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The Ropes Recap

Mergers & Acquisition Law News

A quarterly recap of mergers and acquisition law news from the M&A team at Ropes & Gray LLP.

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NEWS FROM THE COURTS

Court of Chancery Applies Entire Fairness Standard to Commercial Arrangement with Controlling Stockholder

In a recent opinion, Vice Chancellor Laster of the Delaware Court of Chancery held that the entire fairness standard of review governs any transaction between a controlling stockholder and the controlled corporation in which the controller receives a non-pro rata benefit, unless the controller complies with the cleansing steps outlined in the Delaware Supreme Court's 2014 opinion in *Kahn v. M&F Worldwide Corp.* Citing various Delaware cases for the proposition that the entire fairness standard of review is not limited to squeeze-out transactions, the Court held that the transactions at issue—advisory services agreements between EZCORP and entities affiliated with its controlling stockholder—must be evaluated using the entire fairness standard even though the agreements had been approved by an independent committee of EZCORP directors. Applying that heightened standard, the Court rejected the controlling stockholder's motion to dismiss derivative claims filed by an EZCORP minority stockholder challenging the agreements.

EZCORP is a Delaware corporation that provides pawn services and other short term consumer loans. As a result of EZCORP's dual-class structure, Phillip Ean Cohen, through his ownership of 5.5% of the company's outstanding stock, controls 100% of EZCORP's voting power. EZCORP had a long history of entering into advisory services agreements with entities affiliated with Cohen. Under those agreements, Cohen's affiliates agreed to provide EZCORP with business development and strategic planning services. The affiliated entities were small firms with limited resources, and EZCORP was their only publicly-traded client in the United States. The annual fees EZCORP paid to Cohen's affiliated entities steadily increased from $1.2 million in 2004 to $7.2 million in 2012 (constituting roughly 21% of EZCORP's 2012 net income). The company's audit committee approved the renewal of the advisory service agreement in 2013, but then terminated the agreement in 2014. The Court attributed the termination to the committee's concerns about the fairness of the arrangement. Cohen responded quickly, using his voting power to remove the audit committee members from the board.

The plaintiff, an EZCORP minority stockholder, filed a derivative action challenging the advisory services agreements. The plaintiff contended that the agreements were not legitimate contracts for services, but rather a way for Cohen to extract cash from EZCORP. In evaluating the plaintiff's claims against Cohen and his controlled entities, the Court held that entire fairness review governs any transaction between a controller and the controlled corporation in which the controller receives a non-ratable benefit. In so holding, the Court rejected Cohen's argument that the entire fairness standard applied only to squeeze-out mergers – relying on a series of prior cases that reached a similar conclusion and rejecting three prior decisions of the Court of Chancery that had held to the contrary. The Court then evaluated the advisory services agreements to see whether they had been approved in accordance with the process set forth by

the Delaware Supreme Court in *MFW*, which provides that transactions with controllers will be subject to the business judgment standard of review if they are approved by both an independent fully empowered special committee and a majority of the unaffiliated stockholders. The Court found that entry into the agreements had not been conditioned *ab initio* on compliance with the *MFW* requirements, and, accordingly, were not eligible for review under the business judgment standard of review. The Court did explain, however, that the fact that the transactions were approved by the audit committee might be sufficient to shift the burden of proof under the entire fairness standard back to the plaintiff.

In holding that entire fairness applies to all transactions between a controlled company and its controller in which the controller receives a non-ratable benefit, Vice Chancellor Laster reasoned that it would be inappropriate to limit heightened scrutiny to squeeze-out merger transactions where other procedural protections (including appraisal rights) already exist. The Court dismissed the argument that applying entire fairness review to all such transactions would precipitate a drastic increase in litigation, noting that in its view entire fairness was already the standard of review, and that no flood of litigation had ensued.

EZCORP is the first decision since *MFW* to hold that a controlling stockholder may avail itself of the *MFW* protections to avoid entire fairness review outside the minority squeeze-out transaction context. However, to do so the controlling stockholder would have to voluntarily submit a transaction that is not otherwise subject to stockholder approval to a majority of the minority vote. This is unlikely to be a widely attractive option and a more practical approach in many situations will continue to be to rely on the burden-shifting benefit under the entire fairness standard of approval by a special committee of independent directors.

(*In re EZCorp Inc. Consulting Agreement Derivative Litigation*, C.A. No. 9962-VCL, 2016 Del. Ch. LEXIS 14 (Del. Ch. Jan. 25, 2016)).

