CGCC Lunch & Learn Series:
China Outbound Mergers and Acquisitions

China General Chamber of Commerce - U.S.A.
CGCC Foundation
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U.S. M&A MARKET TRENDS
Recent trend in U.S. M&A

Source: Bloomberg
Top Nations for U.S. Inbound M&A Activity

Source: IMMA
China-U.S. Inbound M&A Deals

Source: Bloomberg
Current M&A Outlook

- A slower start to 2017
- Cross-border activity continues
- Equity and debt market volatility worries U.S. investors
- Mega-deals give way to more mid-market activity
- Private equity quiet
- Continued shareholder activism and hostile deal activity
- Tech deals continue strongly
BASIC ACQUISITION STRUCTURES
Basic Acquisition Structures

• **Asset Acquisition**
  ✓ Buyer purchases some or all of Target’s assets. Target may or may not remain in existence
    o Includes divisional carve-out (buyer purchases assets of a given division or business unit held across multiple legal entities)
  ✓ Liabilities stay with Target except to the extent agreed otherwise
  ✓ Generally favored by buyers

• **Private Stock Acquisition**
  ✓ Can be a closely held company or a subsidiary of another company

• **Public Stock Acquisition**
  ✓ Tender or exchange offer, can be friendly or unsolicited
  ✓ Often followed by 2nd step “squeeze out” merger

• **Merger**
  ✓ All assets and liabilities of target are vested in survivor
  ✓ Private companies often use merger structure in friendly deals where a Target has a large number of shareholders
Asset Purchase

ADVANTAGES
• Ability to cherry pick assets and liabilities assumed
• Step-up in tax basis of assets

DISADVANTAGES
• Purchased assets and assumed liabilities must be identified carefully
• Greater likelihood of anti-assignment/consent issues
• In general, “double tax” on proceeds distributed to Target stockholders
Stock Purchase

**ADVANTAGES**
- Fewer assignment / consent issues
- Avoids need to identify assets and liabilities assumed

**DISADVANTAGES**
- All stockholders must agree to sell in order for Acquiror to acquire 100% of target
- No basis step up in assets unless election made to pay tax at corporate level
- Acquiror takes Target subject to all known and unknown liabilities
Merger

**ADVANTAGES**
- Dissenting minority stockholders can be “squeezed out,” usually with a simple majority vote, giving Acquiror 100% ownership
- Fewer assignment/consent issues
- Avoids need to identify assets and liabilities assumed

**DISADVANTAGES**
- Target stockholder vote required
- Dissenting target stockholders may have appraisal rights
- Acquiror takes Target subject to all known and unknown liabilities

*May also be structured to involve a forward/reverse triangular merger, in which Target merges with a subsidiary of Acquiror, with the subsidiary/Target surviving as a subsidiary of Acquiror.*
Two-Step Acquisition Structure

Step 1 – Tender offer

Offeror (Merger Sub) → Offer consideration → Target Stockholders → Target Stock

Step 2 – Reverse Triangular Merger

Parent → Merger consideration → Merger Sub → Merger → Target → Non-tendering Target Stockholders
Forms of Consideration

- **Cash as Consideration**
  - Cash is still king, but continued prevalence of public stock deals

- **Stock as Consideration**
  - Can often be done on “tax-free” basis
  - Issues
    - Pricing/Valuation
    - Securities Laws
      - Stock must be registered or exempt from registration
      - Stock in some cases can be issued without registration if relevant authorities (such as California) approve the issuance in a “fairness hearing”
Public vs. Private Deal Distinctions

• **Heightened attention to board fiduciary duties in public deals**
  - State law issues the same, but greater risk of claims
  - Investment bankers and fairness opinions

• **Public companies are required to publicly report material information**
  - GAAP financials and other material information available and current
  - Non-public information will require NDA, perhaps standstill and nonsolicit

• **Deal terms vary**
  - No purchase price adjustment and infrequent earn out structures
  - Limited scope of representations and warranties
  - Deal certainty / deal protection
  - No survival of representations and warranties, post-closing indemnity
Friendly vs. Unsolicited Transactions

• In “friendly” deal parties negotiate merger agreement, with or without a first step tender offer

