GIBSON DUNN

M & A with Chinese Characteristics

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What We Will Be Covering

Introduction: Overall Trends in Chinese Outbound M&A

- Dramatic increase in Chinese outbound foreign direct investment in the last decade, especially the last few years
- First quarter of 2016 saw more than 100 deals announced, amounting to more than $100 billion in value
- Chinese privately owned enterprises account for half of outbound investment, and their number and size is increasing
- Privately owned enterprises are also partnering with state owned enterprises to further global expansion
- Chinese companies are receiving strong support to invest overseas, including relaxation of administrative requirements from approval-based system to registration and filing-based system

Introduction: Drivers of Chinese Outbound M&A

- Slow economic growth in China drives recent Chinese M&A growth.
  - Consolidation among small-to medium-sized companies in China has reduced number of domestic targets.
  - Quality of U.S. firms and economic growth potential in the U.S. makes it an attractive investment destination.

- Shifts in Chinese M&A activity reflect fundamental changes in the growth and focus of the Chinese economy.
  - Traditional targets of Chinese outbound M&A have been in energy and resources, with an emphasis on acquiring assets.
  - Recently, Chinese companies have had a mandate to pursue acquisitions in the technology and consumption-focused sectors.

Regulatory: PRC Regulatory Approvals

- PRC outbound investment approvals are generally trending towards deregulation, making it easier for PRC investors to make overseas acquisitions
- However, PRC regulatory regime can be unpredictable, and rules may change with little or no advance notice
  - *e.g.*, Recent rapid devaluation of RMB and reduction in foreign exchange reserves → China began to tighten capital outflow
  - Some investors caught off guard → unable to move cash offshore as originally planned
- Sellers may also request "China premium" for risks including PRC outbound investment approvals and regulations imposed on PRC public companies if the buyer is a public company
- PRC buyers should budget sufficient time for closing to account for unexpected regulatory delays
- Of 18 recent Chinese outbound M&A deals surveyed, 12 had failure to obtain PRC regulatory approval as a trigger for a reverse termination fee.

Regulatory impediments to outbound investment have softened, but parties must still be cognizant of possible difficulties and delays

Differences between Chinese and other Buyers: CFIUS

What is CFIUS?

- Inter-agency committee of U.S. government authorized to review, investigate and block transactions or investments that could result in control of a U.S. business or assets by a foreign person that may raise national security concerns, or involve critical infrastructure

Definitions Underlying CFIUS review

- “Control” is defined as “the power, direct or indirect, whether or not exercised, and whether or not exercised or exercisable through the ownership of a majority or a dominant majority of the total outstanding voting securities of an issuer, or by proxy voting, contractual arrangements or other means, to determine, direct or decide matters affecting an entity…”
- “Foreign person” is not determined by where an individual or entity does business, but is determined by whether it is controlled by a foreign interest. The rules reach:
  - The acquisition of a foreign company’s U.S subsidiary by another foreign company *or*
  - The acquisition of a U.S. company by the U.S. subsidiary of a foreign company

Differences between Chinese and other Buyers: CFIUS (cont'd)

Key Areas of Focus for CFIUS

- CFIUS focused on areas of particular national security concern, including foreign control of U.S. businesses that:
  - Provide products/services that could expose national security vulnerabilities, including cybersecurity concerns or vulnerability of supply chain
  - Implicate critical infrastructure.
  - Are involved in activities related to weapons and munitions manufacturing, aerospace and radar systems, or that otherwise do business in defense, security or law enforcement sectors.
  - Engage in R&D, production or sale of technology, goods, software or services subject to export controls.
  - Produce advanced technologies useful to national security, including those with both commercial and military applications.
- And the acquisition of control by foreign persons that are controlled by a foreign government or from a country with nonproliferation or other security concerns.

Differences between Chinese and other Buyers: CFIUS (cont'd)

CFIUS Raises Significant Concerns

- CFIUS issues continue to raise significant concerns for parties involved
- Reinforced by recent high-profile cases stymied by CFIUS issues:
  - *Termination* of attempted acquisition of Philips NV's Lumileds LED business by consortium of Chinese investors due to parties' failure to address national security concerns raised by CFIUS
  - *Termination* of subscription of newly issued shares in Western Digital by Unis Union and Unisplendour after CFIUS determined to investigate transaction
  - *Rejection* by Fairchild Semiconductors of a bid from consortium of Chinese investors, citing CFIUS risk

CFIUS is perceived among China-based acquisition players as a major barrier

Differences between Chinese and other Buyers: CFIUS (cont'd)