Delaware Court Affirms that Entire Fairness is Operative Standard of Review for Controlling Stockholder Transaction that Did Not Satisfy MFW Factors

On January 22, 2016, Vice Chancellor Laster of the Delaware Court of Chancery issued a ruling in post-closing damages litigation regarding partial summary judgment in favor of minority stockholder plaintiffs' after finding that entire fairness review would apply in evaluating a two-step transaction with a controlling stockholder where the necessary conditions for obtaining business judgment deference established by the Delaware Supreme Court in *Kahn v. M&F Worldwide Corp.* had not been satisfied.

The Court ruled that majority stockholder Danfoss A/S, which owned 75.6% of the shares of subsidiary Sauer-Danfoss, Inc., had failed to "disable" itself in a manner that was sufficiently unambiguous from the outset according to the rubric established by the Delaware Supreme Court in *MFW*. Consequently the entire fairness standard would govern the Court's review of the

transaction in which the controlling stockholder acquired the remaining shares it did not already own. Vice Chancellor Laster held that because it did not at the outset expressly condition the proposed transaction on approval by a special committee the controlling stockholder was not entitled to have the transaction reviewed under the more deferential business judgment standard. Vice Chancellor Laster specifically noted that the initial draft of the merger agreement also failed to include a majority-of-the-minority voting provision.

In addition, the Court, drawing a parallel to the rule in *Ams. Mining Corp. v. Theiault*, 51 A.3d 1213, 1243 (Del. 2012) whereby the burden to demonstrate the entire fairness remains with the defendants throughout the trial if they cannot show in the pre-trial record that they are entitled to shift the burden of persuasion, ruled similarly that if the record does not permit a pretrial determination that the controller "disabled" itself in accordance with *MFW*, then the appropriate standard of review remains entire fairness. This conclusion reinforces the suggestion of the Delaware Supreme Court in *MFW* that if triable issues of fact remain after discovery about whether either or both of the dual procedural protections were established, or if established were effective, the ultimate judicial scrutiny of controlling stockholder buyouts will continue to be entire fairness review.

While the Court applied the entire fairness standard, it held that the burden of persuasion nevertheless had shifted to the plaintiffs because the majority of the disinterested stockholders ultimately approved the transaction following a fully informed vote.

Given the particular difficulty of making a pre-trial showing that no triable issue of fact remains with respect to *MFW*'s requirement that the special committee meet its duty of care in negotiating a fair price, this opinion highlights the scrutiny that Delaware courts will continue to apply to transactions involving a controlling stockholder, even when they make attempts to employ the dual protections approach suggested by *MFW*. The decision also highlights the importance of creating a clear record at the earliest stages of any such transaction in order to establish clear compliance with the *MFW* criteria at the pretrial stage. *In re Sauer-Danfoss Stockholder Litigation*, C.A. No. 8396-VCL (Del. Ch. Jan. 22, 2016).

Court of Chancery Requires Affirmative Contractual Statement by Buyer Disclaiming Reliance on Extra-Contractual Representations in Context of a Merger Agreement to Bar Buyer's Claim

In FdG Logistics LLC v. A&R Logistics Holdings, Inc., the Delaware Court of Chancery held that a seller's explicit disclaimer of extra-contractual representations in a merger agreement would not bar a buyer's claim of reliance on fraudulent extra-contractual representations. The common law fraud claim in FdG Logistics arose from the 2012 acquisition of FdG Logistics by a private equity firm through its holding company, A&R Logistics. Specifically, A&R alleged that FdG engaged in an extensive series of illegal activities that were concealed during pre-merger due diligence and that FdG's selling stockholders had committed fraud due to alleged

misrepresentations and omissions in a confidential information memorandum and management presentation provided to A&R. The selling stockholders moved to dismiss A&R's fraud claim because of the merger agreement's exclusive representation clause, which included a disclaimer by the selling stockholders of any extra-contractual representations and a customary integration clause which stated the merger agreement superseded any other understandings, agreements or representation between the parties.