• In unsolicited deals, buyer goes directly to target’s stockholders
  ✓ generally buyer tries friendly approach to target board first (bear hug letter)
  ✓ tender offer/exchange offer
  ✓ often combined with proxy contest if necessary
  ✓ antitakeover defenses of target must be reviewed carefully in planning strategy
  ✓ limited ability to conduct due diligence
Fiduciary Duties

• **Duty of Care.** The duty of care requires the Directors to take reasonable steps to become informed as to all information reasonably available to them. Directors must (i) be informed, (ii) make a reasonable effort to become familiar with relevant and available facts, and (iii) act with due care when making decisions. Directors may rely upon information, opinions, reports, etc. presented by officers, board committees, employees and experts as to matters reasonably within those persons' areas of expertise. Such reliance not a defense but helps establish good faith/care.

• **Duty of Loyalty.** The duty of loyalty requires the Board to act in good faith and not out of self-interest, such that the interests of the Company and its stockholders are paramount. If a Director has an interest in the proposed transaction, that interest must be disclosed to the Board so that a decision can be reached as to whether the interested Director should abstain from voting on the transaction.

• **Issues for Majority Stockholder**
  • Owes fiduciary duties to minority
  • Must deal with company at arm’s-length
  • Even a minority investment can substantially complicate a subsequent acquisition of the company (Entire Fairness, Rule 13e-3)
Recent Developments

• **Changes to Appraisal Proceedings:** In July 2016, the State of Delaware amended its General Corporation Law so that very small appraisal claims for publicly-traded companies will be dismissed. Also, corporations can now pre-pay dissenting stockholders prior to a court’s final value determination, which minimizes the interest a company would have to pay to the dissenting stockholders.

• **Courts are pushing back against M&A stockholder litigation.**
  - *Corwin v. KKR Financial Holdings LLC* (2015): Merger approval by a fully-informed, disinterested majority of stockholders “cleanses” any breach of fiduciary duty claims against a company’s officers and directors.
  - *In re Volcano Corp. Stockholder Litigation* (2016): Majority acceptance of a tender offer has the same “cleansing” effect.
  - In the past, stockholder litigation was frequently settled in a “disclosure-only settlement” wherein the company agrees to provide additional information to the stockholders. However, in *In re Trulia Stockholder Litigation* (2016), the Delaware Chancery Court rejected a disclosure-only settlement of a breach of fiduciary duty claim, writing that disclosure-only settlements will not be approved unless the additional disclosures “address a plainly material misrepresentation or omission.”

• **Adoption of Blockchain and Distributed Ledger Technologies.** The State of Delaware has amended its General Corporation Law to allow corporations to utilize electronic databases and blockchain technology to maintain and distribute corporate records and shareholder communications. These changes became effective August 1, 2017.
KEY U.S. REGULATORY FILINGS AND APPROVALS
Section 13(d) and (g) Reporting Requirements

• **More than 5% Holders must Report:**
  • Section 13(d) under the Securities Exchange Act requires disclosure of certain information to a public company, to each exchange on which the company’s stock is traded and to the Securities and Exchange Commission within 10 days from becoming direct or indirect beneficial owner of more than 5% of any class of the company’s equity securities (typically the common stock).

• **Section 13(d) rules provide for two types of filings: a long-form Schedule 13D and a short-form Schedule 13G.**
  • “Passive investors” (i.e., stockholders that do not hold shares with any purpose, or with the effect of, changing or influencing the control of the company) use Schedule 13G
  • A 5% stockholder that does not meet the “passive investor” criteria (i.e., it acquires more than 20% of the company’s common stock or has a control purpose) must file a long form Schedule 13D within 10 days of such event.
  • 13D filers must disclose intentions and must file amendments for material changes in filed information
Section 16

- Officers, directors and beneficial owners of more than 10% of a class of equity registered under the Exchange Act (determined in the same manner as under Section 13(d)) are subject to Section 16, which means:
  
  - They are liable for the disgorgement of “short-swing profits” (from any sale and purchase or purchase and sale that occur within 6 months of each other) and are prohibited from selling short any equity security of the issuer.
  
