S.*

The M&A Lawyer*: First, what have the practical aspects been in terms of merger reviews? Have the agencies been able to fully perform their functions, given that most of their officials have been working remotely since mid-March?*

Michael Knight: While a few people at the federal antitrust agencies have been found in their offices on occasion, the vast majority are telecommuting and working remotely, so obviously instead of in-person meetings, we're doing calls and videoconferences a lot more. The FTC has set up an electronic procedure for HSR filings, and they have made it workable—it's the only way they are accepting filings right now. For the most part it's been a pretty smooth process.

Michael Gleason: We've continued to see the FTC and DOJ file cases and settle them, ask for divestitures, and proceed with litigation. That's to say that there's ample evidence that they continue to prosecute cases, that they're moving their investigations forward, and are doing what they've always done.

Knight: It has been amazing just how well we've been able to function, whether it's engaging with clients or the government agencies, without missing too much of a beat. It would have been much different even 10 years ago.

MAL*: What has this meant for deal timing—is it taking longer for approvals to get done?*

Knight: For the most part, the review process has been working very well and the agency staffs have been engaged and available. You do have to build in more time with both agencies, in order for them to make decisions that involve their front offices. It's harder for them to coordinate than it used to be. Sometimes things aren't as immediate.

There is an initial statutory review period of 30 days after an HSR filing. If the agencies cannot close their investigation in that period, the staff needs to know whether the parties plan to accept a second request (a large subpoena) or withdraw and refile their filing, giving the agency a second 30 day period. You used to have to tell staff four to five days in advance of that deadline. Now it's typically more like seven to nine days in advance. It's also harder for the agencies to reach all of the third parties whom they typically interview during this time period, and thus it's harder for the agency to accomplish what they need to do within the 30-day timeframe. So, on the margin, this increases the likelihood of receiving a second request—if the agency is on the fence at the end of the period, they may often believe that they need [a second request] because they have to protect the investigation.

Agency leadership has made public statements supporting this. For example, Commissioner Wilson of the FTC tweeted that when the agencies had previously faced government shutdowns [in the 2010s], they had continued to issue second requests, so essentially saying that 'if we can't get our investigations done [in time], we're going to issue a second request.' Other agency leaders have said that 'our standards for getting deals approved are not going to be lessened at all as a result of this crisis. Consumers need the protection of the antitrust laws.'

There have been important changes to timing on the "back end" of agency reviews. The agencies have made it clear that they're often going to need extra time. By statute, the agencies have 30 days (in most cases) after the merging parties comply with a second request to close their investigation, file litigation to block the transaction, or seek a remedy. If you get a second request, in exchange for modifying the burden [on merging companies], parties often enter into a timing agreement, which is an agreement between the merging parties and the agency not to close, and which provides the agency more time to complete its review. The DOJ and FTC both have added 30 days to the post-compliance period in their standard timing agreements. Merging parties need to take this change into account when negotiating the termination date in their transaction agreement.

Gleason*:* When you're negotiating a deal, you have to think about all the potentially related agencies that you may have to deal with. You might have a foreign direct investment filing (*e.g.*, CFIUS) or with certain merger control filings outside the U.S. need to produce certified copies of documents such as the articles of incorporation from a state agency. These can be real logistical challenges at times right now but can be overcome.

MAL: *Are the same types of delays happening in terms of divestitures?*

Knight: One thing worth mentioning with regard to divestitures: in transactions where divestitures are required, the agencies are stepping up their reviews of divestiture buyers. It is not entirely related to COVID, but they are trying to assess whether the potential buyer of the asset will not just be able to compete effectively, but be able to survive any downturns, including those related to COVID.

MAL*: Are some deals involving distressed companies being sold more aggressively as a "necessity" given that the seller is considered a failing firm, and are the agencies more open to that argument?*

Knight: We have seen some deals where the parties have told the agencies that what they said about the deteriorating condition of the seller last year is more true than ever because of COVID. But it's been more on the level of emphasis—I've yet to see anyone make that argument directly: that because of COVID, this seller is now a failing firm.

And the agencies have expressed some skepticism, noting that just because we're in a pandemic, parties shouldn't expect to get a free ride, even if the target is compromised financially. The same standards are going apply as usual. The FTC in particular can be very skeptical as to "failing firm" claims. You're going to have to prove there is no other option for these assets in the market and that they can't be rehabilitated.

MAL*: How has the overall US M&A market been recently? Have there been signs of movement after the "limbo" of the early pandemic weeks?*

Knight: For a while, M&A activity outside of distressed companies seemed somewhat suspended. However, more companies now appear to be starting to think more about the future. There have also been some deals that looked good at the end of last year but no longer look as good to the parties now. There have been recent public examples of parties deciding to terminate transactions in the face of agency opposition. Although it is hard to predict what would have happened, might those parties have extended the outside date or gone further in litigation without the crisis? At the margin, you might continue to see parties rethink their strategies: "do we want to extend our outside date in this transaction?" Some sellers may also be thinking they can't afford to wait, given everything that they're going through. Maybe it's best to break free of the deal and get back to saving their business.

For a while in mid-March, the FTC suspended granting early terminations of the HSR period. When we look at early terminations early on [in the pandemic] in early April, there were still 18-19 clearances being granted per week. Now it's gone down to the single digits. The decline likely reflects the overall decline in M&A volume—one FTC commissioner recently said that filings were down nearly 60%. There appear to be many fewer deals for this time of year, normally.

Gleason: My sense is that HSR filings are something of a lagging indicator, in that it takes a while just to get to a filing—first you've got to negotiate, you've got to come to terms before you file. So we might actually be at the trough of HSR filings, as it now reflects the general lack of new deals at the beginning of the pandemic.

MAL: *Has it been as delayed, regulatory wise,*

on the international front? Are there even greater lags in dealing with European competition regimes, for example?

Knight: From talking with my colleagues in Europe, there appears to be a somewhat similar situation in the EU. Some of the national regimes have suspended their filing deadlines and some have come back on line. The EU had discouraged parties from pushing transactions forward too quickly. But by and large, the system continues to work.

We've actually seen the least disruptions in China. China has made it a point that they remain open and are keeping matters on schedule, particularly for transactions that involve industries considered important relative to the pandemic—healthcare, food supply, and so on. They will give expedited review to any transactions in those fields.

CORPORATE M&A IN TIMES OF THE CORONA CRISIS: SPECIFIC CONSEQUENCES OF THE PANDEMIC FOR THE GERMAN TRANSACTION BUSINESS

By Lutz Englisch, Birgit Friedl, Marcus Geiss, Sonja Ruttmann and Dennis Seifarth

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The Impact of Insolvency Law on the M&A Transaction Business

The cross-sectoral economic effects of the Corona crisis are likely to lead to an increased number of transactions in the medium term where the seller or the target companies, but in certain cases also the purchaser, are operating under distress or the threat of impending insolvency. This trend should apply irrespective of the German Act on the Temporary Suspension of the Insolvency Filing Obligation and Liability Limitation of Corporate Body in cases of Insolvency caused by the COVID-19 Pandemic[1] ("COVInsAG") that recently entered into force.[2]

This kind of crisis scenario makes the initial planning and structuring of M&A transactions, as well as the later implementation thereof, particularly challenging for the parties: both sides are forced to make an informed risk assessment on a potential insolvency of their contract partner and/or the target involved and then settle on a structure that best prevents or mitigates such risk. The possible privileges accorded by the COVInsAG, if applicable, will be of particular interest to the parties. If the seller is in distress, the purchaser should, for instance, evaluate up front whether it might be preferable in terms of legal certainty to acquire the target in the framework of a "pre-packaged deal" in subsequent insolvency proceedings. To the extent, however, that either the seller and/or its main creditors do not consent to this approach, the purchaser is only left with the choice of either not proceeding with the desired transaction or trying to mitigate the risks of a later seller insolvency to the largest extent possible.

