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Note from the Editor

All participants in today's interconnected and global transactional environment are aware of the constant need to keep abreast of new developments, issues, ideas and ways of doing business in different parts of the world. Indeed successful cross-border deal management requires having familiarity with, and the ability to navigate, the many local practices, hurdles and barriers that can arise when crossing borders.

In this edition of the Korea Quarterly, we share recent articles prepared by members of our Firm that focus on and analyze cross-border transactional trends, local practices and potential legal hurdles and issues that may be of interest to the Korean business community. We also provide brief updates of recent representations involving members of our Korea Practice.

We hope that you enjoy this edition. Please let us know if you have any questions or need further information.

Sincerely,

Paul J. Kim
Head of Seoul office
McDermott Will & Emery LLP

오늘의 상호 연결되어 있는 국제적 업무환경 속의 참가자들은 새로운 개발, 이슈, 아이디어, 그리고 세계 곳곳에서 비즈니스를 하는 방법에 관한 정보를 계속 접해야 한다는 사실을 알고 있습니다. 실제로, 국가간의 거래를 성공적으로 운영하기 위해서는 해외에서 발생하는 다수의 관행, 장애물, 그리고 장벽에 친숙하고 이를 잘 다루는 능력이 요구됩니다.

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Recent Representative Matters and News

ACUSHNET IPO

McDermott represented Korean private equity funds Mirae Asset Private Equity Partners Fund VII, Neoplux No.1 Private Equity Fund, and Woori Blackstone Korea Opportunity Fund in the sale of over 22 million shares of common stock in the selling shareholder only initial public offering (IPO) of Acushnet Holdings Corp. (NYSE:GOLF), the global leader in the design, development, manufacture, and distribution of performance driven golf products and owner of the Titleist and Footjoy golf equipment and apparel brands. McDermott also represented the selling shareholders in the negotiation of registration and sell down rights with respect to Acushnet common stock that the funds continue to hold after the completion of the IPO.

In a related transaction immediately following the pricing of the IPO, McDermott represented Mirae Asset Private Equity Partners Fund VII and Neoplux No.1 Private Equity Fund in their private sale of over 14 million shares of common stock of Acushnet to Magnus Holdings Co. Ltd., an affiliate of Fila Korea Ltd.

The Firm's representation of the Korean funds takes place five years after the Firm represented Mirae Asset Global Investments and Fila Korea in their 2011 acquisition of Acushnet from its then parent, Fortune Brands. All of the Korean funds' holdings of Acushnet common stock, including the common stock sold in the IPO and to Fila Korea, were converted from convertible preferred stock and convertible notes issued by Acushnet and structured by McDermott in the 2011 acquisition.

McDermott's team was led by Seoul office head and New York Corporate Advisory partner Paul J. Kim and included partners Gary Emmanuel of our New York office, Heidi Steele of our Chicago office, as well as Jaeho Lee of our Seoul office.

The deal was recognized by the *International Financial Law Review* (IFLR) and shortlisted for "Equity Deal of the Year" as part of the IFLR 2017 America Awards.

MCDERMOTT FILES US SUPREME COURT AMICUS BRIEF ON BEHALF OF THE AMERICAN BAR ASSOCIATION REGARDING SIXTH AMENDMENT RIGHTS OF CRIMINAL DEFENDANTS

McDermott represented the American Bar Association (ABA), by filing an amicus curiae brief in the US Supreme Court in *Jae Lee v. United States,* urging the court to reverse the US Court of Appeals for the Sixth Circuit in a case regarding the scope of Sixth Amendment protections for immigrant defendants in criminal cases. *Jae Lee v. United States* is an appeal of a Sixth Circuit ruling that a long-time legal permanent resident and businessman who pled guilty to a first-time drug offense should be deported, even though his lawyer incorrectly assured him that his guilty plea would not lead to his deportation.

Mr. Lee emigrated from South Korea with his family in 1982, as a 13-year-old boy, and has lived legally in the United States for decades. In 2009, the successful restaurateur was charged with possession of ecstasy with intent to distribute. Based on his lawyer's assurances that his years living legally in the United States, his strong familial and business ties to this country, and his lack of a criminal history made it "impossible" for him to be deported, Mr. Lee pleaded guilty.

When Mr. Lee learned that his lawyer was wrong, he sought to vacate his conviction, claiming ineffective assistance of counsel. However, a federal judge in Tennessee concluded there was no prejudice, because a decision to proceed to trial would have almost certainly resulted in a guilty verdict, a longer prison sentence, and deportation. The Sixth Circuit affirmed. The federal courts of appeal have disagreed about whether such defendants who receive bad legal advice and plead guilty -- not knowing that their pleas will lead to deportation -- are prejudiced by such ineffective assistance of counsel, when there is strong evidence of guilt.

