GIBSON DUNN

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CRAFTING EFFECTIVE DISPUTE RESOLUTION PROVISIONS IN M&A AGREEMENTS

M&A agreements often include procedures to be employed in the event of a dispute between the parties. The purpose of these provisions is to provide an efficient and effective means to resolve disputes without resorting to time-consuming and expensive litigation. However, these provisions may not accomplish their aim if M&A practitioners overlook some common pitfalls. In this edition of the M&A Report, we tackle two common dispute resolution provisions – arbitration clauses and dispute resolution provisions in purchase price adjustment clauses – in an effort to assist counsel in crafting dispute resolution provisions that provide a workable framework for resolving disputes outside the courthouse.

In addition, in this report we provide our latest intelligence on hot-button private M&A negotiating issues, an overview of shareholder activism in the retail sector and a report on M&A developments in China. We hope your 2014 is off to a happy and productive start, and we look forward to assisting you in the year ahead. Best wishes for a New Year filled with great deals!

DRAFTING ARBITRATION CLAUSES TO REDUCE LITIGATION

Parties in an M&A transaction may agree to arbitrate disputes arising under the agreements governing the transaction. But these arbitration clauses, although included to avoid litigation, sometimes lead to significant litigation. This article addresses various tactics that contracting parties can use to avoid such litigation.

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Take Control of the Clause(s)

Once the M&A parties agree to arbitrate claims, there is often a sense that negotiations regarding conflict resolution are complete. It is then left to the attorneys to find an off-the-shelf arbitration clause. The clause could be a generic clause proposed by an arbitral institution, or a more robust clause taken from one of the parties' prior contracts. Much of the litigation surrounding arbitration clauses could be avoided, however, if the parties would take the same care with the arbitration agreements as they do with substantive deal provisions. Considering the future expense that can result from an ill-suited arbitration clause, the parties should consider negotiating the following provisions up front.

- *Limits of arbitrability*. If only certain matters will be arbitrated, make that clear. The more clearly the parties define these limits, the less likely they are to be mired in litigation over the subject matter jurisdiction of an arbitrator or, in extreme cases, the validity of the arbitration agreement itself.[1]
- *Arbitral institution and arbitration location or seat*. These matters are as important to arbitration clauses as choice of law and forum selection clauses are for litigation clauses.
- *Substantive law*. Incorporate by reference the agreement's choice of law clause.
- *Entry of judgment*. The Federal Arbitration Act mandates that if parties agree that a judgment of a U.S. federal court will be entered pursuant to an arbitration award, and specify a court to enter judgment, then that court "must" enter the award.[2] To avoid protracted procedural activity in order to have a judgment entered, parties should always include such a provision where enforcement of the arbitration award is contemplated in the United States.
- *Delegation and Severability*. A delegation clause provides that the arbitrator will decide disputes about the validity of the arbitration clause itself, and a severability clause provides that even if one part of the arbitration agreement is held to be invalid, the rest will be enforceable. Because most institutional rules and national arbitration laws provide for delegation, it may not be necessary to include a delegation clause in the arbitration provision itself. Ensuring that your arbitration clause is both delegable and severable will avoid jumping back and forth between the arbitrator and the courts if the arbitration clause itself is disputed.

Ensure that Arbitration Clauses Are the Same Across All Contracts

Two Federal appellate courts considered this year whether claims arising from more than one related contract were subject to an arbitration provision, when each contract did not contain the provision.

1 In the case of international transactions, even if there is an apparent justification for splitting the resolution of claims, the parties may be unwilling to agree to resolve disputes in the courts of the nation where the other party resides or conducts business.

2 9 U.S.C. § 9. There are exceptions in the event of other judicial intervention in the arbitration or award.

DELAWARE CHANCERY ARBITRATION PROCEDURE UNCONSTITUTIONAL

The recent decision of the U.S. Court of Appeals for the Third Circuit in *Delaware Coalition for Open Government, Inc. v. Strine*[1] may have implications for forum selection and choice of law in arbitration agreements. The *Delaware Coalition* decision reviewed a 2009 amendment to the Delaware Code allowing Delaware Court of Chancery judges to act as neutral arbitrators.[2] Under this rule, judges could arbitrate in their Chancery courtrooms and only parties and their representatives were allowed to attend the proceedings. Stating that "the interests of the state and the public in openness must be given weight, not just the interests of rich businesspersons in confidentiality," the Third Circuit found that these arbitrations violated a First Amendment right of access to the proceedings.

In a split decision, the Third Circuit held that there is a "tradition of accessibility" to this kind of proceeding and that public access played "a significant positive role in the functioning" of proceedings before the Court of Chancery. While conceding that these Chancery arbitrations were not tantamount to a secret civil trial, the majority opinion was focused on how the State of Delaware legitimized the arbitration proceedings. The Court noted that the arbitrations were conducted by Delaware judges, in a Delaware courthouse, during normal business hours, governed by regular Chancery discovery rules, resulting in a binding order of the Chancery Court and had a right of appeal to the Delaware

1 733 F.3d 510 (3d Cir. 2013).

2 § 349 of Title 10 of the Delaware Code.

The U.S. Court of Appeals for the Sixth Circuit decided a case arising from the acquisition by defendants of assets used in the operation of plaintiff's business and the subsequent provision of various services to plaintiff by defendants.[3] Plaintiff brought an action against defendants regarding the services provided, and defendants moved to dismiss and compel arbitration. The decision turns on the presence and absence of arbitration clauses in the material contracts to the transactions at issue, which included an Asset Purchase Agreement ("APA") and a Service Agreement. The APA contained an arbitration provision, but the Service Agreement did not. While noting that an arbitration clause in a "master or umbrella agreement" can encompass a dispute arising under an ancillary agreement that lacks such a clause, the Sixth Circuit rejected defendants' argument that the APA was such an umbrella agreement. The Court found that the APA created only a one-time purchase and transfer of assets and that the Service Agreement was the source of the ongoing relationship between the parties.

The U.S. Court of Appeals for the Second Circuit issued a decision on related grounds when it considered whether a fee sharing agreement between law firms without an arbitration provision was governed by the initial client agreement that did contain an arbitration clause.[4] The Court held that the arbitration clause in the client agreement controlled, notwithstanding that the defendant law firm was not a party to the client agreement, because without the initial client agreement there would be no fee money to share between the law firms. The Second Circuit did not use the terms "master" or "umbrella" agreement, but its rationale was the same.