If German insolvency law is applicable to one of the contract parties, either due to the fact that

the "center of main interest" ("COMI"), which is used to determine the applicable insolvency law, is in Germany or because there would be an option of opening German secondary insolvency proceedings (*Sekundärinsolvenzverfahren*) on the basis of the parties' German operations, the contracting parties are, in particular, faced with two main risks triggered by a later insolvency: On the one hand, the insolvency administrator (or in case of debtor-in-possession proceedings, the insolvent contract party itself) could choose to reject the continued performance of the enterprise sale and transfer agreement ("Acquisition Agreement") if this mutual agreement at the time of the opening of insolvency proceedings has not yet been completely fulfilled by at least one of the two contract parties. On the other hand, the insolvency administrator might under certain circumstances decide to contest either the Acquisition Agreement itself and/or individual completion acts or actions thereunder.

Under both scenarios, the solvent counterparty (typically, the purchaser) could be faced with significant disadvantages including a near-total loss of its own performance actions already rendered (payment of purchase price) while, at the same time, either not receiving title and ownership in the target or facing a restitution and unraveling of an already occurred transfer of ownership.

Rejection Risk of Mutually Unfulfilled Contracts and Potential Safeguards

If insolvency proceedings are opened over the estate of a contract party (seller) at a time when the Acquisition Agreement has not yet been fully performed by, at least, one of its parties, the insolvency administrator is entitled to choose whether or not to continue to perform under the agreement (§§ 103 et seq. of the Insolvency Code (*Insolvenzordnung*—"InsO")). If the insolvency administrator elects non-performance and contract rejection, the mutual obligation not yet fully performed or satisfied become unenforceable. The counterclaims of the solvent contract party due to such non-performance become regular insolvency claims that must be filed to the insolvency table and which in the normal run of events are, thus, almost completely worthless in economic terms.

In the time period between the signing of the Acquisition Agreement and the closing there is significant potential for delays based on the customary closing conditions such as merger clearances(s) and other regulatory clearances, further required corporate steps such as board approvals and/or share transfer restrictions, necessary waivers of pre-emption rights, the change of the fiscal year or the termination of existing enterprise agreements (*Unternehmensverträgen*). Furthermore, there are many cases where the seller and the purchaser have agreed on ancillary agreements like transition services or license agreements between the seller and the target, the details of which are finally negotiated in the time window between the signing and the closing of the Acquisition Agreement. Such agreements are often a key component of the overall transaction but are also themselves subject to the risk of contract rejection by the insolvency administrator.

If the closing under the Acquisition Agreement has already taken place, *i.e.* the in rem transfer of title has occurred or, at least, the purchase price component owed at closing has already been paid, purchasers often feel they are on safe ground. However, since the assessment of the question whether a contract is indeed fully per-

formed and obligations have been completely satisfied does not only take into account the performance of the mutual primary obligations (*Hauptleistungspflicht*) of the parties, but also any currently open ancillary obligations (*Nebenpflicht*), it will, in practice, be very difficult in most relevant acquisitions to argue successfully that all relevant contract obligations of one party are already fully performed. This is even more so in pending, not yet fully performed transactions concluded in times prior to the Corona pandemic where the parties would in most cases not have had reason to dig deeper into potential insolvency-related issues.

There are a number of customary clauses that may end up acting as regular barriers against a successful argument of full performance of the Acquisition Agreement even if the closing has already taken place, including purchase price adjustment clauses, earn-out agreements or purchase price retention amounts aimed at securing possible breaches of representations and warranties. As far as asset deals are concerned, but sometimes also in share deals, where certain target entities are not all owned by one central holding company, certain individual transfer acts under applicable foreign laws are often deferred at the closing date, be it because local share certificates may yet have to be handed over under mandatory local laws or because the necessary registration of an asset or share transfer in a local jurisdictions has not yet been duly made with the competent authorities. To the extent mandatory third party consent to certain transfer steps is necessary (for example, for contract assumptions or transfers), the seller is also unable to argue that the complete fulfillment of all aspects of the agreement has already occurred. There, in addition, are typical other purchaser rights such as potential claims due to breaches of representations and warranties and/or indemnities or non-compete undertakings with time limitations of often several years, as well as obligations to release or replace seller securities granted by the seller for the benefit of the targets, which the insolvency administrator is likely to use as auxiliary considerations to support his argument that the Acquisition Agreement as such has not yet been completely satisfied by at least one of the parties.

In order to avoid or mitigate these risks, the following potential safeguards (which, of course, cannot be addressed comprehensively in this context) should be considered when negotiating future transaction documents with parties in distress.

The purchaser is particularly well-advised to document in scenarios where the seller has (urgent) liquidity needs or where the transaction could be viewed as a "fire-sale" that the purchase price negotiated and ultimately agreed on is a fair market price. Because the insolvency administrator will otherwise (be forced to) reject the continued performance of a mutually not yet fully fulfilled mutual contract if such contract is shown to be unduly disadvantageous. A competitive auction procedure or a fairness opinion may further militate against such decision by the insolvency administrator. The insolvency administrator may, furthermore, consider such contract rejection in asset deal scenarios based on the argument of individual creditors being unduly disadvantaged if the purchaser only assumes selective liabilities of the seller, because in a later insolvency it can be argued that such selective debt assumption unduly benefits creditors whose claims end up fully paid by the assuming purchaser to the detriment

of the remaining creditors of the insolvent seller who will only receive the far-lower insolvency quota on their claims which the purchaser chose not to assume.

To agree on specific insolvency-based contractual termination rights in favor of the purchaser in the time period between the signing and closing of the Acquisition Agreement in order to address a possible seller insolvency are very likely to be viewed as an impermissible circumvention of the insolvency administrator's contract rejection right. A contractual termination right of the purchaser based on a mere deterioration of the seller's financial position may, however, be feasible.

To reduce the time window between signing and closing as much as possible could be a tool to minimize or mitigate the risk of a (further) deterioration in the financial position of a party in distress. To the extent legally possible and depending on the individual bargaining power in each specific case, the purchaser could also try to negotiate weather or that certain legal steps and circumstances that usually become closing conditions or closing actions can already be implemented prior to the signing of the Acquisition Agreement.