The ABA brief cites, among other authorities, the ABA Standards for Criminal Justice with respect to a lawyer's duty to provide competent representation – including the duty to advise a non-citizen defendant about immigration consequences during plea negotiations. The brief argues that a defendant who is deprived of competent legal advice about whether a conviction carries a risk of deportation can be prejudiced, notwithstanding the evidence of guilt, because he cannot make a voluntary and informed

decision about whether or not to accept a plea offer and because he is deprived of the ability to negotiate a more favorable plea agreement in the first place.

The *amicus* brief was written by McDermott partners A. Marisa Chun of our Silicon Valley office and Paul M. Thompson of our Washington D.C. office and associates Erika N. Pont and Matthew M. Girgenti, with assistance from McDermott Senior Counsel and University of California Hastings law professor Rory K. Little.

CJ CHEILJEDANG CORPORATION

McDermott represented CJ CheilJedang Corporation of Korea and its Indonesian and US subsidiaries, PT. CheilJedang Indonesia and CJ America, Inc. in the First Annual Antidumping Administrative Review before the US Department of Commerce in the case on Monosodium Glutamate from Indonesia. The AD review, which just concluded, resulted in a finding of no (zero) dumping by CJ, which allows CJ to obtain a refund of AD cash deposits posted with US Customs on all imports covered by the review, and its US imports going forward will now require zero cash deposits.

Partners David Levine and Raymond Paretzky of our Washington D.C. office represented CJ in this matter.

YELLOMOBILE INC.

McDermott represented Yellomobile Inc. in the closings of its convertible bond financings in the aggregate principal amount of nearly $100 million. The convertible bond financings were led by various overseas investors.

Yellomobile is a rapidly growing mobile lifestyle solutions provider primarily based in Korea that has grown to be one of Asia's leading mobile media groups with over 25 million monthly service users. It has interests in 70 Internet and mobile companies in Korea and Southeast Asia.

The legal team of Yellomobile was shortlisted by the Korea Law Awards 2016 for Technology, Media and Telecommunications In-House Team of the Year and Korea In-House Lawyer of the Year.

McDermott's team was led by Seoul office head and New York Corporate Advisory partner Paul J. Kim.

RECENT RECOGNITIONS

The Seoul office was recently recognized by *Chambers Global 2017* as one of the leading firms for *Corporate/M&A:* International Firms – *South Korea,* citing the Seoul office's focus on providing US legal advice to Korean corporates on their outbound transactions, strong local presence with on-the-ground team based in Seoul and ability to work closely with other departments such as the antitrust and IP groups in order to provide a well-rounded service.

Korea Practice members Paul J. Kim (South Korea, Corporate/M&A: International Firms) of the Seoul office and New York office, Alexander Lee (USA, Tax: International Tax) of the Los Angeles office and David J. Levine (USA, International Trade: Export Controls and Economic Sanctions) of the Washington, D.C. office were also recognized by *Chambers Global 2017* as leading individuals in their respective practice areas.

UPCOMING EVENTS

June 1, 2017: Korea Seminar 2017 | The Trump Administration's Enforcement Priorities (by Marisa Chun & Mary Strimel)

Subtitle: "What Korean companies need to know about the new U.S. government's approach towards antitrust, FCPA, and IP rights enforcement"

CLE credit is pending in California, Illinois, New York and Texas. A Uniform Certificate of Attendance will be made available to participants requesting CLE credit in all other states. For more information and to RSVP, please contact Annie Song (email: asong@mwe.com, phone: 82 02 6030 3611).

The Impact of CFIUS Reviews on M&A Transactions

David Levine (Washington, DC), Raymond Paretzky (Washington, DC), Sherry Liu (Washington, DC)

The Committee on Foreign Investment in the United States (CFIUS), which is comprised of members from the Departments of Treasury (chair), Homeland Security, State, Defence, Justice, Commerce and Energy, was established by executive order in 1975 to monitor foreign investment. Under current legislation (50 USC App. 2170), CFIUS reviews mergers, acquisitions or takeovers that may pose a risk to US national security by foreign control of an entity engaged in US interstate commerce.