Despite the merger agreement's inclusion of an exclusive representation and integration clause, the Court denied selling stockholders' motion to dismiss due to the absence of an affirmative disclaimer of reliance on extra-contractual representations by A&R which would have precluded it from asserting a fraud claim based on extra-contractual representations. The Court affirmed then-Vice Chancellor Strine's principle in Abry Partners V, L.P. v. F & W Acquisition LLC (Del. Ch. 2006) that "the court will not insulate a party from liability for its counterparty's reliance on fraudulent statements made outside of an agreement absent a clear statement by that counterparty—that is, the one who is seeking to rely on extra-contractual statements—disclaiming that reliance." The Court also distinguished the case from its recent decision in Prairie Capital II, LP v. Double E Holding Corp. (Del. Ch. 2015) because the "aggrieved party" in Prairie Capital had provided an affirmative acknowledgement that it was only relying on the representations and warranties in the agreement.

Court of Chancery Applies Different Levels of Judicial Scrutiny to Different Actions Taken by Board in Response to Activist Stockholder

In a recent decision, Vice Chancellor Noble of the Delaware Court of Chancery considered a stockholder plaintiff's challenge to two aspects of a board's response to a threat from an activist stockholder. In evaluating the plaintiff's claims, the Court ruled that *Unocal* enhanced scrutiny is the appropriate standard of review for a defensive bylaw enacted in response to the activist, but that business judgment is the appropriate standard of review for the settlement agreement eventually entered into with the same activist.

The plaintiff alleged that the members of the board of directors of Ebix, Inc., took steps to entrench themselves in response to a threat from the activist stockholder, Barrington Capital Group, L.P., to replace four of Ebix's six directors. In response to Barrington's threat, the Ebix directors enacted bylaws that (i) limited stockholders' ability to call and conduct business at special meetings; (ii) imposed conditions on stockholders' ability to make a proposal or nominate a director; (iii) required any stockholder seeking action by written consent to request a record date and granted the board the right to effectively delay actions by stockholder consent up to 20 days; and (iv) barred advancement or indemnification for any director who files a claim against the corporation.

After the board considered those bylaw amendments, but before they were formally implemented, the board reached a settlement agreement with Barrington whereby the board agreed to expand

from six to eight directors and to appoint two Barrington designees to fill the new vacancies. The board also agreed to pay Barrington $140,000 to reimburse Barrington for out-of-pocket expenses incurred in connection with its proxy campaign. Pursuant to that agreement, Barrington was required to vote for the board's nominees and with the board recommendations on other matters for a certain period of time. The plaintiff alleged that this settlement agreement was a breach of the directors' fiduciary duties.

Although the board did not formally adopt the bylaw amendments until after it had settled with Barrington, the Court still deemed the "salvo of new provisions" implemented via the bylaw amendments to have had "clear defensive value." The Court thus concluded that approval of the bylaw amendments, when viewed collectively, should be subject to *Unocal* enhanced scrutiny, which requires the board to show that its actions were "reasonable in relation to the threat posed" in order to obtain the protection of the business judgment rule. Applying that standard, the Court held that the defendants had failed to show that the board's adoption of the bylaw amendments fell "within the range of reasonableness" as a matter of law, and thus denied the defendants' motion to dismiss.

However, the Court declined to apply heightened *Unocal* scrutiny to the Barrington settlement agreement. While the Court acknowledged that the settlement could "conceivably" trigger *Unocal* review, the Court held that it would be inappropriate to characterize the relinquishment of board seats as entrenchment. Put differently, "because Ebix opened its doors to Barrington," approving the settlement agreement does not qualify as an entrenchment requiring *Unocal* review. Applying business judgment, the Court dismissed the plaintiff's claims concerning the settlement agreement.

Ebix illustrates the Court of Chancery's continuing skepticism – as expressed in recent litigation concerning proxy puts and other procedural devices utilized to protect incumbent directors from activist stockholders – of director conduct that could be viewed as entrenchment. Indeed, the opinion appeared to turn on the question of whether the settlement agreement with Barrington was designed to entrench incumbent directors, with the Court affording deferential business judgment review to that agreement because the Company did cede control of two board seats, even though the settlement agreement preserved majority board control by removing the threat of control by the activist. (*In re Ebix, Inc. Stockholder Litigation*, C.A. No. 8526-VCN (Del. Ch. Jan. 15, 2016).)

Court of Chancery Provides Guidance as to Information Demands by Corporate Stockholders and LLC Members/Managers

In a pair of recent Delaware decisions, *Amalgamated Bank v. Yahoo!, Inc.* and *RED Capital Investment LP v RED Parent LLC*, the Court of Chancery provided valuable guidance as to the rights of stockholders to demand books and records from a corporation and the analogous rights of members and managers to obtain information from a limited liability company.