These cases demonstrate that parties intending to arbitrate M&A disputes should ensure that arbitration clauses are contained in all related contracts and that those clauses are the same in each contract. Failure to do so can lead to protracted litigation about whether the lack of an arbitration provision in one contract means a dispute should be litigated.

Expressly Limit Discovery for U.S. Arbitration

One of the biggest potential advantages of arbitration over litigation is reduced discovery costs. Where U.S. arbitration is concerned, a good arbitration clause should expressly specify that discovery will be limited, and the parties should consider setting certain limits on discovery in the clause itself. Some examples of discovery limitations follow.

- *Motion practice.* Parties can negotiate discovery-related motion practice. The limits could be page limits for discovery-related motions or an expedited time frame for responses and rulings. An even more streamlined approach could call for all discovery disputes to be resolved telephonically.

3 Dental Assoc., P.C. v. Am. Dental Partners of Mich., LLC, 520 F. App'x 349 (6th Cir. 2013).

4 Robinson, Brog, Leinwand, Greene, Genovese & Gluck P.C. v. John M. O'Quinn & Assoc., L.L.P., 523 F. App'x 761 (2d Cir. 2013).

Supreme Court (albeit with only deferential review under the standard of the Federal Arbitration Act). It was this state sanctioning that led the Court to hold that there was a right of access to the arbitrations. A concurring decision stressed that there was nothing inherently unconstitutional about a judge-run arbitration scheme. Outside of the rules specifically regarding confidentiality, there was no reason that the Chancery judges could not set up an arbitration system.

On January 21, 2014, the Chancery Court filed a cert petition with the U.S. Supreme Court asking the court to overturn the Third Circuit's ruling. It remains to be seen whether the Supreme Court will hear the appeal or whether the Court of Chancery ultimately will set up an open arbitration system, but for now one avenue for potential arbitration appears to be closed.

Greg Odegaard

- *Electronically stored information.* Parties can agree to what type of files are, or are not, subject to discovery and for how long electronic information must be retained. One common provision states that the parties are not required to produce electronic data from backup servers or backup tapes.

- *Depositions.* Parties can specify that only a certain number of depositions will be allowed or that no depositions of experts or high-ranking executives will be allowed.

- *Single Arbitrator.* When the parties agree to arbitrate by panel, the arbitration clause can provide that discovery disputes will be handled by a single arbitrator. This approach will increase speed and decrease cost.

- *Cost Allocation.* Parties can negotiate the allocation of costs for discovery disputes and discovery-related motions. Arbitrators generally have inherent authority to engage in such allocation, but do not often do so. Including a negotiated provision regarding cost allocation for discovery disputes makes it much more likely that an arbitrator will allocate costs. Including a cost allocation provision may also cause parties to use more discretion in initiating discovery disputes, especially when seeking marginal discovery.

The discovery limitations described above are applicable primarily to U.S. arbitration. In international arbitrations, U.S.-style discovery is not available. In fact, the term "discovery" itself is seen globally as associated with U.S. court proceedings; in an international setting, this concept is more commonly referred to as "disclosure." In arbitrations involving cross-border disputes, it is more common to consider providing for the discovery that is desired rather than to limit the discovery that is available. When providing for what disclosure is required in an international arbitration, many parties now refer to the International Bar Association Rules on the Taking of Evidence in International Arbitration.

Do Not Allow Unilateral Changes to the Arbitration Clause

A number of recent cases have found arbitration agreements to be illusory.[5] All of these cases have been decided on the ground that one party had the right to amend the arbitration provision or terminate it altogether. Because of the unilateral right to amend, various courts have found that there was no consideration from the party with the amendment right and that the arbitration agreement was therefore unenforceable. In the event that the parties to an arbitration agreement want to create such a right to amend, the Sixth Circuit has suggested that providing for unilateral alteration of an arbitration clause after a thirty-day period may be enough to overcome the charge of illusoriness because it would provide a fixed period of time in which the altering party would be bound by the original terms.[6]

Consider Appointing Only One Arbitrator

Conventional wisdom dictates that a single arbitrator should be used only for minor disputes and that any dispute arising in connection with a significant transaction should be heard by a panel of three arbitrators. But the benefits of appointing only one arbitrator should not be overlooked. Arbitration clauses governing all disputes arising under an M&A agreement, in which case a panel may be more appropriate than a single arbitrator, are practically absent from U.S. public target M&A deals and are present in less than a quarter of private target deals.[7] Large U.S. M&A deals more commonly have provisions requiring arbitration only in discrete circumstances. In such cases, the parties should consider whether it would be beneficial to appoint only one arbitrator. And even when an arbitration clause calls for a panel of three, the provision can stipulate that a single arbitrator be used in certain circumstances, like the discovery dispute example discussed above. In addition to the reduced cost

5 See, e.g., Carey v. 24 Hour Fitness, USA, Inc., 669 F.3d 202 (5th Cir. 2012); Day v. Fortune Hi-Tech Marketing, Inc., ---F. App'x ---, 2013 WL 4859781 (6th Cir. 2013); Scudiero v. Radio One of Texas II, L.L.C., --- F. App'x ---, 2013 WL 5755484 (5th Cir. 2013).

6 Day, 2013 WL 4859781, at *3.

7 John C. Coates IV, Managing Disputes Through Contract: Evidence from M&A, 2 Harvard Bus. L.R. 295, 331-33 (2012).

of paying only one arbitrator, there may be a concomitant benefit of reducing litigation over the appointment of the arbitrator because it will be difficult to argue that an arbitrator each party had a hand in selecting through arms-length negotiations was biased against one of them.

Please note that consideration of the above issues can be very different in cross-border/international M&A transactions, where the arbitration of all disputes has become the default option.

Robert B. Little
Greg Odegaard

DRAFTING DISPUTE RESOLUTION PROVISIONS IN PURCHASE PRICE ADJUSTMENT CLAUSES

Purchase Price Adjustment clauses ("PPAs") are designed to allow a transaction's purchase price to be adjusted post-closing, such as to account for deviations between estimated and actual amounts of net working capital, cash or other items or to reflect the differences between a target amount of inventory and the amount actually present at closing. PPAs generally include a dispute-resolution mechanism and provide that all disputes are to be submitted to an accountant for a final and binding determination. This article will address the current legal treatment of purchase price adjustments and will provide drafting tips for the dispute resolution provisions of PPAs.