Implications

- Sellers often ask for a "China premium" to compensate for additional CFIUS risks, as well as other risks and delays associated with seeking internal Chinese regulatory approvals
- Sellers often ask for a reverse termination fee triggered by a failure to obtain CFIUS approval
  - 22% of recent deals surveyed specifically had failure to obtain CFIUS approval as a trigger for a reverse termination fee
  - 60% of recent deals surveyed had CFIUS covenants related to closing conditions
- CFIUS efforts covenants are heavily negotiated, including:
  - Whether buyer would be subject to "hell or high water" efforts standard (10% of recent deals surveyed had this standard)
  - Whether there would be any limitation on extent of mitigation measures buyer is obligated to take
    - *e.g.*, cap on amount of assets/business buyer/target are obligated to divest, material vs. MAE threshold, etc.
    - 66% of recent deals surveyed had some form of limitation on buyer's mitigation obligations

CFIUS review and blockage risks have significant impact on transaction terms requested by Chinese buyers

Differences between Chinese and other Buyers: Financing

- Buyers
  - PE Buyers - unlike traditional PE funds, many Chinese PE funds only start raising capital after an investment opportunity has been identified, often after signing of a deal.
  - Strategic Buyers - for strategic buyers that are public companies, acquisitions will most likely be financed (or refinanced) by equity financing.

- Timing issues
  - Equity financing by public companies in connection with a major acquisition will likely require the approval of CSRC, which generally takes a considerable period to obtain (9-12 months).
  - Sellers are unlikely to be wiling to wait for this period and bridge financing may become necessary.
  - If equity financing is ultimately required, it is important to know what is needed to obtain CSRC approval and to reflect such requirements in the transaction documents.

- Chinese financing is typically not as committed at signing as customary U.S. bridge loans
  - Local Chinese banks may not be able to produce U.S.-style debt commitment letters
  - Chinese buyers may provide a simple commitment from a bank (e.g. “Buyer will provide up to $X in financing…”)
  - Even if commitment documentation from a Chinese bank appears to be on a “committed” basis, Chinese buyers typically won’t agree to be subject to an obligation to enforce lenders’ funding obligations

- Sellers sometimes ask for a higher reverse termination fee to compensate for the lack of committed financing at signing

Differences between Chinese and other Buyers: Enforceability of U.S. Judgments

- When disputes arise in cross-border transactions, arbitration before an international panel, as opposed to litigation in the courts of a particular country, is usually the parties' dispute-resolution mechanism of choice.
  - China is a party to the New York Convention on Recognition and Enforcement of International Arbitration Awards.
  - International arbitration is preferred as Chinese courts can readily overturn results of domestic arbitration.
  - New York Convention permits court of signatory state to refuse to enforce foreign arbitration award that violates the "public policy" of the state.
  - Supreme People's Court of China has used the "public policy" exception on occasions.

- Suing Chinese companies in the U.S. is generally not advised
  - Judgments in U.S. courts are generally not enforceable in China.
  - China has not yet entered into bilateral treaties or conventions for recognition and enforcement of judgments with its major trading and investment partners.
  - Unless Chinese defendant has assets in the U.S. upon which a U.S. court can levy, recovery is not likely.

Differences between Chinese and other Buyers: Reverse Termination Fee

Triggers

- Sellers typically want the buyer to bear regulatory risks by asking for a reverse termination fee triggered by the failure to obtain required approvals (88% of recent deals surveyed had a Reverse Termination Fee, or RTF)
  - PRC regulatory approvals (75% of recent deals surveyed with RTFs)
  - Buyer shareholders approval (44% of recent deals surveyed with RTFs)
  - CFIUS approval (25% of recent deals surveyed with RTFs)
  - Anti-trust approvals (38% of recent deals surveyed with RTFs)

Enforcement challenges

- Due to enforcement risks, sellers typically ask Chinese investors to provide some form of credit support for obligation to pay reverse termination fee and/or purchase price (88% of recent deals surveyed with RTFs)

Typical credit support mechanisms

- Cash deposit paid into an offshore escrow account at or shortly after signing (25% of recent deals surveyed with RTFs)
- Cash deposit paid into an onshore escrow account at or shortly after signing (25% of recent deals surveyed with RTFs)
- Parent/shareholder guarantee (19% of recent deals surveyed with RTFs)
  - For public company buyers, controlling shareholder sometimes provides a parent guarantee to backstop buyer’s obligation to pay reverse termination fee and/or purchase price
- A performance guarantee/standby letter of credit issued by an international bank or offshore branch of a Chinese bank (19% of recent deals surveyed with RTFs)