The complete fulfillment of the contract by the purchaser can probably only be argued beyond material doubt if the purchaser pays a final one-off purchase price at closing without any additional purchase price adjustments or earn-out provisions being agreed on. As a tendency, a sale agreement with a locked-box mechanism would, therefore, appear to be the preferred choice in such crisis scenarios. From an insolvency-law perspective, it should also be considered to forfeit any attempts to negotiate purchase price retention amounts as a means of securing potential claims under representations and warranties or indemnities (even if such retention amounts are paid to an escrow account), because such structures also mean that the seller has not yet received the purchase price in full. An alternative worth exploring would be a directly enforceable bank guarantee (*selbstschuldnerische Bankbürgschaft*) or to take out W&I insurance to secure such claims of the purchaser.

With a view to avoiding multiple transfer acts at closing, a share deal will often be the preferred option to an asset deal. If the parties nevertheless opt for an asset deal, the corresponding transfer acts at closing should be prepared meticulously and in detail and should all be taken on or about the closing date. In the context of movable assets, the purchaser may acquire a strongly protected position already via a retention of title (*Eigentumsvorbehalt*) and regarding real estate may protect itself against contract rejection by way of a recorded priority notice (*Vormerkung*).[3] As far as acquiring rights (shares, IP, receivables) is concerned, no such expectant or inchoate rights worthy of protection (*schutzfähige Anwartschaftsrechte*) are granted in the context of the insolvency administrator's election right to perform or reject contracts.

In certain cases, the provisions in the Insolvency Code on already made partial performance[4] may also help the purchaser as such partial performance do not have to be restituted as a rule. For instance, if individual transfer measures regarding certain—usually non-essential—assets in a transaction remain pending, such partial performance may be argued to exist. It would follow that the insolvency administrator usually could not reclaim or unravel the already

transferred parts of the business solely based on his choice not to perform the outstanding contract as a whole. As far as business sales are concerned, such separate deal parts are, however, only assumed to exist if there is a separate partial business unit (*Teilbetrieb*) and the outstanding transfer act or implementation measure does not concern the "inseparable core business."

In cases where the conclusion of ancillary transition services agreements, license, lease or supply agreements with the insolvent seller is provided for in connection with the closing of the Acquisition Agreement, the purchaser should be aware that each of these agreements may, in turn, be subject to selective contract rejections rights of the insolvency administrator.

The solvent party is able to achieve legal certainty on the continued fate of the mutually unfulfilled agreement by formally requesting the insolvency administrator to exercise the corresponding election right.

At the end of the day, a comfortable safeguard against the risk of potential rejection of further contract performance by the insolvency administrator will only be realistic for the purchaser if the Acquisition Agreement contains a fixed purchase price based on a locked-box transaction which is settled in full at closing. Indemnities or claims for breaches of representations and warranties could, in addition, be secured by a directly enforceable bank guarantee (*selbstschuldnerische Bankbürgschaft*) or W&I insurance taken out by the purchaser.

Contestation Risk and Precautionary Steps

A further possible challenge to the existence and implementation of a business acquisition lies in the risk of a later insolvency contestation (*Insolvenzanfechtung*). If the relevant prerequisites are met, the insolvency administrator may contest the Acquisition Agreement itself and/or individual performance acts related thereto.[5] Under certain circumstances and if the contestation succeeds in the seller's insolvency, the purchaser may have to re-transfer the performance received by him (*i.e.*, the ownership of company assets or shares) back to the insolvent estate, while his corresponding repayment claim regarding the purchase price paid will normally only be a regular unsecured insolvency claim and, thus, be largely worthless in economic terms due to the low insolvency quota.

The contestation rights of the insolvency administrator are manifold. Under certain circumstances, however, the COVInsAG, which recently entered into force, may privilege the Acquisition Agreement and/or measures taken to implement it for a transitional period. In addition, certain general, precautionary measures are well-advised which will, at least, mitigate the risk of subsequent insolvency contestation.

Contestation of the Acquisition Agreement Itself

In the first instance, the new provisions of the COVInsAG which will be in force until September 30, 2020[6] aim at suspending the obligation to file for insolvency in spite of existing illiquidity caused by COVID-19 and privilege the conduct of the corporate bodies in such scenarios. From a contestation perspective, in particular, loan agreements which provide new liquidity are privileged and exempted from later contestation for a limited period of time. However, the new law stops short of expressly declaring all agreements contestation-proof which were concluded during

the period where the obligation to file for insolvency was suspended and which serve restructuring purposes. As far as the contestability of the Acquisition Agreement itself is concerned, the existing contestation rules are, therefore, likely to apply.

When structuring and drafting the Acquisition Agreement, it is, thus, of particular importance to prevent a potential later contestation of the Acquisition Agreement based on an argument that creditors are directly disadvantaged.[7] This contestation option exists if the disadvantage for creditors is directly caused by the Acquisition Agreement itself, the seller was illiquid at the time of the signing of the Acquisition Agreement and the purchaser knew of these circumstances, provided that the conclusion of the Acquisition Agreement occurred in a period three months prior to the filing for insolvency or after such filing. The argument that the purchase price was set below the threshold of the fair market value can be refuted by reference to a competitive auction process. Alternatively, a fairness opinion by an independent expert can be obtained. If the purchaser does, however, assume selected but not all of the seller's liabilities in an asset deal, a disadvantage for creditors in a later insolvency may already be seen in the fact that only the creditors of the assumed liabilities were fully satisfied by the purchaser, whereas the remaining creditors of the seller were left to settle for the much lower quota.

Any imputed knowledge of illiquidity can, in practice, be refuted by a positive confirmation of solvency in an analysis of the insolvency status prepared by an expert according to standard IDW S 11 (*Analyse der Insolvenzreife nach IDW S 11*). In certain cases, it may also be opportune to fix a closing date that is more than three months after the signing of the Acquisition Agreement. However, such approach runs contrary to the above suggested aim of quickly achieving full performance of the agreement in order to preempt the insolvency administrator' election right to either reject or continue to perform under a contract which is partly still unfulfilled by both parties.

The contestation of the Acquisition Agreement due to disadvantaging creditors with intent[8] in cases of impending illiquidity (*drohende Zahlungsunfähigkeit*) of the seller and seller's intention to disadvantage his creditors requires the purchaser to know of such circumstances. The purchaser can protect himself against such allegation by submitting an expert analysis of the insolvency status, which also covers impending illiquidity, as well as a restructuring expert opinion under standard IDW S 6, which concludes that the seller's restructuring efforts have a serious expectation of being successful.

Contestation of Closing Actions / Performance Measures

The newly enacted COVInsAG[9] generally declares performance acts which are congruent in terms of time and substance to be exempt from contestation for a transitional period until September 30, 2020,[10] unless the restructuring and refinancing efforts of the seller were unsuitable to remedy the crisis and the buyer knew about this. According to the wording, the privileged exemption applies without restrictions to all performance acts, *i.e.*, a restriction to performance acts related to credit agreements is not provided for in the new law. Having said that, the official legal justification of the new law (*Gesetzesbegründung*) reasons that the new provision is intended to protect the performance of existing

contracts with suppliers or under recurring long-term obligations against insolvency contestation rights, as the relevant counterparties would otherwise be forced to terminate the business or contractual relationship, which, in turn, would frustrate restructuring efforts. Even though there is not yet any indication for a prevailing opinion on the scope of this protection clause against contestation under the COVInsAG, there are good reasons to argue that it also covers performance actions under an Acquisition Agreement. The purchaser would, thus, be protected if he is able to submit an expert opinion on the restructuring of the company which considers a successful restructuring to be likely when taking into account the transaction proceeds.