Arbitration or Appraisal?

The vast majority of M&A contracts contain PPAs calling for purchase price disputes to be resolved using a single accountant.[8] But there is no controlling law regarding whether such a PPA determination is subject to enforcement as an arbitration award. A recent examination of PPAs by the New York City Bar Association ("NYCBA") concluded that such clauses are better characterized as "expert determinations" or, in common law parlance, "appraisals."[9] The NYCBA found four ways in which a PPA determination differed from an arbitral decision. (1) Arbitration generally resolves an entire dispute while a PPA determination is limited to specific facts. (2) Arbitrations are conducted according to adversarial procedural rules while PPA determinations are made by experts acting as inquisitors who are free to consider any evidence they believe will help them make their expert determination (unless the evidence they can use is limited by the PPA itself). (3) The review of arbitration awards is governed by the Federal Arbitration Act (the "FAA"), which sets strict rules for how and when an arbitration award can be reviewed. PPA determinations, on the other hand, are governed by state law, and the standard of review can be set in the contract itself. (4) Arbitration awards result in the entry of a court judgment, but expert determinations generally resolve only fact issues, not liability—although this too can be set by contract. Numbers 3 and 4 are particularly important for the drafting parties to keep in mind, because they impact whether and how a court will review an accountant's determination under a PPA.

Notwithstanding its four-part analysis, the NYCBA report states that there is considerable uncertainty over whether a court will enforce a PPA determination to the same extent as an arbitration award. New York law has a specific provision stating that appraisals may be enforced like arbitration awards.[10] But many states do not have such provisions in their statutes, and in any event there is no general rule about how a PPA determination will be reviewed. Drafting parties should therefore make clear whether they intend for a PPA determination to be treated as an arbitration or an appraisal.

8 John C. Coates IV, *Managing Disputes Through Contract: Evidence from M&A*, 2 Harvard Bus. L.R. 295, 331-33 (2012).
9 New York City Bar Committee on International Disputes, *Purchase Price Adjustment Clauses and Expert Determinations* (June 2013), *available at* http://www2.nycbar.org/Publications/reports/reportsbycom.php?com=101.
10 N.Y. Civ. Prac. L. R. § 7601 ("A special proceeding may be commenced to specifically enforce an agreement . . . that a question of valuation . . . be determined by a person named or to be selected. The court may enforce such an agreement as if it were an arbitration agreement . . . .")

If the parties intend for the PPA determination to be binding, they should include language in their PPA stating that the accountant's decision is "final, binding on and not appealable by the parties." If the parties want to give a court even more guidance, they can explicitly provide that the accountant's determination is an arbitration and is not subject to further review, subject to applicable provisions of the FAA. On the other hand, if the parties prefer that an accountant's determination be more easily reviewable, they should include language in their PPA stating that the accountant will "act as an expert and not an arbitrator." This language will convey that the parties did not intend the determination to be an arbitration and will allow either state law (which in New York, for example, makes appraisals binding in the absence of "fraud, bad faith or palpable mistake") or the PPA itself to govern the standard of review. For example, the PPA could provide that the accountant's determination will be binding except in the event of mathematical error.

Contract Has Both PPA and General Arbitration Clause

PPAs can have an unclear relationship with arbitration in another context as well. Where the parties to an agreement containing a PPA decide to include a general arbitration clause, there can be confusion about whether disputes regarding the requirements of the PPA are subject to the arbitration clause. For example, if the agreement includes a general arbitration clause, should a challenge regarding the failure of a party to provide books and records in breach of the PPA be brought before an arbitrator or a court? The same question could arise if one party tries to enforce, or to set aside, an accountant's determination under a PPA. Some courts have found that the presence of a general arbitration clause means that all disputes arising from the PPA are subject to arbitration. Other courts have held that the general arbitration provision does not apply to a PPA that includes its own dispute resolution mechanism. Because a court could reasonably expect that drafting parties intended either of these outcomes, one cannot predict how a court will treat this issue should it arise. Therefore, a contract with both a general arbitration clause and a PPA should expressly address the issue. If the PPA is intended to stand alone, the parties should expressly carve it out of the general arbitration clause. If PPA disputes are intended to be arbitrated under the general arbitration clause, the contract should say so explicitly.

Is an Accountant the Best Party to Resolve PPA Disputes?

PPAs generally provide that an accountant will settle disputes between the parties. But in some contracts, PPA determinations are not based solely on accounting-related matters. If an adjustment depends on something more than just numbers (for example, whether a seller entered into a "final, valid and binding sales contract" with a particular customer between signing and closing), it could lead to a dispute that an accountant is not qualified to resolve. In the above example, if there were a dispute about the validity of the contract, an accountant would not be competent to determine whether a contract was "final, valid and binding" as a matter of law, and the accountant may decline the engagement. When negotiating a PPA that entails non-accounting determinations, the parties may be better served to appoint an arbitrator to resolve disputes arising under the PPA rather than an accountant.

Engaging Accountants: Mandatory or Discretionary?

It is not uncommon for a PPA to provide that either party "may engage" an accounting firm to resolve a purchase price dispute. But this conditional *may* leaves unclear whether the other party is required to join the engagement, or whether that party can simply refuse or demand unreasonable terms in the engagement letter. Some PPAs attempt to avoid this situation by providing that if there are unresolved issues both parties "shall submit" their views to the accountant by the end of a specified period. Another, perhaps preferable, variation of this clause would be that if one party elects to engage an accountant, the other party shall enter into a customary engagement letter with the accountant and shall work with the accountant on the disputed matters.

Independence of Accountant

PPAs sometimes provide that the parties agree to have disputes resolved by an "independent accounting firm" without identifying a firm by name. This language amounts to little more than an agreement to agree on the accountant. Better

practice is to name the accountant up front. When negotiating about identifying a specific accounting firm, parties may agree upon a particular firm without much discussion. When naming a recognized accounting firm, however, both parties may have used the firm at some point, which makes the independence of the firm difficult to ensure. To promote the independence of the accountant, the parties can name a specific office of the accounting firm with which neither party has had any material dealings. The possibility would remain, however, that one of the parties hires that office of the firm after signing and prior to the resolution of any PPA dispute. Practically, the firm should then say that it cannot resolve the PPA dispute because of the conflict. To safeguard the accountant's independence, however, parties should not simply rely on general accounting practice. One drafting option to avoid this uncertainty is to provide that the parties agree to use a particular office of the chosen firm so long as neither party has a material relationship with that office at the time of the PPA dispute.

