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Hot Topics - M&A Activity in the United States: What Chinese Investors Need to Know to Be Successful

Introduction

Despite the recent market volatility and a weak global economic outlook, outbound acquisitions by Chinese corporations reached a new record for the six-month period ending on June 30, 2011, with a 14 percent increase over last year. The United States continues to be a preferred destination for Chinese acquisitions and strategic investment, driven by China's huge dollar reserves, combined with opportunities presented in the United States by virtue of the weak dollar, the debt crisis and the strategic drive for Chinese companies to gain access to U.S. global brands, commodities, distribution systems and technology.

Chinese acquisition activity in the United States will likely intensify in the second half of the year, as recent European monetary instability and increases in commodity prices and currency exchange rates in the Asia-Pacific region make U.S. targets comparatively more attractive to Chinese investors. In addition, given the U.S. Securities and Exchange Commission's (the "SEC") increased scrutiny and regulation of China-based companies going public in the United States via reverse merger transactions involving dormant publicly traded shells (there have been more than 150 such transactions since 2007), not to mention the significant litigation which has resulted, Chinese companies may have to look for different ways to access the U.S. markets.

Those who follow Chinese investment activity in the United States know that in recent years, several high-profile strategic investments by Chinese companies have been blocked by the United States on national security grounds. These failed deals included a 51% investment by a government-controlled Chinese company in Nevada-based gold mining company Firstgold Corp., a 60% investment by a Chinese investment company in New Mexico-based fiber optics company Emcore Corp. and, most recently, the controversial purchase by Huawei Technologies Co. of certain assets of 3Leaf Systems, a California-based server technology company.

These setbacks have caused certain commentators to question whether the United States disfavors this inbound activity and is engaged in an "M&A cold war" against China. The fact of the matter is, however, that in recent years, the vast majority of Chinese investments in the United States have obtained regulatory clearance, making the United States the top target of Chinese strategic investments by value in 2010. Earlier this year, for example, CNOOC Limited, a company controlled by the Chinese state oil company, purchased equity interests in two of Chesapeake Energy Corporation's oil and natural gas projects. In 2010, Ford Motor Company consummated the sale of its Volvo unit to a Chinese car manufacturer for $1.8 billion. On August 17, during his four-day diplomatic visit in China, Joe Biden reiterated the U.S. commitment to welcoming Chinese investments and encouraged "Chinese companies investing abroad to look first at the United States."

Our M&A team has handled numerous complex cross-border transactions in varying industry sectors and has come to understand that most transactions undertaken by Chinese and other foreign companies in the United States can be successfully implemented through a combination of (a) careful analysis of relevant local and national political implications and the early involvement of federal and state governmental agencies and other stakeholders, (b) the identification of the most appropriate transaction structure, and (c) a timely review of all legal issues that are likely to complicate the negotiations.

Below is a checklist of issues that Chinese companies should consider in advance of any acquisition or strategic investment in the United States.

National Security Review

It is of key importance for Chinese companies to understand the regulatory framework for market entry in the United States and to undertake an early and thorough analysis of potential political implications of a proposed transaction, especially if the target company is in a sensitive industry or if the acquirer is part or wholly government owned.

In addition to securities, antitrust and industry-specific regulations (which are further discussed below), Chinese investors must pay particular attention to the national security review of the Committee on Foreign Investment in the United States ("CFIUS") pursuant to the Exon-Florio Amendment to the Defense Production Act ("Exon-Florio"), as modified by the Foreign Investment and National Security Act of 2007 ("FINSA").

Exon-Florio authorizes the President to suspend or prohibit any transaction that could result in a foreign person having, directly or indirectly, control over a U.S. business, if the President finds that: (i) "there is credible evidence that the foreign interest exercising control might take action that threatens to impair the national security," and (ii) other provisions of law are not adequate to protect the national security. The acquisition of control of U.S. assets that do not constitute a "business" (such as leases, greenfield investments or mere physical assets) does not implicate the statute. At the same time, the Treasury Department, as the leader of CFIUS, takes a broad view of what constitutes "control" and has found in some circumstances that a foreign acquirer is deemed to control a U.S. business even with an equity stake of less than 20% if the acquirer is one of multiple persons with the ability to direct operations of the U.S. business.