If the privileged exemption under COVInsAG is held not to apply, the seller would again need to evidence that the seller was not illiquid at the closing date by submitting an expert analysis of the insolvency status to avoid a contestation risk under the header of contestation of congruent performance actions.[11]

When attempting to avoid a contestation under the header of intentionally disadvantaging creditors through performance acts that are congruent from a temporal and substantive perspective,[12] the solvent party may refute the allegation that actual illiquidity existed at the time the closing actions were taken by submitting an expert analysis on the insolvency status according to standard IDW S 11. The counterparty's imputed knowledge of a debtor's possible intent to disadvantage creditors presumed by law is likely rebutted as well, although this has not yet been confirmed by rulings of the highest court(s). An update as of closing of the expert restructuring opinion pursuant to standard IDW S 6 already obtained at signing should eliminate any remaining grounds for the insolvency administrator to justify a contestation based on intent.

Furthermore, if the purchaser succeeds in structuring the performance of the agreement as a so-called "cash deal,"[13] the contestation rights of the insolvency administrator to challenge performance actions are excluded per se, with the exception of disadvantaging creditors with intent.[14] In order to qualify a transaction as a cash deal, the parties must exchange performances of equivalent worth directly, *i.e.*, in close temporal proximity. Since the exchanged performance must be objectively of equivalent value, absolute deal certainty can ultimately only be obtained by way of a valuation expert opinion. However, a competitive auction process or, if applicable, a fairness opinion might also provide meaningful indications in this regard.

The necessary temporal link permits staggered closing actions or implementation steps only to a very limited extent, even though strictly simultaneous performance (*Zug-um-Zug*) is not mandatory but recommended. Purchase price retention amounts to secure potential claims for breaches of representations and warranties, purchase price adjustment clauses and, especially, earn-out provisions should be avoided. If the purchaser wants to agree on and implement a "cash deal" within the meaning of insolvency law, he should, as a precaution, also consider not to include a conditional assignment of share title already in the Acquisition Agreement.

Finally, specific issues arise if the seller also concludes further ancillary agreements either with the purchaser or the target at the closing, such as lease or tenure agreements (*Miet-oder Pachtverträge*), license agreements, supply

agreements, transitional services agreements or the like, which, in turn, are subject to separate contestation rights.

Unlike in the case of the insolvency administrator's election right to either reject or continue to perform under pending contracts, the insolvency administrator cannot be forced into a timely decision on his potential contestation right. This causes considerable uncertainty for the purchaser (whilst giving the insolvency administrator strong leverage in negotiations) since the contestation right is only limited by the regular three year time limitation period under German law.

In summary, reducing the risk of possible subsequent contestation requires some effort on the part of the purchaser. In addition to a fairness opinion and an expert analysis of the insolvency status, a restructuring expert opinion in accordance with standard IDW S 6 may also be well-advised, but the purchaser will have to rely on the cooperation of the seller in this regard. The respective mutual performance actions should, in an ideal case, be agreed upon and implemented as a cash deal with a simultaneous exchange of performance actions. At least on a literal reading of the wording, the purchaser could also rely on COVInsAG to make performance actions taken during the transitional period contestation-proof if a positive expert restructuring opinion exists.

COVID-19 and M&A Transactions in Germany

Whereas the start of 2020 was still characterized by lively M&A activities, the German market was taken by surprise in March by the speed and massive impact of the COVID-19 pandemic. For the majority of investors and companies, measures to stabilize sales and liquidity were and are still the focus of attention.

In this situation, a share purchase agreement (the "Acquisition Agreement") already signed but not yet closed may represent a welcome influx of liquidity for the seller, while the same agreement may now be viewed as a drain on liquidity by the buyer which might no longer be welcome. Various contractual and legal provisions may play a role in this dilemma, which are outlined below and may also serve as guidelines for negotiations of Acquisition Agreements in the near future.

Termination Clauses

The respective Acquisition Agreement usually provides for a termination provision which, in principle, allows both parties to terminate the agreement if the transaction has not been completed (closing) by a certain long stop date. Also, further provisions, which frequently are agreed and allow unilateral termination before the long stop date has occurred, usually require that the closing has become impossible due to the definitive frustration of a closing condition. Not least because deal certainty is regularly a priority for both parties to an Acquisition Agreement, it seems fair to expect that in German transactions a general right of termination or a termination due to the effects of COVID-19 can only in rare cases be based on the agreed upon regular termination provisions. However, even if the conditions for terminating the Acquisition Agreement are met, the actual exercise of this right will require careful review of whether such termination would, in turn, result in an obligation to pay any pre-agreed contractual penalties, break-up fees or damages to the counterparty.

Specific Closing Conditions: Merger Clearance and Material Adverse Change

(i) Merger Clearance. If a contractual termination right in the Acquisition Agreement is tied to the failure of closing occurring within a certain agreed-upon timeframe, the necessary analysis must consider, first and foremost, the specific closing conditions agreed in each individual case. One of the key closing conditions in this context regularly is obtaining merger clearance by the specifically named anti-trust authorities. The impact of the COVID-19 pandemic on the work of these anti-trust authorities varies greatly from jurisdiction to jurisdiction.[15] In the case of M&A transactions that have been signed but have not yet closed, the contract parties would, thus, be well-advised to examine in each case whether the originally envisaged time frame is (still) sufficient, whether and which complications and delays are possible and what measures could or even must be taken to further ongoing proceedings. Where appropriate, it is recommended to enter into timely discussions on the potential adjustment of the long stop date.

If no amicable agreement can be reached in this respect, further questions under contract law could arise. This is so because, irrespective of any potential statutory obligations to adjust or modify the contract (see below *Statutory Provisions on the Refusal to Perform or the Adaptation of the Agreement)*, there may be contractual provisions in the Acquisition Agreement which could conceivably result in an obligation of a contracting party to agree to an adjustment of the contract. In practice, there are some cases, for instance, where a general mutual obligation to cooperate and facilitate the closing is included in the Acquisition Agreement or the severability clause provides for an obligation to agree on a fair commercial solution if unforeseen or unforeseeable contractual gaps or omissions later become apparent. Whether such provisions indeed lead to a contractual adjustment obligation of a contracting party can only be assessed on the basis of the individual provision in the relevant Acquisition Agreements.

(ii) Material Adverse Change. Another contractual provision in the Acquisition Agreement, which may lead to either a contract adjustment, potential compensation payments or even to the termination of the Acquisition Agreement, depending on the substance of the clause in question, are so-called Material Adverse Effect (MAE) or Material Adverse Change (MAC) clauses. Essentially, these are clauses which—if agreed as a closing condition or as a right of rescission—provide for a closing reservation to address the occurrence of unforeseen, material adverse developments of the target company's business (so-called Business or Target MAC) between signing and closing, or, less frequently, with regard to the industry in which the target company operates (so-called Market MAC), which have a value-diminishing long-term impact on the target company. If such an adverse development occurs or exists, the purchaser does not have to close or complete the transaction.