In *Yahoo!, Inc.*, the Court ruled that Yahoo must provide certain information, including personal emails, in response to a Section 220 demand made by a stockholder. Under Section 220 of the Delaware General Corporation Law, stockholders may request copies of a corporation's books and records for a "proper purpose." Amalgamated Bank, a stockholder of Yahoo, requested materials related to alleged mismanagement with respect to the hiring and firing of Yahoo's Chief Operating Officer, Henrique de Castro, who received nearly $60 million in benefits upon his termination after working for the company for only fourteen months. Plaintiffs requested, among other documents, electronic documents and emails, including personal emails of Marissa Mayer, Yahoo's CEO, who had used her personal email account for some of the communications related to de Castro. Citing Delaware precedent ordering production of electronic records, including emails, the Court rejected Yahoo's argument that it need not produce electronic documents and emails because the statute uses the term "books and records." The Court determined that Yahoo was required to provide much of the requested material, including Mayer's personal email, and noted that "if Mayer chose to use a personal email account to conduct Yahoo business, she must produce responsive documents" because the "rights of shareholders secured by §220 cannot be defeated simply by having another entity hold the records." The opinion is also notable for providing a thorough description of the scope and requirements of Section 220 demands.

In another case addressing the right to demand books and records, the Court in *RED Capital Investment* ruled that RED Parent, a limited liability company, was required to provide certain information with respect to its subsidiaries in response to a demand made by a manager under the Delaware Limited Liability Company Act. Section 18-305 of the Delaware Limited Liability Company Act enumerates certain categories of information that are subject to member and manager inspection in the absence of limitations in the governing limited liability company agreement, so long as the member or manager has "a purpose reasonably related to the position." RED Capital Investment, a member of RED Parent, and George Polk, the individual controlling RED Capital Investment and also a manager of RED Parent, requested certain information with respect to a number of subsidiaries of RED Parent that were formed to operate separate energy projects, for the purpose of understanding their current cash financial position and solvency. RED Parent's operating agreement limited the rights of a member to obtain information, but did not limit the rights of a manager to such information. Accordingly, the Court determined that Polk's request could proceed under Section 18-305 in his capacity as a manager. The Court noted that the language used in Section 18-305 is "tantamount to that used in Section 220 of the Delaware General Corporation Law with respect to director requests for corporate information" and that, accordingly, LLC managers "should be afforded similar unfettered access to company books and records." The Court rejected RED Parent's argument that the information was not required to be produced because each energy project subsidiary was legally distinct from each other, as well as from the parent entity of which Polk was a manager, noting that RED Parent had no businesses other than those of its subsidiaries and that the conformity of management across the entities was "sufficient to subject [an] operating subsidiary information to a proper request by a parent Manager in accordance with Section 18-305(b)."

These two decisions demonstrate that the Court will scrutinize refusals by companies to provide information in response to formal requests by holders of equity, directors or managers. These types of requests should be taken seriously and a company's refusal to comply with them may lead to litigation.

Delaware Court Continues to Scrutinize Disclosure-Only Settlement Cases

In the two most recent issues of Ropes Recap, we have discussed the Delaware Court's increasing scrutiny of so-called "disclosure-only" settlements, highlighting, in particular, Vice Chancellor Glasscock's decision in *In re Riverbed Technology, Inc. Stockholders Litigation* (which expressed skepticism regarding the merits of such settlements and approved a proposed disclosure-only settlement based on the parties' reliance on the Court of Chancery's past practices with a warning that future plaintiffs and defendants should be on notice that similar reliance-based arguments would be given far less weight in the future) and Chancellor Bouchard's decision in *In re Trulia, Inc. Stockholder Litigation* (rejecting a proposed disclosure-only settlement of stockholder litigation challenging the acquisition of Trulia, Inc. by Zillow, Inc. and holding that the proposed settlement terms, which involved immaterial supplemental disclosures concerning the work performed by Trulia's financial advisor, did not provide Trulia's stockholders with adequate consideration for the released claims). As we noted at the time, Chancellor Bouchard held that, going forward, disclosure claims should be raised either in a preliminary injunction motion or through a mootness application for attorneys' fees if a company voluntarily moots a stockholder plaintiff's disclosure claim by disclosing the relevant information, each of which procedural vehicles would result in the parties to litigation advocating in an adversarial context the true value of the supplemental disclosures.