  - They are required to report their beneficial ownership on Forms 3, 4 and 5.
Antitrust

• Subject to the “passive investment” exception, the 30-day waiting period following an HSR notification must be observed prior to (i) the acquisition of $80.8 million or more of voting securities or assets of the company if either the investor or the company has assets or annual sales of at least $161.5 million and the other party has assets or annual sales of at least $16.2 million or (ii) any acquisition involving more than $323 million of voting securities or assets of the company.

  • The obligation to report under the HSR Act depends on the size of the “person” involved. “Person” is defined as the “ultimate parent entity” of the investor or the company, which is in turn defined as the company, individual or entity that controls a party to the transaction and is not itself controlled by anyone else. Control is established by having beneficial ownership of 50% or more of the outstanding voting securities of a person.

  • The information filed pursuant to the HSR Act is not made public, except as may be relevant to an administrative or judicial proceeding. However, if a request for early termination of the 30-day waiting period is granted, that fact will be published on the FTC’s website.
Committee on Foreign Investment in the U.S. (CFIUS)

- Parties to an acquisition may file notification with CFIUS to give the U.S. government an opportunity to review the transaction and, if necessary, address any national security concerns
  - The CFIUS review period is 30 days; if at the end of the initial 30 day period CFIUS has not completed its review, it can initiate a 45-day investigation

- CFIUS filings are confidential and voluntary; however, in the absence of a filing there is a risk that the transaction could be subsequently unwound or the foreign acquiring party forced to accept mitigation measures that may be unacceptable as a business matter
  - The scope of CFIUS review is expansive and applies to any transaction that results in foreign control of a U.S. company or assets engaged in interstate commerce in the U.S. that may implicate national security issues

- CFIUS process has been particularly challenging for Chinese acquirers:
  - In 2012, Ralls Corporation, owned by the Chinese Sany Group, was ordered to divest itself of four small wind farm projects located too close to a U.S. Navy weapons systems training facility in Boardman, Oregon
  - A similar issue arose in the CFIUS review of Procon Resources’s private placement deal with Lincoln Mining Corporation; in June 2013, the parties agreed that Procon would divest its investment in Lincoln subject to the review and approval of CFIUS
  - In January 2016, following CFIUS’s review of GO Scale's proposed acquisition of the Philips Lumileds Lighting Company, the parties announced that they were terminating their transaction because regulatory clearance had not been obtained
Industry Regulations

• **Insurance**
  • Under the *Insurance Holding Company System Regulatory Act* (adopted in most states), control of an insurance company (generally presumed with ownership of 10% or more of voting power (but 5% in Florida)) requires prior approval by the Insurance Commissioner of the domiciliary state.

• **Banking**
  • The *Change in Bank Control Act* prohibits any person from acquiring control of an insured depository institution without first obtaining approval from the appropriate federal regulator. Control is considered conclusive with ownership or control of 25% or more of any class of voting securities and is presumed with ownership or control of 10% or more of any class of voting securities.
  • The *Bank Holding Company Act* requires a company to obtain approval from the appropriate federal regulator before taking any action that causes the company to become a bank holding company – i.e., a company that directly or indirectly controls a bank. Control is presumed with ownership of 25% or more of voting securities or controlling the election of a majority of the directors; rebuttable presumption of control if owning between 10%-25% of the voting securities.
Industry Regulations (cont’d)

• **Public Utilities**
  • The *Federal Power Act* requires the prior approval of the Federal Energy Regulatory Commission (FERC) for change in control of a public utility. Ownership of 5% or more of voting securities of an exempt wholesale generator or 10% of voting securities of other public utilities creates a rebuttable presumption of control.

• **Telecommunication**
  • Under the *Communication Act*, a substantial change of ownership or control requires prior approval of the Federal Communications Commission (FCC). Control may be either de facto (determined on a case by case basis) or de jure (greater than 50% of the voting stock of a corporation, holding of a general partnership interest). Control exists where an individual can determine the manner or means of operating the licensee. Certain limitations on non-US ownership of certain categories of “radio station” licenses and cross-ownership limitations may also apply.

• **Gaming**
  • The *Nevada Gaming Commission* requires a beneficial owner of more than 10% of any class of voting stock of a company registered with the Nevada Gaming Commission to apply to the Commission for a finding of suitability within 30 days after notice requiring such filing. Similar requirements are in force in other states.
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