Scope of the PPA Determination

An off-the-shelf PPA may simply set the terms for engaging an accountant and provide that the accountant will resolve the dispute. But there is no need to give the accountants more rein than necessary. Whether the determination will be an arbitration or an appraisal, the drafting parties can specify the grounds upon which the accountant may opine. For example, the parties can specify that the accountant will consider only those items and amounts that the parties themselves have identified as being subject to disagreement. This approach will avoid the accountant potentially making a binding determination that varies from a value that was not in dispute. Similarly, the parties can narrow the grounds for the accountant's review to math error or noncompliance with the terms of the underlying agreement, which will limit the universe of facts that an accountant can consider when making its determination. Finally, the parties can minimize the likelihood of an outlier decision by mandating that the accountant pick a number that is no higher than the highest number proposed by the parties and no lower than the lowest number proposed by the parties.

Time Limits for Determinations

An open-ended requirement for an accountant's determination in a PPA dispute leaves the door open to an unreasonably long wait for the decision. Drafting parties can remove this uncertainty by including time limits for the accountant to provide the determination. One possibility is to include language that the accountant "shall deliver a determination within [X] days." But the accountant is not a party to the contract containing the PPA, so it would not be bound by any such provision. A better provision would provide that the parties "will enter into a customary engagement letter which shall provide that the accountant will deliver its determination within [X] days."

Rationale of the Accountant

PPAs do not always address whether the accountant is required to give an explanation for its determination. But the lack of justification for a PPA determination can leave the losing party feeling aggrieved without explanation. Parties should agree to include language specifying that the accountant shall deliver its determination under a PPA dispute with a description of its rationale.

Allocating Fees for PPAs

The parties can predetermine how to allocate accountant's fees for the PPA determination and the parties' separate third-party costs incurred in connection with the dispute resolution process. There are many ways to formulate the allocation. The parties may decide to follow litigation practice and have each party pay its own third-party costs. They may also decide to split the accountant's fees equally among themselves or to adopt a loser pays system (either with respect to only the accountant's fees or including the parties' separately incurred third-party costs). One approach to consider is for the accountant's fees to be allocated in inverse proportion as the parties may prevail on the matters resolved. This clause would cause the accountant to consider the amount by which each party prevailed in each issue relative to the amount in dispute. The prevailing party would then pay the inverse of that percentage of the accountant's fees. Because the agreement generally will include a separate provision that addresses the parties' responsibilities for fees and expenses incurred in connection with the transaction, the

parties should remember to carve out from that provision the arrangement with respect to fees and expenses in the PPA.

Access to "Books and Records"

PPAs often contain a provision that one party is to provide the other with reasonable access to all relevant books and records needed to make any objections to a calculation. The NYCBA study of PPAs identified provisions ensuring access to books and records to be problematic because the only remedy for a breach is usually litigation, which creates a substantial delay. The Bar recommended using language allowing the early intervention of the accountant to resolve disputes about noncompliance with the obligation to provide access to books and records. For parties who wish to allow the accountants to make such a determination, language can be added conferring the accountant with the power to: (i) order a party to provide access if the accountant determines access was not provided, (ii) extend deadlines for the provision of access and filing a notice of objection and (iii) allow a party to amend a notice of objection if that notice was prejudiced by lack of access to information.

Robert B. Little
Greg Odegaard

LATEST HOT BUTTON ISSUES IN PRIVATE M&A

Purchase agreements, while retaining their basic form, are ever-evolving creatures. Emerging case law and negotiation trends continue to provide purchasers and sellers with an expanding checklist of issues to consider and address in negotiating and drafting their contracts. Below are some issues to consider and a few ideas for addressing them when drafting M&A agreements:

1. Right of buyer to review/revise estimated net working capital statement

Many stock purchase agreements provide for purchase price adjustments based on the net working capital of the target at closing. Typically, the purchase price is adjusted at closing based on a working capital statement prepared by the seller followed by a post-closing true-up based on an agreed-to net working capital statement prepared 30 to 90 days after closing. Buyers are increasingly asking for the right to provide comments to the working capital statement prepared by the seller prior to closing. Sellers may resist because a dispute stemming from the buyers' comments could delay or jeopardize closing. However, buyers may insist on this right out of concern that a purchase price inflated by an unusually large working capital adjustment due at closing could require the buyer unexpectedly to obtain additional funds to pay the purchase price and could make it difficult for the buyer to recover a true-up payment post-closing. One approach is to permit the seller to comment only if the adjustment exceeds a certain threshold. If sellers agree to give buyers the right to consent or comment, a mechanism for resolving disputes regarding the estimated net working capital statement should be built into the purchase agreement to avoid a stand-off.

2. Purchase price increases to offset tax benefit of transaction expenses

Sellers are often responsible for paying transaction expenses on behalf of the target. In some cases, transaction expenses are tax deductible, resulting in a post-closing tax benefit to the target (and ultimately the buyer). To restore symmetry, we have seen sellers request an increase to the purchase price in an amount equal to a certain percentage (e.g., 40%) of the transaction expenses paid by the seller. Buyers may balk because transaction expenses do not translate directly into a tax benefit to the buyer, as they may not be deductible at all, may be deductible in the pre-closing period or otherwise not produce a tax benefit to the buyer. Another approach is to have the parties agree that transaction expenses are attributable to the pre-closing tax period and that the seller is entitled to use them to mitigate its pre-closing period tax liabilities or entitled to tax refunds received by the target attributable to that pre-closing period.

3. Covenants to satisfy closing conditions

Some purchase agreements include a covenant in which the seller agrees to use its reasonable best efforts or commercially reasonable efforts to satisfy the conditions to closing. A buyer's remedy for seller's breach of a covenant is different from its remedy for seller's failure to satisfy closing conditions: if a covenant is breached, the buyer may seek monetary damages; if a closing condition is not satisfied, the buyer can refuse to close. A covenant in which seller obligates itself to satisfy the closing conditions effectively transforms each closing condition into a covenant such that the buyer may seek monetary damages if the seller fails to satisfy a condition. Further, the purchase agreement may contain a very specifically negotiated covenant related to satisfaction of a particular condition, such as the covenant regarding obtaining regulatory approvals. If, for example, a covenant regarding regulatory approvals specifies a level of efforts required, that covenant should not be overridden by, or inconsistent with, a generic covenant regarding satisfaction of closing conditions that requires a different level of efforts.