Under the seller-friendly M&A market conditions prevalent in recent years, the inclusion of such clauses in German transactions has become more rare. However, if the Acquisition Agreement contains a MAC clause, the issue of its interpretation will likely come more into focus now. Whether the COVID-19 pandemic and its consequences actually constitute a material adverse change event must be carefully determined

on the basis of the specifically agreed clause and the details and spheres of knowledge of the parties at the time of entering into the Acquisition Agreement. Even if the MAC clause does not contain any specific wording regarding the inclusion or exclusion of epidemics or pandemics, this is only the starting point for such an analysis.

In a second step, the agreed-upon exclusions then need to be assessed. In particular, it may be required to clarify whether the frequently used exclusion of general or industry-specific negative market developments is applicable here, and then again whether there might be a counter-exception in case the target company is disproportionately affected by these developments.

A further issue that needs reviewing in the specific MAC clause is the exact reference point in time for, and probability threshold of, the MAC event occurring. There will also be cases where—depending on the industry—certain adverse effects are (partly) becoming apparent already now, but have not yet (fully) materialized. In such scenarios, the outcome will depend on whether the wording of the clause only covers disadvantages that have already occurred or also—already foreseeable—future consequences.

It is also crucial by which criteria the materiality of an event is to be measured. In some cases, the parties agree on specific thresholds (*e.g.*, a reduction of EBITDA by x%). If such materiality criterion is not defined in greater detail, this must be assessed by interpreting the agreement with specific focus on the target company.

Finally, even if a MAC event has occurred, the contractual consequences provided for in the agreement must be clarified. Withdrawal from the Acquisition Agreement or a refusal to close the deal may only be the ultima ratio. It would also be conceivable to negotiate in good faith on the adaptation of the Acquisition Agreement to the changed commercial circumstances.

Statutory Provisions on the Refusal to Perform or the Adaptation of the Agreement

The issue whether the parties to an Acquisition Agreement may also rely on the statutory provisions in view of the COVID-19 pandemic is likely to be a matter of increasing activity for (arbitration) tribunals in the near future: In particular, the legal instruments in the event of a disruption to the basis of the transaction (*Störung der Geschäftsgrundlage*) pursuant to § 313 of the German Civil Code (*Bürgerliches Gesetzbuch*—"BGB") are likely to be at the forefront. These rules allow the adaptation of the contract or, in case of impossibility or unreasonableness of such adaptation, the rescission of the contract, if the parties' mutual conceptions on which the agreement was based have changed to such an extent that one party cannot reasonably be expected to adhere to the unchanged contract. With the COVID-19 pandemic, the various restrictive governmental measures to combat the spread of the virus, but also, in turn, specific governmental stabilization and support measures and, in many cases, the grave effects thereof on the business of the target company, its profitability and the assumptions in the business plan, may be seen, at a first glance, as such momentous changes arising from the COVID-19 pandemic without either of the parties having been in a position to foresee such impact or be held responsible for the consequences. However, even if the manifold economic effects resulting from the outbreak of the pandemic seem to be a textbook example of a disruption of the contractual performance obliga-

tions, the legal significance of such disruption must be analyzed in a differentiated manner and on the basis of the specific contractual agreements.

In the Acquisition Agreement, the parties often agree on specific comprehensive exclusions of the statutory provisions, which may in certain cases also include the—generally negotiable—provision in § 313 BGB. However, even if such an exclusion is not expressly provided for, it may, for example, follow from a past effective date, on which the (economic) transfer of risk is deemed to occur, that any risks which materialize after such date have to be borne by the purchaser. The conclusion may be similar in the case of a MAC clause contained in the Acquisition Agreement. As specific expression of the intentions of the parties, such concrete agreements must, in principle, be given priority and can, as a specifically agreed contractual allocation of risk, override or exclude the application of § 313 BGB even for unforeseen circumstances. All of this does not *per se* exclude a possible adjustment of the contract due to disruption of the basis of the transaction, as any contractual provision (including an exclusion) could also have been affected by the parties' underlying fundamental misconceptions. In any case, however, the hurdles to be overcome would then be significantly higher and require a comprehensive evaluation of the wording and spirit of the Acquisition Agreement.

If these initial hurdles can be overcome, the second step is to examine whether there has been, taking into account the circumstances of the individual case, such a momentous change in the parties' underlying conceptions of the agreement that adherence to the contract would be unreasonable. Here, similar considerations will then play a role as discussed above when assessing the application and interpretation of MAC clauses, *i.e.*, what did the parties know at the time of signing the Acquisition Agreement, do the contractual provisions as agreed entail a certain allocation of risk between the parties, how significant are the changes for the subject matter of the contract and how significant would the consequences of an application of § 313 BGB be for the parties.

To make matters worse, there is another major factor of uncertainty: It is currently completely unclear how COVID-19 and its consequences will pan out (internationally) in purely factual terms. The length of the restrictions in the individual countries, possible further waves of outbreaks, economic catch-up effects, government support and economic stimulus programs and the concrete effects on the respective target companies—these and many other aspects will only reveal themselves fully in the future. In any case, the individual allocation of risk between the parties of future Acquisition Agreements is likely to play a greater role again in the respective contract negotiations going forward—also with a view to possible further COVID-19 "waves."

Purchase Price Mechanics and Evaluation Matters

When predicting the development of the M&A market in the near and medium term future, COVID-19 and the economic effects of the pandemic will be one of the central issues in determining the value of a company and, thus, also the purchase price. The discussions are likely to focus on the question whether the fair enterprise value can be justified on the basis of normalized EBITDA, taking into account or excluding the

effects of the COVID-19 pandemic, among other things. However, this is also likely to play a major role in the case of already concluded Acquisition Agreements with earn-out or staggered payment regulations or in connection with management incentive schemes or bonus arrangements. In these cases, EBITDA is also regularly used as a benchmark and specific rules are agreed on to determine it.

With regard to the two main approaches for determining the purchase price, the following considerations are fundamental: If the parties have agreed on a so-called fixed purchase price (locked-box approach), this should basically be exactly that, a definitive purchase price which is typically not subject to any later adjustment. The purchase price is determined by reference to an economic reference date and the risk of changes in value transfers to the purchaser on such date. In principle, there is no mechanism for some kind of value clarification regarding the underlying valuation assumptions. Instead, the purchaser is protected against changes in value after the reference date until the closing date by means of positive and negative covenants and guarantees (ring-fencing), which are essentially related to the conduct of the business in the ordinary course.