The Court of Chancery took its new views on disclosure-only settlements a step further in two recent cases (*Johnson v. Driscoll* and *Chester County Retirement System v. Collins*), calling into question the underlying claims process that tends to set up such settlements – expedited pre-closing claims for injunctive relief. Despite precedent suggesting that colorable disclosure claims threaten irreparable harm to plaintiff stockholders such that expedited review and injunctive relief are often appropriate, *Driscoll* and *Collins* found that disclosure-only claims raised legal issues that were best resolved post-closing when the Court could have the benefit of full review and deliberation rather than being bound by the constraints of an expedited process.

The Court went on to state, more importantly, that the effect of the disclosure (or lack thereof) on deal price would be the deciding factor going forward, with post-closing remedies for disclosure-only claims to be awarded only if plaintiffs are able to show both that their disclosure claims have merit and that the transaction itself was underpriced as a result. We anticipate that this focus on mispricing will, over time, result in a material decrease in disclosure-only claims, as plaintiffs will need to fully asses the merits and likelihood of success of a given claim before pursuing it, something rarely required under precedent Court approaches that frequently allowed plaintiffs to threaten stalling a transaction and most often resulted in expedited settlements.

Delaying disclosure claims post-closing further narrows the field of possible claims in the application of Section 102(b)(7) of the Delaware General Corporations Law, which permits corporations to exculpate directors from personal liability for monetary damages for breaches of the duty of care. Disclosure claims, when merited at all, typically arise out of negligence, so plaintiffs will find their post-closing claims for monetary relief regularly dismissed if the defendant company's charter includes an appropriate exculpation clause. Coupled with the requirement that plaintiffs show the transaction at issue was mispriced due to the alleged lack of disclosure, the Court's decisions in these cases significantly raised the bar on disclosure claims.

Driscoll and Collins reflect the Court's continued distaste for disclosure claims and willingness to set new standards to do away with them – attacking them at their very source. While *In re Riverbed Technology, Inc.* and *In re Trulia, Inc. Stockholder Litigation* signaled a movement in the Court's analysis of disclosure-only settlements, *Driscoll* and *Collins* portend a much more aggressive shift in the Court's willingness to hear pre-closing disclosure claims at all, which may result in dramatic decreases in such claims in the future.

Johnson v. Driscoll, C.A. No. 11721-VCL (Del. Ch. Feb. 3, 2016) (transcript).

Chester County Retirement System v. Collins, C.A. No. 12072-VCL (Mar. 14, 2016) (transcript).

In re Riverbed Technology, Inc. Stockholders Litigation, C.A. No. 10484-VCG (consol.), memo. op. (Del. Ch. Sept. 17, 2015).

In re Trulia, Inc. Stockholder Litigation, C.A. No. 10020-CB (Del. Ch. Jan. 22, 2016).

Federal Court Rejects Disclosure Claim Concerning Financial Advisor's Premiums Paid Analysis

In a recent decision, the United States District Court for the Central District of California rejected a stockholder plaintiff's claim that the Emulex Corp. violated the federal securities laws by issuing a false and misleading 14D-9 in connection with Emulex's acquisition by Avago Technologies Wireless (U.S.A.) Manufacturing, Inc. The plaintiff asserted that the Emulex 14D-9 was false and misleading because it omitted a one-page premiums paid analysis that Emulex's financial advisor had prepared for the Emulex Board of Directors, but upon which the financial advisor did not rely in rendering its fairness opinion. The Court rejected that claim, holding that the plaintiff had not met its burden to show that Emulex and its directors had acted with scienter in omitting that analysis from the 14D-9, and that the omission of that analysis had not rendered the 14D-9 false.

The plaintiff focused on the omission of the premiums paid analysis, likely because it stated that the 26.4% premium offered to Emulex

stockholders in the Avago acquisition was below average for transactions in that sector. In so doing, the plaintiff claimed that Emulex misled stockholders into believing the transaction was a better deal than it actually was, in violation of Sections 14(e) and 20(a) of the Exchange Act. The defendants moved to dismiss on the grounds that the plaintiff had failed to allege that defendants acted with the scienter necessary to state a claim under Section 14(e), and that the omission was not material.