CFIUS may review any covered transaction on its own initiative or upon notification of the interested parties. Although notification is not mandatory, absence of clearance by CFIUS leaves a covered transaction subject indefinitely to potential divestment or other sanctions under Exon-Florio. Only once in the history of Exon-Florio has a U.S. President ordered divestiture — namely, President George H.W. Bush's order in 1990 requiring China National Aero-Tech to divest itself of a U.S. aircraft parts manufacturer, Mamco Manufacturing Co.

FINSA requires CFIUS to determine the "national security risk" of a covered transaction by assessing the potential threat posed by the foreign person, the vulnerability of the U.S. assets and business at issue, and the potential consequences. Although the Exon-Florio statute does not define "national security," FINSA codified many of the factors that the President and CFIUS may consider in making their Exon-Florio assessments, including national defense needs, "technological leadership," "critical infrastructure," "critical technologies," foreign government-controlled transactions, "U.S. requirements for sources of energy and other critical resources" and the involvement of countries implicated in terrorism or weapons. The characteristics of proposed Chinese investments that have been related to these factors in the past include: (a) the perceived ties of Chinese companies to the Chinese government and military; (b) the use of state subsidies to assist Chinese investors; (c) the perceived risk of espionage presented by a given transaction; (d) the regulatory compliance record, including in particular export control compliance record, of Chinese companies; and (e) a perceived rivalry between the U.S. military and the Chinese military.

We believe there are some helpful guidelines that should be followed when dealing with CFIUS. First of all, the recent post-closing request by CFIUS to unwind Huawei's purchase of 3Leaf is a cautionary reminder that it is prudent to make a voluntary filing with CFIUS if there is any possibility of a national security review. Second, as CFIUS has increased the use of mitigation agreements and conditional approvals for covered transactions, it is often best to propose methods of mitigation early in the review process to deal with certain identified issues. These measures range from undertaking certain obligations with respect to production, recordkeeping and participation in certain sensitive activities to more stringent measures, including technical and physical security requirements, permitting U.S. government access to systems and personnel, testing and screening of personnel, and third-party auditing. Third, discussions with U.S. Treasury officials and CFIUS experts can give Chinese acquirers some degree of predictability with respect to process, timeframes and, ultimately, results on the regulatory and political fronts.

Other Regulatory Approvals

Securities Regulation

If the target is a company with shares registered on a U.S. stock exchange, there are several requirements under U.S. securities laws and regulations that may be imposed on either the U.S. target company or the Chinese investor.

First, registered U.S. entities must file a Form 8-K with the SEC to provide a detailed disclosure of any change of control transaction and related acquisition agreements. Second, persons who acquire beneficial ownership interest of more than 5 percent of any voting securities registered under the Securities Exchange Act of 1934 must file with the SEC a beneficial ownership report – Schedule 13D – disclosing, among other things, the shareholder's intent with respect to the target. Third, tender offers for publicly held stock must comply with the SEC's tender offer rules, which include filing a schedule with the SEC describing the tender offer and providing substantive disclosures. Fourth, shareholder votes required under state corporate law and stock exchange regulations for acquisition transactions involve the filing of a proxy statement with the SEC to be disseminated to the target's shareholders who are entitled to vote on the transaction.

Finally, acquisition transactions are also governed by anti-takeover state laws and the rules of various stock exchanges, including the New York Stock Exchange, NASDAQ and Amex, which impose various requirements regarding disclosure and shareholder and board approvals of such transactions.

Antitrust

An additional standard federal review in connection with U.S. business combination activity is a competition review conducted by the U.S. Federal Trade Commission (the "FTC") and the Department of Justice ("DOJ"). The U.S. antitrust laws prohibit acquisitions of interests or assets of a U.S. company if the "effect of such acquisition may be substantially to lessen competition" in a relevant U.S. product market. The Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HSR") requires parties to submit a pre-merger notification for most significant acquisitions. The HSR notification requirements apply if the transaction meets certain thresholds based on the value of the transaction and the size of the parties, or if, regardless of the size of the parties, the transaction will result in the acquirer receiving at least $252.3 million of the target's interests and assets.