As far as variable purchase prices are concerned, there are ultimately many different approaches to agreeing such a variable purchase price. In the first instance, the reference values agreed on by the parties for determining the purchase price and the influence of the COVID-19 pandemic on these values must be taken into account. Under the so-called closing accounts method, which is often used in German transactions in this regard, the parties generally agree on a fixed enterprise value, which is typically not subject to adjustments. Only the reconciliation bridge to the equity value is based on a subsequent adjustment of cash, debt and (normalized) working capital positions in the so-called closing accounts prepared by reference to the agreed economic effective date. It follows that COVID-19 effects are therefore only recorded under this method to the extent that they affect the aforementioned reference values. The extent to which changes are then to be reflected depends on the principles laid down for the preparation of the closing date accounts (including the degree to which any value-adjusting facts are taken into account), it being understood that the parties regulate the granularity of these principles to varying degrees. A particularly thorough and careful assessment of the provisions in the Acquisition Agreement is required in this regard, which should not only include the necessary legal analysis but also cover the commercial and economic evaluation and accounting methods to be applied.

The questions raised in this context are also likely to feature prominently when interpreting agreed clauses on purchase price components payable only in the future, as in the case of earn-outs or other staggered payment arrangements, if these are related to key company benchmark figures (and not, for example, to the realization of future minimum exit sale proceeds). Here, too, the payment of the additional purchase price components is linked to certain economic reference values, the determination of which is governed by the individual agreement regarding the applicable (accounting) provisions. The parties would, therefore, be well-advised also with regard to already existing earn-out regimes to monitor the likely effects of the COVID-19 pandemic on the company's key benchmark figures at this early stage and consider their

evaluation impact and suitable accounting treatment as well as their potential scope for maneuver under the specific, individually agreed upon provisions.

W&I Insurance in Times of COVID-19

Among the consequences of the COVID-19 pandemic have been certain new trends and challenges in the private equity and M&A arena, including W&I insurances. Even though there are no current indications that W&I insurances will generally become unavailable in transactions, COVID-19 certainly has an influence on the insurer's risk assessments and the details of the insurance policies that are on offer.

Potential Impact of COVID-19 on the Future Scope of W&I Insurance

At the moment, there is no market trend that insurers are generally re-considering the scope of the guarantees and representations and warranties that can be insured. Having said that, to insure certain, previously customary and coverable representations and warranties in new policies not concluded prior to the occurrence of the COVID-19 pandemic will now and in future be subject to a more detailed insurance assessment (see below) regarding the consequences for the underwriting process. This, in particular, concerns guarantees which are related to a contractually defined reference or balance sheet date and the absence of material disadvantageous deteriorations regarding the target entities or their business operations since then, as well as guarantees that refer to an adequate level of insurance coverage of the sold business operations—it being understood, for instance, that, depending on the business model, the question whether and under which circumstances a particular business interruption insurance policy provides "adequate" insurance coverage may well have been affected and modified by the COVID-19 pandemic. A further focus is likely to be on guarantees regarding compliance with all (material) laws and regulations, in particular on health and safety, and on customer and supplier relationships. With a view to the scope of damages covered, several insurers currently exclude any and all damages that are caused by and arise from the pandemic in their entirety. Other insurers are willing not to insist on such a blanket exclusion of damages and negotiate modified, specifically defined and tailored damage exclusions. This means that in these Corona times the selection of the W&I insurer and the ensuing negotiation of the actual W&I policy have gained added practical relevance and are more important than ever before, especially since the contractual provisions agreed on in the transaction documentation with the purchaser might in many cases allow recourse to the seller for certain uninsurable risks.

Impact on the Underwriting Process

It is nothing new that the insurers have always put special emphasis on the topics most critical for the insurance's potential liability during the underwriting process. If the purchaser's due diligence exercise on such specific risk topics is not sufficiently thorough from an insurer's perspective, the policy will usually contain corresponding exclusions of insurance coverage. Furthermore, an exclusion from insurance coverage of all known problematic issues and risks, which had been identified in the course of the due diligence process by the purchaser or which arose and were identified in the time window between the signing and the closing of the transaction, was customary in the past already.

Currently, this conclusion is of particular and increased relevance for the potential impact and consequences of the COVID-19 crisis on the business operations of a company undergoing a sales process and the corresponding catalogue of guarantees contained in the sale and transfer agreement: It depends on the nature of the business sector and the industry of the sold business how strict the insurer's parameters for this evaluation will be and whether they may differ to a significant degree—reflecting the fact that not all enterprises are affected by the current crisis in the same manner, relative to the nature and structure of their business, their geographic footprint, potential interdependencies in their production procedures and supply chain, the consequences of the pandemic for their customers, suppliers and staff, and, of course, the existence of any liquidity or balance sheet reserves and buffers. As far as (material) customer and supply agreements are concerned, it is especially pertinent whether such contracts—based on the respective applicable law—may be terminated or modified based on force majeure or an undue change of the underlying common commercial understanding of the parties (*Änderung der Geschäftsgrundlage*) or whether there may, at least, be a (temporary) defense of withholding or delaying performance (*Leistungsverweigerungsrecht*). Another point of special importance for the insurers is the question how the parties deal in the transaction documentation with the particular further transaction risks potentially triggered by the COVID-19 crisis in the time between signing and closing, *e.g.*, by way of relevant closing conditions, specific termination rights prior to closing or the inclusion of a specially-tailored MAC clause. We are under the general impression that the insurers have a current market expectation that the parties should normally agree on express provisions in their sale and transfer agreements dealing with the potential COVID-19 risks. This means that the insured party should therefore examine and assess the impact and consequences of COVID-19 on the business operations of the target extra-thoroughly and with specific care to put themselves in a position where they can negotiate with the insurer on a solid factual basis on a successful, moderate exclusion of such risks rather than being hit with a blanket exclusion of all COVID-19-related risks.

Special Case: Occurrence of the Pandemic between Signing and Closing

The above considerations apply to those cases where the negotiation and conclusion of the insurance policy and its terms are completed subsequent to the occurrence of the COVID-19 pandemic. The second, also practically relevant scenario concerns cases where the signing of the transaction (and, thus, the insurance policy) predate COVID-19 but the closing only occurs thereafter. W&I insurances regularly provide for the disclosure of new facts and circumstances, which arose in the time period between signing and closing and which result in breaches of guarantees and representations and warranties, and then exclude them from insurance coverage, at least, for such guarantees which are repeated at closing (so-called bring-down). The details and scope of such additional disclosure is, in particular, stipulated in the insurance policy negotiated between the insurer and the insured party and is normally limited to facts and circumstances occurring between signing and closing which would result in a breach of a guarantee as of the closing date had they been left undisclosed. Irrespective

of such underlying contractual agreement, however, certain insurers have already requested blanket disclosure of all abstract consequences of COVID-19 for the transaction and have asked for a description of the concrete measures the target has taken in order to mitigate the impact of the pandemic or the purchaser's assessment of the changed business case of the target entities or have enquired whether the parties may have settled on modified transaction parameters to address the crisis. Normally, such questions are likely designed to allow an argument that the corresponding consequences and adaptations identified can then be excluded from coverage as a disclosed known risk. The parties should therefore take the utmost care to limit such disclosure in terms of its content and scope strictly to the contractually agreed degree and not make any further-reaching, sweeping written or oral generalizations on the target entities or the transaction vis-à-vis the insurer so that their W&I policy is not compromised unduly. However, the insured party must, in turn, also take care that it does not fall short in fulfilling its contractually agreed disclosure and information obligations, because a breach of such obligations could also result in a loss of insurance coverage.