Transactional parties should evaluate the benefits of voluntarily notifying CFIUS in advance of completing any "covered transactions." While doing so may generate additional costs and might delay closing, failing to obtain prior CFIUS approval may require a deal to be restructured or even unwound. In addition, with only a few exceptions, once a transaction passes CFIUS review it may not be reinvestigated. Relative to an entire transaction's costs, the time and legal fees associated with voluntary review are a small and important investment. It is therefore no surprise that there has been a noticeable increase in the number of deals voluntarily submitted for CFIUS review – from 65 in 2009 to 147 in 2014, the last year covered by a CFIUS annual report to Congress.

THE CFIUS PROCESS

A CFIUS review may be initiated through a voluntary written notice jointly filed by the transactional parties or directly by CFIUS at any point during the transaction, even post-closing. The CFIUS review process has a strict timetable, beginning with a 30 day review followed, if necessary, by a 45 day investigation and 15 day US Presidential review.

CFIUS examines factors pertaining to US national defence; US technological leadership; US critical infrastructure, resources and technologies; control of the foreign acquirer by a foreign government; and adherence by the acquirer to US export control requirements. CFIUS considers these factors in light of the parties' government contracts, cyber security practices, supply chain features, and the proximity of business operations and property to US government facilities.

"Critical infrastructures and resources" include vital systems and assets, physical or virtual, the incapacity or destruction of which would have a debilitating impact on national physical or economic security, and/or public health or safety. "Critical technologies" may include either defence or other export-controlled technology. CFIUS may examine whether or not the US target has classified contracts with the US government, or technology that is subject to export controls or needed for national defence.

Parties filing a voluntary notice are well advised to allow for adequate pre-notice time and to prepare the notice at the same time as drafting transactional agreements and conducting due diligence. They should establish responsibilities among personnel and agree on the process for preparing the notice and for dealing with CFIUS. Parties should also agree whether or not to include deal terms contingent on the outcome of the CFIUS review.

It is important for parties to engage in a dialogue with CFIUS prior to filing the materials needed for the review, since the 30-day review clock starts ticking only after CFIUS staff determines that the joint notice is sufficient. Parties should initiate an informal discussion with CFIUS staff and work cooperatively with them to ensure the notice is complete and to address all of CFIUS' questions.

If, at the end of the 30-day review, all CFIUS members conclude that the transaction poses no threat to US national security, CFIUS notifies the parties that it does not intend to take further action and the deal is cleared. Alternatively, CFIUS may begin a 45 day investigation, at the conclusion of which, if CFIUS finds that the transaction is not a national security threat, the transaction is cleared. If CFIUS concludes that the transaction does threaten national security, it may ask the parties to restructure the transaction to mitigate the threat or, in rare cases, may recommend to the President of the United States that the transaction be prohibited or suspended.

CFIUS TRENDS

The CFIUS process has been criticized for its complicated nature, amorphous definitions and lack of transparency. Regardless of the criticism, CFIUS-reviewed transactions have increased dramatically in recent years, from 65 CFIUS notices, 25 investigations and two notice withdrawals in 2009, to 147 CFIUS reviews, 51 investigations and nine notice withdrawals in 2014. It is unclear whether the increase in CFIUS reviews merely correlates with an increase in cross-border transactions (from 900 foreign acquisitions of US targets in 2009 to 6,000 in 2014), or whether it reflects a unique rise in CFIUS-based concerns, i.e., national security. Under either scenario, reported trends may help in deciding whether or not to seek review.

From 2012 to 2014, China accounted for the most CFIUS notices filed and reviewed (19 percent), followed by the United Kingdom (13 percent), Canada (11 percent) and Japan (10 percent). From 2009 to 2014, CFIUS notices primarily came from the following sectors: manufacturing (41 percent); finance, information and services (FIS) (32 percent); mining, utilities and construction (MUC) (19 percent); and wholesale, retail and transportation (WRT) (8 percent).

From 2012 to 2014, Chinese, UK and Japanese acquirers generally reflected these sector averages, while Canadian acquirers concentrated on the MUC and WRT sectors; French, German, Israeli and Swiss acquirers on the manufacturing sector; and Australian, German, Dutch and South Korean acquirers on the FIS sector. From 2009 to 2014, the number of CFIUS notices proceeding to investigations has consistently ranged from roughly 35 percent to 40 percent.

The following is a subsector breakdown of CFIUS activity in 2014.

Manufacturing: The computer and electronic products (42 per cent), machinery (13 per cent), transport equipment (13 per cent) and chemical (10 per cent) subsectors yielded the most CFIUS notices.