The Court concluded that the plaintiff could only satisfy their scienter pleading burden by showing that the defendants acted intentionally or with deliberate recklessness. In reaching that holding, the Court held that the defendants' failure to disclose the premiums paid chart did not render the 14D-9 false, as the fairness opinion held that the premium paid to Emulex stockholders in the transaction was fair and the board did not represent that the premium was above average. The Court further held that public disclosures concerning a financial advisor's fairness opinion are the product of directors' business judgment and that the Court could not say that it was an extreme departure from the standards of ordinary care to exclude the chart from the company's public disclosures concerning the transaction. The Court further held that the desire of the Emulex directors to enhance their reputation was not a sufficient basis to find that they acted intentionally or with deliberate recklessness to exclude relevant information from the 14D-9.

(*Varjabedian v. Emulex Corporation*, Case No. SACV 15-00554-CJC (JCGx).)

UK UPDATES

OWNING AND CONTROLLING A COMPANY IN THE UNITED KINGDOM: THE NEW STATUTORY PSC REGISTER

The PSC Register

As of April 6, 2016, all UK companies are required to take reasonable steps to identify individuals who have significant control over the company (a "**PSC**"), and to compile and maintain a register of these individuals (a "**PSC Register**"). The introduction of the new PSC Register regime is one of a number of important reforms of UK company law that will increase the accountability of companies organised in the UK. The reforms are part of a global initiative designed to tackle the criminal misuse of companies by means of enhanced corporate transparency. Certain aspects of the reforms will impose significant compliance and administrative burdens on companies and certain shareholders.

The new PSC Register regime will be of immediate relevance to anyone who owns, manages or controls a company (or limited liability partnership) organised in the United Kingdom.

The regime will apply to all companies incorporated in the United Kingdom (even if they are dormant). A limited exception is made for (1) companies that are subject to Chapter 5 of the Financial Conduct Authority's Disclosure and Transparency Rules and (2) companies with voting shares admitted to trading on a regulated market in the UK or European economic area (other than the UK) or on specified markets in Switzerland, the United States, Japan, or Israel. UK limited liability partnerships are also subject to the regime. Companies must ensure that their PSC Registers are never empty. If a company has not yet concluded its investigations into the identity of any individuals (or entities) with significant control, it should ensure that the PSC Register reflects the status of any on-going review. Starting June 30, 2016, a company will have to provide the information contained in a PSC Register to Companies House at least on an annual basis. Perhaps the most controversial aspect of the reforms is that the PSC information that Companies House receives will be available online for public review. Companies House will maintain a system that will be searchable either by company or by individual.

Individuals (and certain registrable legal entities) with significant control will also be required to proactively disclose their status to the company, either in response to a request for disclosure from a company or if the company has failed to identify their status. Any such disclosure will be required to be made within a prescribed timeframe, which varies depending on the circumstances.

Individuals with significant control

A company will have to collect information regarding individuals or relevant legal entities (whether UK resident or otherwise) who either own or control more than 25% of the shares or voting rights of a company or have the right to appoint or remove a majority of the board. In addition, companies must collect information regarding individuals or relevant legal entities who exercise significant influence or control over the company or who exercise significant influence or control over a trust or firm that satisfies any one of the other conditions.

Various fact specific rules establish how a company should assess the extent of any individual's shareholding or voting rights for these purposes. For example, significant control will also encompass interests that are held via joint arrangements and/or indirectly, including via nominee arrangements and via trusts and partnerships, and again specific rules clarify how these arrangements should be assessed in practice.

Practical implications

Failure to comply with the regime is a criminal offense. In addition, a company may impose restrictions on interests held in the company, if the holder of the interest has failed to respond to requests for information from the company issued as part of the process of compiling its register.

ASIA UPDATES

MANAGING CFIUS FOR CHINESE BUYERS

In the past ten years China has become a major participant in the global M&A arena, including the U.S. market. Chinese firms invested a record USD $15.7 billion in the United States in 2015, representing a 30% increase from 2014, and the trend has accelerated in 2016. The top industries targeted by Chinese firms most recently have been services (including entertainment, financial and business services), high-tech (including ICT, health and biotech) and real estate[1]. With a gradual slow-down in the growth of China's domestic economy and continued pressure on devaluation of its currency, it is likely that the market will see further expansion of Chinese investors' appetite for global and U.S. targets. However, outbound Chinese investments continue to be exposed to a number of legal and political risks, and review by the Committee on Foreign Investment in the United States ("**CFIUS**") has been viewed by many Chinese investors as a formidable hurdle.

This article sets out a high-level overview of the CFIUS review and its implications on China's outbound investments into the United States.