Outlook

COVID-19 places new and difficult challenges and demands on both the insurers and the insured party when it comes to structuring M&A procedures and developing tailor-made, risk-appropriate W&I solutions. It nevertheless is to be expected that the W&I insurance will continue to remain a practical and valuable tool for the purchaser to ensure adequate coverage for damages caused by breaches of contractual guarantees or representations and warranties—irrespective of their bargaining power in the sales process and the solvency position of the seller. Taking into account the expected shift of the M&A markets towards an even more buyer-friendly market climate, potential purchasers will be well-advised to evaluate the suitable liability recourse structure for the time after closing (*e.g.*, seller's liability, W&I insurance or a mixture of both) with particular emphasis in each individual case on the potential exclusions of insurance coverage that can be expected under new W&I policies. There is, at least, some good news in the short term for the potential insured party, however, in that the current decrease in the number of M&A transactions during times of crisis could easily result in a trend towards lower insurance premiums in the immediate short term.

ENDNOTES:

[1]*Gesetz zur vorübergehenden Aussetzung der Insolvenzantragspflicht und zur Begrenzung der Organhaftung bei einer durch die COVID-19-Pandemie bedingten Insolvenz.*

[2]In this context, also *see*: https://www.gibsondunn.com/whatever-it-takes-german-parliament-passes-far-reaching-legal-measures-in-response-to-the-covid-19-pandemic/, under section II.2, as well as with further analysis in this regard https://www.gibsondunn.com/european-and-german-programs-counteracting-liquidity-shortfalls-and-relaxations-in-german-insolvency-law/.

[3]*See* §§ 106, 107 InsO.

[4]§ 105 InsO.

[5]§§ 129 et seq. InsO.

[6]The temporal application of these provisions may be extended by way of governmental regulation until March 31, 2021.

[7]§ 132 InsO.

[8]§ 133 InsO.

[9]§ 2 para. 1 no. 4.

[10]Regarding the potential extension option, please *see* endnote 6 above.

[11]§ 130 InsO—*Kongruenzanfechtung von Erfüllungshandlungen*.

[12]§ 133 para. 3 InsO—*Anfechtung wegen vorsätzlicher Benachteiligung durch inhaltlich und zeitlich kongruente Erfüllungshandlungen*.

[13]§ 142 InsO—*Bargeschäft*.

[14]§ 133 para. 3 InsO.

[15]Reference is again made to: https://www.gibsondunn.com/corporate-ma-in-times-of-the-corona-crisis-current-legal-developments-for-german-business/, *see* Section 4 (Anti-Trust and Merger Control in Times of COVID-19), available in German and in English.

2019 YEAR END ACTIVISM UPDATE

By Barbara L. Becker, Richard J. Birns, Eduardo Gallardo, Saee Muzumdar and Daniel S. Alterbaum

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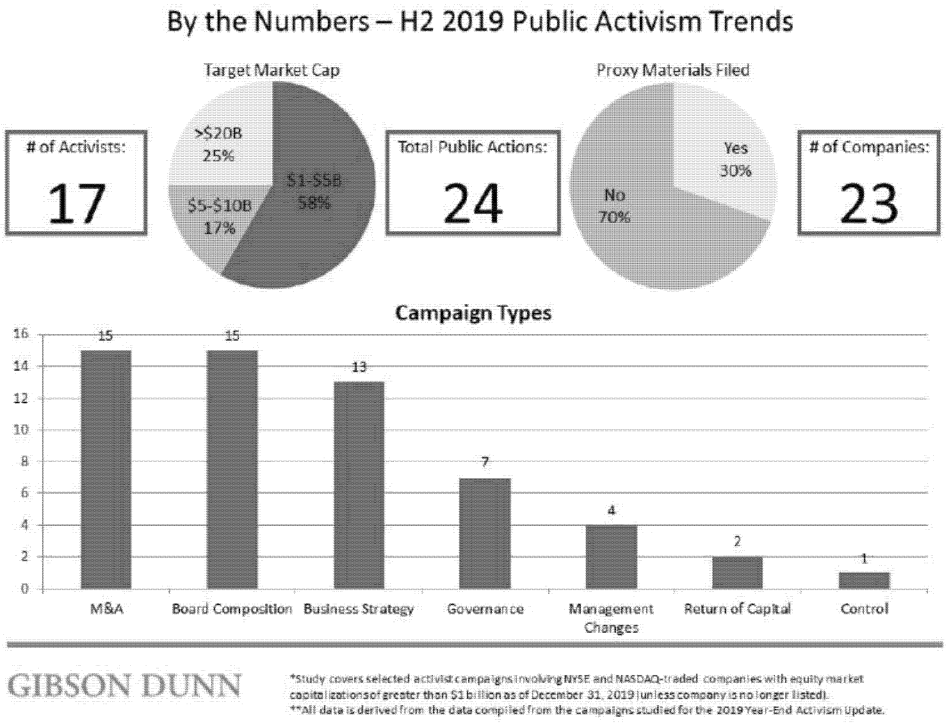
This article provides an update on shareholder activism activity involving NYSE- and Nasdaq-listed companies with equity market capitalizations in excess of $1 billion and below $100 billion (as of the last date of trading in 2019) during the second half of 2019. Announced shareholder activist activity declined relative to the second half of 2018. The number of public activist actions (24 vs. 40), activist investors taking actions (17 vs. 29) and companies targeted by such actions (23 vs. 34) each decreased substantially. The slowdown was in contrast to the first half of 2019, during which period shareholder activism activity was robust. On a full-year basis, however, 2019 represented a slowdown in activism versus 2018, as reflected in the number of public activist actions (75 vs. 98), activist investors taking actions (49 vs. 65) and companies targeted by such actions (64 vs. 82).

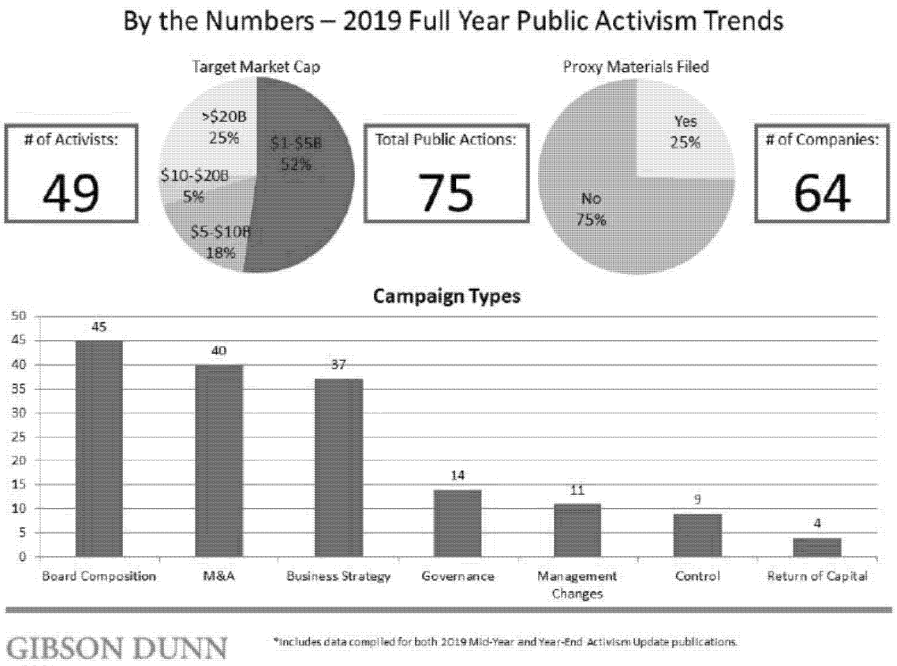
Despite the overall decline in shareholder activism activity, certain trends continued unabated. During the period spanning July 1, 2019 to December 31, 2019, two of the 23 companies targeted by activists—Instructure, Inc. and Occidental Petroleum Corporation—were the subject of multiple campaigns. The activism campaign launched by activist Carl Icahn against Occidental Petroleum Corporation was supported by activist Krupa Global Investments. In addition, certain activists launched multiple campaigns during the second half of 2019: Carl Icahn, Elliott Management, Land & Buildings, Sachem Head Capital Management and Starboard Value. These five activists represented 42% of the total public activist actions that began during the second half of 2019.