In addition, a covenant to use reasonable best efforts to satisfy the closing conditions may inadvertently transform each representation into a covenant. Typically, contracts contain a closing condition that all representations and warranties be true in all material respects as of closing. In the context of a post-closing claim by a buyer for breach of a representation and warranty, the buyer may argue that the seller breached the covenant to use reasonable best efforts to satisfy the closing condition that each representation and warranty be true in all material respects as of closing. Because sellers' indemnification obligations with respect to covenants are often not subject to the deductible, basket and/or cap on indemnification, buyers may use this argument to fully recover losses for breaches of representations without being subject to the indemnification limitations applicable to such breaches. In other words, agreeing to a covenant to use reasonable best efforts to satisfy closing conditions may have the unintended consequence of permitting buyers to hold sellers liable for the full amount of any losses attributable to breaches of representations and warranties. As an alternative, sellers may insist that the buyer rely on the efforts requirements in specific covenants (e.g., the covenant to seek material consents), rather than accepting a covenant that the seller use reasonable best efforts to fulfill all closing conditions, or sellers may include a provision in the indemnification section stating that a claim that could be brought as a breach of a representation or a covenant must be brought as a breach of a representation.

4. Litigation closing conditions

Purchase agreements frequently provide that the parties are not obligated to close if the target is subject to certain litigation. Sellers frequently fail to parse the language of this closing condition to ensure that non-governmental, non-deal-related litigation (which should be captured by the litigation representation and the related bring-down closing condition) does not trigger an out for the buyer. A seller may seek to tailor this condition so that only litigation actually pending by a governmental authority challenging the transaction will cause the condition to fail. A buyer may argue that threatened or pending litigation against the target challenging the deal, whether or not the plaintiff is a governmental entity, should be covered by the condition. Sellers may be concerned that claims brought in the ordinary course of business, claims brought by the buyer and unsubstantiated claims threatened or brought by an insignificant governmental authority could stall or extinguish the deal. Therefore, sellers may insist that the condition be limited to litigation in which a restraining order or injunction prohibiting the consummation of the transaction has been issued.

5. Fraud exceptions

Buyers often bargain for fraud exceptions to the exclusive remedies provision of a purchase agreement[1] and/or the limitations (deductibles, baskets and caps) on a seller's indemnification obligations. In many cases, a court likely would not view a fraud claim as barred by an exclusive remedies provision in the purchase agreement, even if there is no explicit fraud exception in the provision. The Delaware courts have held that a fraud exception can be read into an agreement, but such an "implied" fraud exception is limited to intentional fraud (i.e., a buyer cannot bring claims of recklessness, gross negligence or negligence when the contract includes an exclusive remedies provision without a fraud exception).[2] Said differently, an explicit exception to an exclusive remedies provision for "fraud" may constitute an exception for fraudulent conduct of a type that is different than what the parties envision (i.e., intentional fraud v.

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1 An exclusive remedies provision limits a buyer's post-closing remedies to the indemnification rights contained in the purchase agreement.

2 We note that recent New York case law suggests that claims for gross negligence, not just intentional fraud, are permitted despite exclusive remedies provisions without a fraud exception.

reckless disregard for accuracy), and parties may desire to specify the exact scope of the fraud exception to avoid unintended consequences.

6. Who controls the defense of indemnifiable claims

When a party is obligated to indemnify the other party for losses resulting from a third party claim, the indemnifying party often has the right to assume the defense of the third party claim. Sellers may reason that because their money is at stake, they should be able to control the defense and/or settlement of such claims. Buyers may counter that they should have a right to control the defense in light of the fact that there are deductibles, baskets and/or caps on the seller's indemnification obligations and that buyers are generally at risk for losses to the extent they fall outside the bounds of recourse permitted against the seller. To address such concerns, some parties agree that the indemnifying party can control the defense unless the amount of damages sought by a third party exceeds the post-closing escrow amount, or unless the amount of damages sought by a third party that exceeds the post-closing escrow amount is greater than 50% of the total damages sought.

7. Seller's counsel post-closing

Two important issues often arise involving seller's counsel following the closing of a transaction: (1) can seller's counsel represent the seller in matters opposite the target/buyer and (2) who retains control of the attorney-client privilege for pre-transaction communications? It is becoming more common for parties to address these two issues in purchase agreements.

Because Seller's counsel often has an intimate knowledge of the target's affairs, especially relating to the negotiation of the transaction, sellers may request a provision in the purchase agreement allowing seller's counsel to represent the seller in matters opposite the buyer after the closing of the transaction. Buyers may refuse to waive their right to object to seller's counsel, or buyers may agree to waive their right with respect to certain matters but not others.

Parties are also negotiating purchase agreement provisions specifying which party retains pre-transaction attorney-client communications (particularly those regarding the negotiation of the transaction). Although the Delaware Chancery Court has held that, in the case of mergers pursuant to Section 259 of the Delaware General Corporation Law, the attorney-client privilege passes as a matter of law to the surviving corporation, the court has acknowledged that parties may exclude attorney-client communications from the assets being transferred in a transaction.

Robert B. Little
Melissa L. Persons

BARGAIN SHOPPING: ACTIVISM IN THE RETAIL SECTOR

Shareholder activism continues to be a powerful force in corporate America. In 2013, activists launched 206 campaigns against U.S. companies.[1] In addition, many more activist initiatives resulted in early settlements and corporate transactions before a public campaign was even launched by the activist. And, the pace of activism is expected to accelerate during 2014. In fact, recent estimates indicate that approximately $10 to $12 billion was invested in activist hedge funds in 2013, bringing their collective total assets under management to more than $100 billion.[2]

As activists have become increasingly sophisticated, their campaigns have broadened in scope. Although there continue to be many instances where an activist's main agenda is to precipitate a sale of the target company, there has been a significant increase in the level of refinement of activists' proposals, including with respect to board representation, reorganizations, return of capital to shareholders, changes in strategic direction, capital allocation plans, and corporate governance reforms.