Regulatory framework of CFIUS

CFIUS is an interagency committee of the U.S. government authorized to review transactions that could result in control of a U.S. business by a foreign person (the "***Covered Transactions***"), in order to assess the effect of such transactions on U.S. national security interests. The U.S. Foreign Investment and National Security Act of 2007, the governing regulation in this area, does not clearly define the concept of "national security" other than noting that it should "include those issues relating to 'homeland security', including its application to critical infrastructure". "Critical infrastructure" can be any systems or assets whose incapacity or destruction "would have a debilitating impact on national security". CFIUS generally takes into consideration a number of factors in determining whether the transaction will pose any national security risk, including but not limited to:

- involvement of state-owned enterprises with the Chinese buyer;
- technology controlled by the U.S. business that may have military use; or
- physical proximity of assets of the U.S. business to U.S. military facilities or areas considered sensitive by the U.S. government.

[1] Thilo Hanemann and Cassie Gao: Chinese FDI in the U.S.: 2015 Recap, http://rhg.com/notes/chinese-fdi-in-the-us-2015-recap

In order to assess "control" by the foreign person, CFIUS will look at such foreign person's ability, either directly or indirectly, to determine, direct or decide important matters of the U.S. business being acquired.

The CFIUS Process

A typical CFIUS process may consist of one or two phases and, in unusual cases, a third phase. In the first phase, CFIUS conducts a review that may last up to 30 days. If CFIUS is unable to conclude action during the first phase, it may then move the case into a second phase – investigation, which may last up to 45 days. If at the conclusion of an investigation CFIUS is still unable to resolve its national security concerns, CFIUS will then initiate a third phase by submitting a report and recommendation to the President, who in turn must decide what action to take within a period of 15 days.

A majority of CFIUS cases are addressed at the review phase. According to CFIUS's most recent annual report to the U.S. Congress, which covers activities for 2014, of the 147 total notices filed and reviewed in 2014, 51 cases were carried over to the investigation phase. However, for buyers controlled by a foreign government (such as the state-owned enterprises in China), going through the investigation phase is mandatory. The third phase of the CFIUS process continues to be rare and has happened only once in the past 6 years.

Filing a notice to CFIUS for review of a Covered Transaction is always voluntary. No party is required to submit a notice to CFIUS. However, failure to notify CFIUS of a Covered Transaction with potential national security concerns involves significant risks to the buyer. For any Covered Transaction where the transaction parties have not taken the initiative to submit the notice to CFIUS and the transaction nevertheless has come to CFIUS's or any member of CFIUS's attention either pre-closing or post-closing, CFIUS may ask the parties to make a submission or such member of CFIUS may submit a notice based on information available to such member to trigger a CFIUS review. In such a situation, the Covered Transaction in question is subject to review and potential unwinding. As a matter of practice, the buyer generally takes the risk of any subsequent unwinding or mitigation that may be imposed by CFIUS (unless parties agree to otherwise in the deal documents) and may suffer material losses and damage to its reputation. For this reason, parties typically are well advised to notify CFIUS and condition their transaction upon clearance of the CFIUS review process, especially for transactions that implicate U.S. national security interests. Such clearance operates as a "safe harbor": if a review or investigation is concluded without the taking of any action by CFIUS or the President, then, as a legal matter, such transaction is insulated from a later order of divestment or prohibition on national security grounds.

Implications on China Related Transactions

Because of the potential exposure discussed above, prudent Chinese buyers usually insist on conditioning the transactions upon the clearance of CFIUS review in order to take advantage of the safe harbor. CFIUS's enhanced scrutiny, demonstrated through a few high-profile failed transactions in early 2016[2][3], have further cautioned Chinese buyers. However, such a condition precedent may put Chinese buyers at a significant disadvantage to U.S. buyers (with whom transaction are not subject to CFIUS review) and buyers from certain other countries (for whom failure to clear CFIUS review is of lower risk). The "market" for Chinese buyers has become less favorable than for investors of certain other jurisdictions.

In order to make their bids competitive, some Chinese buyers have offered higher price premiums compared with bidders from other jurisdictions and agreed to pay higher than average reverse termination fees. A subsidiary of Hainan Airlines recently agreed to a USD $400 million reverse termination fee (constituting 6.7% of the purchase price) to Ingram Micro if the transaction fails to clear anti-trust or CFIUS review. Sometimes a reverse termination fee is not enough to allay seller's concern over CFIUS risk. In February 2016, Fairchild Semiconductor rejected an acquisition offer by a Chinese consortium and elected to go forward with ON Semiconductor, a U.S. buyer with a lower offer, even when the Chinese consortium offered a reverse termination fee equivalent to 4.4% of the equity value. In connection with the announced rejection, Fairchild's board noted that "the consortium's proposed $108 million CFIUS reverse termination fee would not adequately justify risking the company stockholder premium present in the ON Semiconductor transaction".