Upon filing of the HSR notification, the proposed transaction may not be consummated until the expiration of a 30-day waiting period, unless (a) the waiting period is terminated early by the FTC, (b) additional information is requested by the FTC or DOJ thereby extending the waiting period, or (c) the FTC or DOJ requires a restructuring of the transaction or imposes some condition or restriction on the transaction. To the extent that a Chinese acquirer directly or indirectly competes or holds an interest in a company that competes in the same industry as the target company, antitrust concerns may arise either at the FTC or DOJ level. Any integration efforts contemplated to occur prior to closing should also take into proper account any antitrust considerations.

Industry-Specific Approvals

In certain particularly sensitive sectors, U.S. laws expressly restrict the percentage of foreign ownership and require certain state and federal regulators to approve the acquisition of U.S. businesses. Therefore, Chinese companies looking to acquire control of a U.S. target must also consider what, if any, industry-specific federal and state regulatory approvals are required as part of advance planning. The following industries are heavily regulated in this regard:

- *Aviation.* Domestic air transport of passengers and freight in the United States is limited to aircrafts registered by (a) U.S. citizens, or (b) U.S. corporations in which the president and two-thirds of directors and managing officers are U.S. citizens and 75% of the stock is held or controlled by U.S. citizens. The approval of the U.S. Department of Transportation is required for all mergers or acquisitions of control over U.S. air carriers.

- *Banking*. Banking transactions are heavily regulated at the federal and state level and M&A transactions in this industry often require multiple approvals. In general, a foreign bank must receive U.S. Federal Reserve Board approval and obtain a banking charter from either the U.S. Comptroller of the Currency or the pertinent state supervisor, although foreign banks sometimes operate through a branch or agency which is licensed to perform specifically limited banking services. The Federal Bank Holding Company Act requires the Federal Reserve Bank to review and approve any transaction that would result in any company, foreign or domestic, acquiring control of a bank holding company or certain types of banks. Control is deemed to exist when the transaction results in the acquisition of 25% of more of the bank, although an even lower percentage (down to 5%) may trigger the regulatory approval requirement if other indicia of control are present.

- *Communications and Broadcasting.* All radio and TV broadcasting in the U.S. requires a license from the Federal Communications Commission (the "FCC"). Section 310 of the Federal Communications Act of 1934 prohibits foreign governments and companies from owning more than 20% of the stock of a broadcast, common carrier or radio station licensee or more than 25% of a U.S. corporation owning or controlling such licensee. However, Section 310 allows foreign investments in excess of the 25% limitation at the holding company level if the FCC does not find the foreign ownership to be inconsistent with the public interest. Chinese acquirers should also be aware that acquisitions of telecommunications providers often require approval by state utility commissions, which have authority to review the acquisition for its competitive effects on the local market.

- *Defense Industry.* The Defense Industrial Security Program is designed to promote national security by preventing companies under foreign control from engaging in classified work. In general, a facility or contractor found to be under foreign ownership, control or interest ("FOCI") is not eligible for a facility security clearance. FOCI is determined on a case-by-case basis and factors such as percentage of foreign beneficial ownership (5% or more), nationality of directors and officers, and percentage of income from foreign sources (10% or more) are considered.

- *Insurance.* Insurance companies in the United States are regulated heavily on the state level. Some states have U.S. citizenship and residency requirements for directors of insurance companies. Despite this regulation, there are many foreign insurers operating throughout the United States.
- *Maritime.* Coastal and freshwater shipping in the United States is restricted (with limited exceptions) to vessels built and registered in the United States and owned by U.S. persons. A corporation qualifies as a U.S. person only if (a) it is organized under U.S. laws; (b) its chief executive officer, chairman of the board and a majority of its directors are U.S. citizens; and (c) at least 75% of its shares are owned by U.S. citizens.
- *Mineral Leases and Resources.* Energy resources are also heavily regulated by both state and federal laws. The federal Mineral Lands Leasing Act allows mineral lands owned by the federal government to be leased only to U.S. citizens and to corporations organized in the United States The latter may be foreign owned, but in general a greater than 10% foreign ownership is allowed only to the extent the foreign owner's country grants similar rights to U.S. citizens. Also, for an alien to obtain an interest in a mineral lease held by a U.S. person, the Secretary of the Interior must approve any subleases or assignments of such lease.
- *Power Generation and Utility Services.* The Atomic Energy Act prohibits foreign ownership or control of nuclear power facilities. In addition, only U.S. persons may obtain geothermal steam and similar leases of federal land or licenses to own or operate hydroelectric power facilities. In the latter cases, the U.S. person may be a U.S.-registered corporation, and there is no limit on foreign ownership, although applications where foreign ownership or control is involved are often more highly scrutinized.