Although activists have targeted companies in a wide range of industries, the fashion retail sector was a frequent target in 2013 and can be expected to continue to be a target in 2014. Activists often view fashion

1 Data from FactSet.
2 "No Barbarians at the Gate; Instead, a Force for Change." Alexandra Stevenson, *Dealbook*, http://dealbook.nytimes.com/2014/01/06/no-barbarians-at-the-gate-instead-a-force-for-change/ (Jan. 6, 2014)

retailers as relatively inexpensive targets, with the potential for significant upside. In the fashion retail sector, the goal of recent activist campaigns can be divided into three main categories: (1) implementing management changes to force a strategic change, (2) effecting a going private transaction or (3) engaging in a strategic consolidation, all as illustrated below.

Management Change

In an example of an activist seeking a management change, in December 2013, Engaged Capital LLC (Engaged) announced it had acquired a 0.5% stake in Abercrombie & Fitch Co. (A & F). Engaged made public a letter sent to the board calling on the directors to initiate a search process to replace incumbent CEO Mike Jeffries. Subsequently, on January 28, 2014, A & F announced that it would split the offices of Chairman of the Board and CEO, appoint three new board members, one of whom will serve as the new chairman, and eliminate its poison pill. Engaged released a statement asking A & F to explore further strategic and organizational changes.

Going Private Transaction

In April 2013, Barington Capital Group LP (Barington), a 2.3% shareholder of The Jones Group Inc. (Jones), confirmed media speculation that it had attended a meeting with Jones executives. Within a month of such media reports, Jones announced that it had entered into an agreement with Barington pursuant to which Jones would nominate Barington's CEO James Mitarotonda to its board of directors at the upcoming annual shareholders meeting and that Barington had agreed to a standstill and to vote its shares in favor of the board's nominees.

Barington pushed Jones to effectuate a strategic transaction, either through divestitures of individual brands from its substantial portfolio or through a going private transaction. On December 20, 2013, after a lengthy process, Jones entered into a merger agreement with affiliates of Sycamore Partners (Sycamore) pursuant to which Sycamore will take Jones private in an all cash transaction expected to close in the second quarter of 2014. The purchase price per share in the Sycamore transaction is $15 per share, a $0.93 premium over the $14.07 per share price at which Jones shares closed on the day that Barington's stake was disclosed.

In a comparable situation, in July 2012, Clinton Group LLC (Clinton) made public a letter disclosing its 4.25% (presently 8.1%) stake in Wet Seal Inc. (Wet Seal) and launched a proxy contest to remove and replace the board with directors more willing to seek out and negotiate a going private transaction. Wet Seal settled with Clinton in October 2012 agreeing to nominate four of Clinton's proposed directors to the board, including the chairman. To date, Wet Seal has not found a potential buyer and continues to explore financing alternatives to effectuate a going private transaction.

Strategic Consolidation

In September 2013, JoS. A. Bank Clothiers (JoS. A. Bank) made an unsolicited takeover bid for its larger rival The Men's Wearhouse Inc. (Men's Wearhouse). Eminence Capital, LLC (Eminence) publicly disclosed its 9.8% stake in Men's Wearhouse on November 7, 2013. Eminence's stated goal was to effectuate a consolidation of Men's Wearhouse and JoS. A. Bank in order to realize potential synergies and increase shareholder value.

On November 15, 2013, after the Men's Wearhouse Board rejected Jos A Bank's offer, Eminence commenced a proxy solicitation to amend the Men's Wearhouse's bylaws such that shareholders could remove and replace Men's Wearhouse's directors at a future special meeting of shareholders. In late November, Men's Wearhouse took the strategic initiative of proposing an acquisition of Jos A. Bank – which was consistent with Eminence's stated goal of having the two companies combine. This acquisition proposal was rejected by JoS. A. Bank's board on December 23. Men's Wearhouse responded on January 6, 2014 by proposing an increased cash tender offer. On January 13, Eminence, which also holds a 4.9% stake in JoS. A. Bank, filed suit in an

effort to force negotiations between the companies and announced they will be nominating two directors to the JoS. A. Bank board at the next annual meeting.

In another example, in November 2013, Hirzel Capital Management, LLC (Hirzel) publicly disclosed its intent to actively seek to influence the management of Aeropostale Inc. (Aeropostale), of which it owns 6%. To date, Hirzel has not announced its proposed strategy for the company although other shareholders have indicated support for a sale of Aeropostale.

Although the fashion retail industry has provided attractive targets for shareholder activism, the ultimate results of recent activist efforts will likely determine whether the retail space will continue to attract attention from activist investors.

Lois Herzeca
Eduardo Gallardo

PRC M&A UPDATE

2013 was a record year for mergers and acquisitions in China. According to press reports, total value for M&A in China exceeded USD93 billion last year, higher than that for Japan. China has embarked on an ambitious reform program, and as a result, mergers and acquisitions are expected to further accelerate in 2014.

In this article, we examine the regulatory regime relating to acquisitions by foreign entities of PRC domestic companies and businesses. The primary feature of this regulatory regime is that all such acquisitions have to be approved by government authorities prior to completion regardless of the nature of the business of the target company or the size of the transaction. This is different from the registration based system for PRC domestic acquisitions where both the buyer and the target are PRC domestic companies.

General Approval

The primary regulation relating to acquisitions by foreign entities is the Regulation in respect of Acquisitions of Domestic Enterprises by Foreign Investors adopted in 2006 and amended in 2009. Because it was first issued by the PRC Ministry of Commerce ("MOFCOM") with a serial number of 10 in 2006, the regulation has become widely known as "Circular No. 10".

Circular No. 10 applies to the following transactions: (i) acquisitions by foreign investors[1] of more than 10% of the equity interest (by purchase of existing equity and/or subscription of new equity) in a domestic enterprise that is not a foreign invested enterprise[2] (a "FIE"); (ii) purchase by foreign investors of the assets of a non-FIE domestic enterprise and the subsequent establishment of an FIE with such purchased assets; and (iii) establishment by foreign investors of an FIE for purposes of purchasing the assets of a non-FIE domestic enterprise. While Circular No. 10 does not apply to transfers of equity interests by shareholders of an existing FIE, such transfers are still subject to approvals by government authorities under PRC's general FIE related laws and regulations.