Chinese buyers will likely continue to face headwinds in the CFIUS process and in the negotiation of CFIUS-related transaction terms. If ongoing negotiations between China and the U.S. for a bilateral investment treaty are successful the standards and processes for national security review in both directions may become clearer. Until then it remains critical for Chinese buyers investing in the United States to manage CFIUS in a proactive and positive way:

- Engage professional advisors on CFIUS matters early on. Experienced CFIUS counsel can help analyze the potential transaction, assess the risk, form a view as to whether a CFIUS filing is recommended and plan for remedial actions that might be necessary to secure approval if there are likely areas of concern. When advisable, CFIUS counsel can also liaise with CFIUS staff for informal review even before the formal procedure kicks off. This will accelerate the CFIUS process and demonstrate the parties' commitment to transparency with CFIUS.
- Initiate the information collection process before signing. The information required by CFIUS in its submission package is extensive and sometimes sensitive (such as certain

[2] China's Tsinghua to buy Western Digital stake in U.S. tech push, http://www.reuters.com/article/us-western-digital-investment-unisplendo-idUSKCN0RU1E720150930
[3] U.S. blocks Philips' $3.3 billion sale of Lumileds to Asian buyers, http://www.reuters.com/article/us-philips-lumileds-sale-idUSKCN0V02D4

detailed personal information about individual board members of the buyer). Once parties decide to submit a CFIUS notice, parties should initiate collection of information in parallel with the deal negotiation with a goal to formally submit the CFIUS notice promptly after the signing of definitive transaction documents. This will prevent unnecessary delays in obtaining CFIUS clearance.

- In complicated cases, buyers should be prepared to manage effective public communications and government relations as well as the legal process.

CONTRIBUTORS

Partners:	**Associates:**
C. Thomas Brown (New York) thomas.brown@ropesgray.com	Nikhil Bodade (New York) nikhil.bodade@ropesgray.com
Jason Freedman (San Francisco) jason.freedman@ropesgray.com	James Davis (Chicago) james.davis@ropesgray.com
Jane Goldstein (Boston/New York) (co-head of M&A) jane.goldstein@ropesgray.com	Darlyn Heckman (New York) darlyn.heckman@ropesgray.com
Jieni Gu (Hong Kong) jieni.gu@ropesgray.com	Natalie Logan (San Francisco) natalie.logan@ropesgray.com
David Hennes (New York) david.hennes@ropesgray.com	Marc Migliazzo (Boston) marc.migliazzo@ropesgray.com
James Lidbury (Hong Kong) (co-head of M&A) james.lidbury@ropesgray.com	Michael Pilo (New York) michael.pilo@ropesgray.com
Carl Marcellino (New York) (co-head of M&A) carl.marcellino@ropesgray.com	Anna Rozin (New York) anna.rozin@ropesgray.com
Anne Johnson Palmer (San Francisco) anne.johnsonpalmer@ropesgray.com	Jaclyn Ruch (New York) jaclyn.ruch@ropesgray.com
Kiran Sharma (London) kiran.sharma @ropesgray.com	Larissa Smith (New York) larissa.smith@ropesgray.com
John Sorkin (New York) john.sorkin@ropesgray.com	Laura Steinke (New York) laura.steinke@ropesgray.com
Peter Welsh (Boston) peter.welsh@ropesgray.com	Peter Wang (San Francisco) peter.wang@ropesgray.com
Marko Zatylny (Boston) marko.zatylny@ropesgray.com	Jakub A. Wronski (Boston) jakub.wronski@ropesgray.com
Counsel: Martin Crisp (New York) martin.crisp@ropesgray.com	**Professional Support and KM Lawyers:** Fay Anthony (London) fay.anthony@ropesgray.com
Chief of Legal Knowledge Management: Patrick Diaz (Boston) patrick.diaz@ropesgray.com	Marc Feldhamer (New York) marc.feldhamer@ropesgray.com
	Marvin Tagaban (New York) marvin.tagaban@ropesgray.com