Chinese Regulatory Approval

Chinese acquirers and U.S. targets should also be aware that Chinese outbound acquisitions in non-financial foreign companies are also subject to scrutiny by the Chinese Ministry of Commerce ("MOFCOM"), pursuant to the Measures on the Administration of Overseas Investments. While a fast track approval process applies for investments of less than $10 million, the prior approval of MOFCOM's provincial authorities is required to approve any acquisitions having a value between $10 and $100 million or involving natural resources or capital to be raised in the People's Republic of China. Approval by the central MOFCOM is required for any investment in excess of $100 million involving a foreign public listing or affecting multiple jurisdictions or countries with no diplomatic relations with China.

Collaboration With Other Stakeholders

Clearance of regulatory obstacles is often best achieved with a concerted effort involving all relevant stakeholders, including federal, state and local agencies, as well as target's employees, customers, suppliers and any highly organized political groups (such as labor unions) that may be interested in the transaction. It is often best to approach these stakeholders in partnership with the target's management and local legal and financial advisors, to emphasize the benefits of the transaction to the local community and reduce the appearance of a national security threat.

M&A and Corporate Issues

Acquisition Structure

The acquisition of a U.S. business can be structured as a purchase of the target's stock or assets or a merger of buyer (or buyer's wholly-owned acquisition vehicle) with target. The choice of the most-efficient structure is usually driven by the specific facts of each particular transaction, with a particular eye to varying tax implications, issues surrounding the buyer's assumption of target's liabilities, required corporate consents and third-party approvals, and other statutory issues. In addition, the acquisition agreement for each structure presents peculiar issues with respect to such issues as scope of representations and warranties, price-adjustment mechanisms, key closing conditions, pre- and post-closing covenants, and scope of indemnities.

Special considerations apply to acquisitions of publicly traded companies. In public deals, generally the scope of representations and the need for due diligence are less critical, indemnity provisions are very rare, and the main issues are economics, deal certainty and break-up fees.

Chinese companies should also be aware of shareholders' derivative litigations, which are fairly routine in U.S. public acquisition transactions. In addition, when the target is a public company, the timing of any public disclosure of acquirer's interest in the target should also be carefully analyzed, keeping in mind the various disclosure requirements under the securities laws and regulatory agency rules.

As described above, CFIUS often closely examines the Chinese investor's ongoing role in the target business, especially when the acquirer is foreign government-controlled. Therefore, certain Chinese acquirers may need to consider alternative transaction structures, including settling for a minority investment or a joint venture; investing in preferred stock or debt securities; making the acquisition in collaboration with a U.S. lender or U.S. private equity firm or co-investor; or employing a U.S. acquisition vehicle with U.S. involvement in the management.

Forms of Business Entities in the United States

A Chinese investor may choose among a variety of company structures to do business in the United States The most frequently used forms are corporations, limited partnerships, and limited liability companies. Important factors to consider in selecting the form of business entity include whether limited liability exists for the entity's owners, governance rules, capital and credit requirements, tax considerations, transferability of ownership, and corporate formalities. In the United States, corporate entities are creatures of state law, not federal law. Therefore, if a new U.S. entity is contemplated, foreign investors will need to choose one of the 50 states (or Washington, DC) in which to establish such entity. Because of the flexibility of its statutes and the excellent guidance offered by its courts in matters of corporate governance, Delaware is an extremely popular state for entities to be formed in the United States, whether or not business will actually be conducted in that state. California and New York are also popular because of their importance as commercial centers.

Compared to China, the process of organizing a new corporation, limited liability company, or limited partnership in the United States is speedy (from 2 to 5 days), relatively informal, and not expensive. Moreover, there are no minimum capitalization requirements.

Due Diligence and Acquisition Process

A thorough due diligence review of a potential acquisition target must take account of the target jurisdiction's legal regime and industry-specific issues and regulations. Areas of critical concern include current or threatened litigation, employment, labor and ERISA, environmental, and intellectual property matters. A Chinese acquirer should carefully assess not only current liabilities that have been identified, but also ongoing compliance issues arising from the acquisition.