1 A foreign investor means an entity not organized under PRC laws or an individual not a PRC national.

2 A foreign invested enterprise means an enterprise wholly or partially owned by a foreign investor.

A transaction subject to Circular No. 10 requires approval either by MOFCOM or its counterpart at the provincial or local government level, depending on the size of the transaction.[3] Generally, if the consideration of a transaction or the total investment amount[4] of the resulting FIE is less than USD300 million, such transaction is subject to approval at the provincial or local government level, except that MOFCOM's approval is required in respect of a transaction that involves (i) a restricted industry[5] and the transaction value or the total investment amount exceeds USD50 million; (ii) change of control of a domestic enterprise that owns well-known Chinese trademarks[6] or Chinese traditional trade names;[7] or (iii) a related party transaction where a PRC resident-controlled offshore entity buys domestic enterprises controlled by the same resident.[8]

Obtaining the required approvals can be a cumbersome and uncertain process. While Circular No. 10 provides that approval or disapproval should be given within 30 days following the submission of the required documents, it often takes much longer in reality. In addition, such approval involves a substantive review of all the relevant contracts, including the equity purchase agreement and, if applicable, the joint venture contract of the resulting FIE. In connection with such review, the parties involved in a transaction often have to renegotiate certain commercial terms in order to satisfy the requirements of the reviewing authority.

Circular No. 10 also has detailed rules regarding how a transaction is to be priced and paid for. For instance, the target assets have to be appraised by PRC qualified appraisal agencies and the purchase price cannot be significantly lower than the appraised value. The foreign purchaser is also generally required to pay the full consideration within 90 days, making it difficult to negotiate any earn-out arrangements without breaking down the acquisition into a two-stage process. Under special circumstances and subject to special approvals, a foreign purchaser may pay 60% of the total purchase price within six months and the remaining 40% within one year.

In addition to those required under Circular No. 10, approvals by other PRC governmental authorities may also be necessary for foreign acquisitions of PRC companies. For instance, if the target is state-owned, an acquisition must be approved by the state-owned assets supervision authorities and go through an open auction/bidding process. In case the target is a listed company, the transaction also needs to be approved by the China Securities Regulatory Commission.

Anti-trust Review

The PRC Anti-trust Law came into force in 2008, which introduced the mandatory anti-trust filing and review regime. Under this regime, a "concentration of operators"[9] meeting specified turnover thresholds must provide notice to and be cleared by MOFCOM before it can be implemented. This requirement applies to both inbound and outbound M&A transactions, as well as transactions that are entirely among foreign entities so long as such entities have revenues derived from China.

Currently, anti-trust filings are mandatory for the following transactions: (i) the parties to the transaction have a combined after-tax revenue in the world in excess of RMB 10 billion, and at least two of the parties each have an after-tax revenue in China in excess of RMB 400 million; or (ii) the parties to the transaction have a combined after-tax revenue in China in excess of RMB 2 billion, and at least two of the parties each have an after-tax revenue in China in excess of RMB 400 million. In addition, MOFCOM may initiate an anti-trust review of a concentration of operators even if such transaction does not meet the filing threshold as set forth above if it believes that such transaction has or could have effects of eliminating or restricting competition.

3 Generally speaking, it is easier and faster to obtain approvals from local governments than from MOFCOM. Transaction parties often adopt special structures or transaction steps in order to avoid the need for a MOFCOM approval.

4 The total investment amount of an FIE means the total amount of funds required to complete the project for which the FIE is approved to carry out. Generally speaking, one third of the total investment has to be in the form of equity (also called "registered capital") and the remaining two-thirds can be borrowed from onshore or offshore lenders.

5 Industries are divided into four categories for purposes of foreign investments under PRC law: encouraged, permitted, restricted and prohibited. Prohibited industries, such as news media and military facilities, are closed to foreign investment. For restricted sectors such as financial institutions, foreign ownership is permitted, but generally cannot exceed 50%.

6 Well-known Chinese trademarks are those certified as such by the PRC Trademark Bureau.

7 China traditional trade names are important historical trade names in China, as certified by MOFCOM.

8 We understand that MOFCOM has not formally issued a single approval of a related party transaction, which has led transaction parties to adopt creative structures and transaction steps, such as variable interest entities (see discussion below), to avoid the need to obtain such approval.

9 Under the PRC Anti-trust Law, "operators" include individuals, entities and other organizations that engage in manufacturing, business operations or providing services, and "concentration of operators" includes: (i) the consolidation of operators, (ii) the acquisition by an operator of control of other operators by way of equity or asset acquisition and (iii) an operator, through contract arrangements, obtaining control of other operators, or obtaining the power to exert decisive influence over other operators.

In quite a few recent cases, MOFCOM has approved a concentration of operators conditionally, i.e., imposing restrictive conditions on the transaction so as to reduce its perceived anti-competition effect. Such restrictions include the requirement to spin off certain assets or businesses, license a key technology, terminate an exclusive contract and grant third parties access to the relevant network or platform.

National Security Review

China recently has adopted a national security based review of foreign acquisitions similar to the CFIUS review process in the U.S. In 2011, pursuant to orders from China's State Council, MOFCOM promulgated the Provisions on the Implementation of the National Security Review System in respect of Mergers and Acquisitions of Domestic Enterprises by Foreign Investors.

China's national security review covers (i) acquisitions by foreign investors of domestic military industrial enterprises and affiliated enterprises, enterprises located close to important or sensitive military facilities or other enterprises that relate to national defense security; and (ii) acquisitions that result in actual control[10] by foreign investors of enterprises in industries involving important agricultural products, important resources, important infrastructure, important transportation facilities, key technologies, key equipment manufacturing or other industries relevant to national security. Unlike Circular No. 10, the national security review rules also apply to the purchase by a foreign investor of equity interests from a PRC shareholder in an existing FIE and subscription by a foreign investor of new equity in an existing FIE. A foreign investor is specifically prohibited from circumventing the national security review rules by any means, including nominee shareholding, trust, multiple-level investment, lease, loan, variable interest entity structure or any offshore arrangement.

The national security review is conducted by a joint committee under the State Council led by MOFCOM and the National Development and Reform Commission. Parties involved in a transaction that may have national security implications are required to file an application to MOFCOM. If MOFCOM determines that national security review is warranted, it will forward the application materials to the joint committee, which will consult with the relevant government departments. If any department determines that the relevant acquisition may impact national security, the joint committee will conduct a special review. The whole process could take up to six months. It is important to note that a government department, a national trade union and other enterprises in the same industry can also request a national security review such that a completed transaction may be ordered to be unwound if it did not pass national security review in the first place.