By the Numbers—H2 2019 Public Activism Trends



The rationales for activist campaigns during the second half of 2019 remained consistent with those in the first half of 2019. Over both periods, M&A, board composition and business strategy represented the most frequent rationales animating shareholder activism campaigns. These three rationales collectively reflected approximately 75% of activism campaigns during each time period (noting that many campaigns have multiple rationales), with other rationales (governance, management changes, return of capital and change of control) representing the minority. M&A (which includes advocacy for or against spin-offs, acquisitions and sales) and board composition were each a motivator for activist activity in the case of 63% of campaigns (as compared to 55% and 67%, respectively, in the first half of 2019). M&A and board composition were followed by business strategy (54% of campaigns, as compared to 51% in the first half of 2019). On the other hand, advocacy for changes in governance (29% of campaigns in the second half of 2019), managerial changes (17% of campaigns), return of capital (8% of campaigns) and attempts to take corporate control (4% of campaigns) represented less frequently cited rationales for activist campaigns. Proxy solicitation occurred in 29% of the campaigns, representing a significant increase relative to the first half of 2019, in which 15% of campaigns featured activists filing proxy materials. (Note that the above-referenced percentages total over 100%, as certain activist campaigns had multiple rationales.)

By the Numbers—2019 Full-Year Public Activism Trends



The diminution in shareholder activism activity brought with it a decline in publicly filed settlement agreements. Only five such settlements were filed during the review period, which is the lowest number observed for a half-year-period since 2014. Those settlement agreements that were filed had many of the same features noted in prior reviews, however, including voting agreements and standstill periods as well as non-disparagement covenants and minimum and/or maximum share ownership covenants. Expense reimbursement provisions were included in approximately half of those agreements reviewed, which is consistent with historical trends. Additional data and detail are provided in the longer version of this piece on Gibson Dunn's website at: https://www.gibsondunn.com/wp-content/uploads/2020/05/2019-Year-End-Activism-Update-May2020.pdf.

By the Numbers—Trends in Settlement Agreements (2014—2019)

H2 2019 Board Representation Analysis

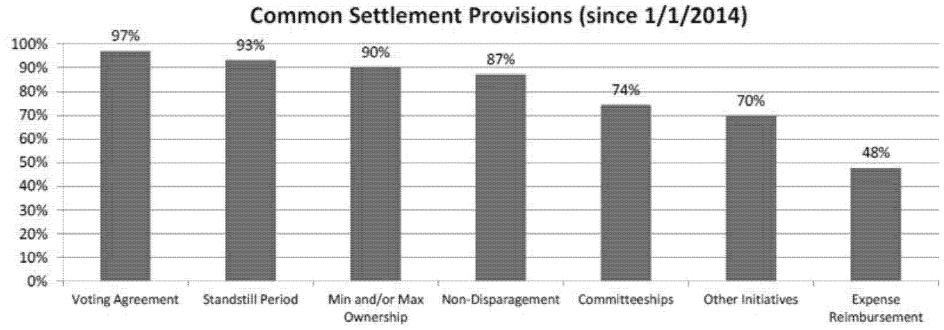
Category	Average
Board Seats Granted	1.4
Total Board Size*	11.4
Percent of Board*	12.3%

*Following settlement agreement

2014-H2 2019 Board Representation Analysis

Category	Average
Board Seats Granted	2.1
Total Board Size*	11.0
Percent of Board*	19.3%

*Following settlement agreement



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*All data represented here is derived from the data compiled from the campaigns studied for Activism Update and includes 12 agreements filed in 2014, 22 agreements filed in 2015, 30 agreements filed in 2016, 16 agreements filed in 2017, 30 agreements filed in 2018 and 22 agreements filed through H2 2019.

Though not discussed here, early indications suggest that the COVID-19 pandemic has caused a decline in shareholder activism activity during the first half of 2020. However, some activists may see opportunities in market dislocation to increase pressure on certain targets and/or to increase their positions in certain companies opportunistically. These trends may be borne out in both the types of targets on which activists focus as well as in the rationales for the campaigns that activists launch. Gibson Dunn will analyze these trends in detail in a future shareholder activism update.

FROM THE EDITOR

Forecast: Cloudy, With a Chance of Sun or Rain

More than three months into the COVID-19 pandemic and the economic chaos that the international lockdowns have caused, much of the M&A market remains in the same state of suspension that it's been in since the lockdowns began. As of late May, M&A deal volume year-to-date was down roughly 43% compared to the same period in 2019. In particular, mega-deals (those over $10 billion) unsurprisingly have been scarce, with mega-deal volume nearly three-quarters less in mid-May 2020 than it was in the same period the year before.

And the deal cancellations continue to pile up. In early May, the U.S. payments company Wex said it would pull out of a $1.7 billion deal to purchase eNett International and Optal, two British companies in the travel and business-to-business payments sector. Wex is reportedly looking to claim a material adverse event on its sellers' business to get it off the hook. But this might be a challenge, as sellers have argued the deal agreement dates from late January 2020, when the coronavirus was already of public concern, and that language in the MAE clause explicitly excludes a pandemic.

Indeed, private equity looks to be the kingmaker in M&A during the COVID period. Along with being notable participants in the deals that have managed to come to market, private equity firms are conducting more management buyouts, the volume of which is up slightly year-over-year. For distressed companies and companies hit hard by the pandemic, private equity investors have often been a financial lifeline, with some firms making more, and more substantial stake purchases at discount prices.

There are other signs of life, offering hints of an M&A market that might return to some semblance of normalcy in the summer, should pandemic infection rates continue to decline and states keep reopening. As per an interview with Jones Day antitrust lawyers elsewhere in this issue, the Department of Justice and the Federal Trade Commission have managed to keep deal reviews running smoothly, if at a slower pace.

By the time *The M&A Lawyer* returns in August, we should have a better sense of whether COVID is a short-term or longer-term phenomenon, and if the M&A market has revived or still remains cautious. We hope that our readers remain healthy and safe—please have a good early summer.

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