In addition, it is particularly important, especially in a competitive auction situation, that due diligence and negotiations be conducted by experienced U.S. advisors in line with local custom and practice. Understanding how to negotiate with the target's management and its stakeholders can be essential to achieving a negotiated deal and discouraging competitors, including those who might raise political or regulatory issues as a way of trying to derail the transaction.

Post-Closing Considerations

Although any integration plan with the target cannot be implemented until regulatory approvals are obtained, Chinese acquirers should recognize and attempt to deal from the outset with any post-closing integration issues that could complicate the successful closing of the deal. Some of these risks may be minimized by establishing a relationship with incumbent management and addressing the concerns of employees, customers and suppliers at an early stage.

We also recommend that Chinese acquirers pay great attention to the following ongoing compliance issues that may arise from the acquisition to ensure compatibility with home country rules:

- *Corporate Governance and Securities Law.* U.S. securities and corporate governance rules, including those set forth by the Sarbanes-Oxley Act and the New York Stock Exchange's and NASDAQ's listing standards, can frequently raise issues for Chinese acquirers who will be acquiring or issuing publicly traded securities as a result of an acquisition. Rules relating to director independence, internal control reports and loans to officers and directors, among others, can be troublesome for Chinese companies listing in the United States.

- *Foreign Trade Controls Regulations*. For Chinese investors who may wish to access U.S. technology in connection with their investments, it is important to be aware of U.S. licensing restrictions on certain export items, including the rules set forth by the Export

Administration Regulations ("EAR"), the International Traffic in Arms Regulations ("ITAR") and the Office of Foreign Assets Control ("OFAC"). EAR specifically provides restrictions on the export and re-export of commercial products and technologies from the United States (including foreign-made items with minimal U.S.-origin content). Under current ITAR rules, export or re-export to China of certain U.S. defense articles and services is prohibited. OFAC prohibits certain business dealings with targeted countries (e.g., Cuba and Iran) and parties (e.g., terrorist organizations and narco-traffickers).

- *Foreign Corrupt Practices Act of 1977 ("FCPA").* The FCPA is a broad anti-corruption statute with both criminal and civil provisions that address bribery directly and through provisions relating to accounting and internal controls that hide corrupt transactions. The FCPA can have special relevance for Chinese companies because its bribery prohibitions apply not only to U.S. persons but also to Chinese nationals in the United States who provide gifts to employees of state agencies, state-owned companies and quasi-private entities serving state functions. Given the broad scope of the FCPA and its stiff penalties, it is often prudent for a Chinese investor to plan for a strong FCPA compliance program. Likewise, in a stock-for-stock or a joint venture transaction, a U.S. counterparty may seek strong FCPA-related representations from a Chinese investor.

Conclusion

The United States remains a particularly attractive destination for Chinese investors. In addition to the traditional lure of the rich public and private capital markets, opportunities for investment abound in a wide variety of industry sectors, including infrastructure, information technology, media and entertainment, life sciences, pharmaceuticals, real estate, natural resources, power generation and consumer products. Although regulatory oversight, as in most countries around the world, is a fact of life, as participants in China's fast-growing economy begin to ponder expansion beyond the lands of the Middle Kingdom, they will likely find the U.S.'s entrepreneurial spirit and decidedly pro-business environment a very compelling proposition.

Our **New York** corporate team includes sophisticated multilingual and multijurisdictional cross-border practitioners who are well versed in representing U.S. and foreign companies and private equity funds in a variety of cross-border transactions, including mergers, acquisitions, cash and stock-for-stock mergers, leveraged buyouts, auctions and divestitures, takeover defenses, stock and asset purchases, proxy contests, spin-offs and restructurings, joint ventures and strategic alliances, distribution and sales arrangements, and intellectual property licensing. Our international experience includes not only inbound work on behalf of overseas clients, but also outbound work to Europe, Latin America, Canada and Asia. We are dedicated to assisting our Chinese and other foreign clients reach their business goals in the U.S. by guiding them through the pitfalls of U.S. M&A practice and implementing ongoing compliance frameworks that work cost-effectively in both the U.S. and the foreign business and regulatory environments.

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