The regulation in respect of national security review does not provide clear definitions as to what constitutes "important agriculture products, important resources, important infrastructure, important transportation facilities, key technologies, key equipment manufacturing or other industries relevant to national security." Since its promulgation, there have been few reported cases where transactions have been disapproved on national security grounds. Therefore, it remains to be seen as to whether the regulation will be used to block foreign acquisitions of Chinese assets.

VIE Structure

A variable interest entity ("VIE") structure refers to a structure whereby an FIE obtains control over and receives most of the economic benefits from a domestic enterprise (the Chinese operating company) not through acquisition of its equity but rather through a series of contractual arrangements.[11]

10 A foreign investor will be deemed to have obtained actual control of an enterprise if it becomes the controlling shareholder or the actual controlling party of a domestic enterprise, including situations where (i) it and its affiliates hold more than 50% of the equity interest of the target enterprise; (ii) the aggregate equity ownership in the target enterprise by all foreign shareholders exceeds 50%; (iii) the foreign shareholders hold a significant (though less than 50%) stake in the target enterprise and are able to exercise significant influence over its board and shareholder actions; or (iv) the foreign shareholders obtain actual control under other circumstances in respect of the operations, financial matters, human resources or technologies of the domestic enterprise.

11 The contractual arrangements usually include (i) an equity pledge agreement where the shareholders of the operating entity pledge all their equity interest in the operating entity in favor of the FIE, (ii) an exclusive option agreement where the FIE has an exclusive option to purchase from the shareholders of the operating entity all their equity interest for a nominal price when permitted under PRC laws, (iii) an exclusive services agreement where the FIE will provide exclusive services to the operating entity for fees that normally would include substantially all the net profits of the operating entity from its operations, (iv) a power of attorney issued by the shareholders of the operating entity in favor of the FIE granting the FIE power to vote on their behalf in respect of all their equity interest in the operating entity and (v) a loan agreement where the FIE would provide a loan to the shareholders of the operating entity for them to make a capital contribution to the operating entity.

Specifically, the Chinese owner of an operating company can set up an offshore company which in turn can set up an FIE in China. The FIE can enter into a service agreement and other arrangements with the Chinese operating company whereby most of the revenues of the Chinese operating company will be paid over to the FIE as the service fee. This structure is used in cases where the actual acquisition of the Chinese operating company by the FIE is not allowed or where the engagement by the FIE in the relevant business is subject to approval that is difficult or impossible to obtain.[12] This structure allows foreign investors to enjoy the economic benefits of the Chinese operating entity even though they do not actually own the operating entity.

The VIE structure is very popular in China and many leading Chinese internet companies with this structure are listed on the NASDAQ or NYSE. However, as disclosed in these companies' SEC filings, the VIE structure presents both contractual risks and regulatory risks. First, under a VIE structure, foreign investors do not have direct equity ownership of the Chinese operating company and can only rely on contractual agreements to exercise effective control over the Chinese operating company. These agreements have not been tested in PRC courts and in the event that the shareholders of the operating company breach the agreements, it is unclear whether the rights of the FIE under the agreements will be enforced by PRC courts. Second, there is a risk that the PRC government authorities may require the VIE structure to be unwound or rectified as the VIE structure could be seen as a way of circumventing PRC foreign investment restrictions or other relevant regulations. Currently, many PRC legal practitioners are of the view that this is unlikely because there have been many successful and well-known companies with VIE structures listed on overseas stock exchanges and a ban on the VIE structure would have significant implications on these overseas listed companies and their relevant industries.

Nevertheless, while the PRC government authorities have intentionally turned a blind eye to the VIE structure, they have also been very careful not to expressly endorse this structure. MOFCOM has recently refused to accept applications for anti-trust review of several transactions involving acquisitions of target entities that use VIE structures so as not to be viewed as endorsing the validity of the VIE structure. An acquisition of a company with a VIE structure therefore may be difficult if such acquisition requires anti-trust approval under PRC laws.

New Developments – Shanghai Free Trade Zone and the Third Plenum

The PRC government announced the establishment of the Shanghai Free Trade Zone (the "Shanghai FTZ") in September 2013. Based on the published policies for the Shanghai FTZ and press reports, the name "free trade zone" is something of a misnomer, as the real intention for setting up the free trade zone does not seem to be a further liberalization of trade in goods within the zone, but an attempt to promote a general market oriented economic regulatory regime more in line with the modern economies in the world. For instance, the announced reforms would include deregulation of the financial services industry and loosening of the foreign exchange control over certain capital account items in the Shanghai FTZ (China already allows free convertibility of its currency for current account transactions).

Further, the policies announced in connection with the Shanghai FTZ seem to recognize the need to afford more "national treatment" to FIEs. Specifically, unless otherwise required (for example, in cases where national security review is required or the industries involved are prohibited or restricted to foreign investment), the approval regime for FIEs is expected to be similar to that for non-FIE domestic companies. If this happens, it should make it much easier to obtain approvals or registrations for M&A transactions in the Shanghai FTZ.[13] Some policy makers have pointed out that the Shanghai FTZ will serve as a pilot program for the other regions. In fact, according to press reports, another 12 FTZs may soon be established in other parts of China. Eventually the special policies applicable to the FTZs will be adopted for the country as a whole.

The other major development in 2013 was the adoption of the Decisions on Several Important Issues relating to the Comprehensive Deepening of Reforms by the Third Plenum of the 18th Central Committee of China's Communist Party in mid-November. These Decisions cover a wide range of topics and are designed to modernize

12 An example would be the ICP license that is required for operation of a value-added telecommunication business (such as e-commerce) in China.

13 The Shanghai FTZ is still in its early development. Many detailed implementation rules have yet to be published.

the Chinese society as a whole, including its government structure as well as its economy. Some of the specific reform measures mentioned in these Decisions relate to foreign investments. For instance, more sectors will be opened up to foreign investment, including financial, education, cultural, medical and other service sectors, and the restrictions on foreign investments in architecture design, accounting, e-commerce and commercial logistics areas will be lifted. In addition, the government will adopt a "negative list" approach to foreign investments whereby prior approvals for investments in those sectors that are not on the list will be changed to post-investment registration.

Given these new policies and the need to draft and adopt specific rules to implement them, 2014 promises to be an interesting year for China's economy in general and foreign investment (including mergers and acquisitions) in particular.

Yi Zhang
Ally Zhu

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