FIS: The professional, scientific, and technical (37 per cent), publishing (24 per cent) and real estate (11 per cent) subsectors produced the most CFIUS notices. Publishing industries experienced the greatest growth from 2013 to 2014 (18 per cent), with software publishing representing a significant number of covered transactions.

MUC: The utilities (52 per cent), oil and gas extraction (20 per cent), and mining (12 per cent) subsectors yielded the most notices, with oil and gas extraction experiencing the most growth in the period 2012 to 2014 (5 per cent).

WRT: Support activities for transportation (53 per cent) and merchant wholesalers for nondurable goods (20 per cent) generated the most CFIUS notices. Support activities for transportation and merchant wholesalers for nondurable goods experienced consistent growth from 2011 to 2014 (7 per cent and 9 per cent respectively), while merchant wholesalers for durable goods experienced a significant decrease (from 22 per cent to 0 per cent).

CFIUS treats all the material it reviews as confidential and does not publish transaction-specific information. The information released by transaction parties and news reports does, however, help illustrate some key factors considered by CFIUS that have resulted in deal terminations or mitigations.

These include consideration of whether or not an acquisition of a US fibre optic network posed a risk to the security of US data transmission and increased the possibility of foreign wiretaps; an acquisition of an oil company could impact US energy supplies; a foreign acquirer was associated with its country's military; US property proposed for acquisition was located close to sensitive US military installation; and, recently, whether or not the acquisition of mobile data software applications posed risks of breaches of date privacy.

In light of the uncertainty and scheduling issues posed by the CFIUS process, parties to foreign acquisitions of US businesses should plan early to collaborate and to prepare for possible CFIUS review.

Coordinating the Effective Date of Mergers in a Global-Post Acquisition Integration

John Huang (Shanghai), Tom Conaghan (Washington, DC), Andreas Kurtze (Frankfurt), Nicolas Lafont (Paris), Giovanni Nicchiniello (Milan), Roy Zhu (Shanghai), Paolo Cocchini (Milan), Anna Steudner (Frankfurt), Calum Thom (London), Joe Williams (Washington, DC)

Negotiating a business combination with a large global competitor is a complicated process, and the complications do not necessarily end at the closing of the deal.

The primary focus of post-acquisition integration projects is to eliminate redundant legal and operational structures. Duplicated legal entities mean duplicate costs, including taxation, human resources and the basic operational and legal costs of maintaining the separate entities. Redundant legal entities can also lead to market confusion.

The other main area of concern is the coordination of the timing of the business combination to ensure the following being in place the day the merger comes into effect:

- The two companies should be ready, from an operational perspective, to start acting like a single company, *e.g.*, pitching for work and processing payroll.
- Supplier and customer contracts from the redundant entity transferred to the surviving acquirer entity.
- The licenses and regulatory approvals needed to affect the transfer of the redundant entity's business to the surviving acquirer entity.
- The legal transfer of employees and employment insurance.

The company will also prefer to have the legal effective date of the merger coincide with the effective date of the merger from a tax and accounting perspective

THE GLOBAL PICTURE

In the United States, the primary means for eliminating a redundant target legal entity is to merge it out of existence. US merger law is very accommodating and flexible, which results in a clean transfer of the assets and liabilities of the redundant entity into the acquirer's legal structure. These mergers can often be structured as tax-free reorganisations under the US federal income tax law. Timing is also very manageable in the United States, as most states permit mergers to be effected within a single day.

Many global companies discover that, in other jurisdictions, however, it is not possible to achieve these objectives when combining redundant and surviving entities through mergers or similar transactions.

In many countries, including Austria, China, Finland, Germany, Sweden and Switzerland, the "legal" effective date of the merger is tied to the date the merger is officially "registered" in the local commercial registry, which relies to a large extent on the actions (or inactions) of certain commercial courts and regulators. In practice, in certain countries (including Austria, Finland, Germany, Sweden and Switzerland) the company's "preferred" legal effective date may be requested, and is ordinarily respected by the commercial registry.

In Italy, provided that the merger is by acquisition (a company merging with and into another existing company, with all assets and liabilities transferring to the surviving company), the effective date can be postponed until the date on which the deed of merger has been filed with the competent local commercial registry. The Italian Civil Code provides simplified rules for mergers of a company that is fully owned by the absorbing entity, which can help to eliminate redundant entities.

In China, however, the legal effective date of the merger is the date determined by the local commercial registry, *e.g.*, Shanghai or Beijing, which has complete discretion. For this reason, many business combinations in China that start as legal "mergers" often end as a transfer of assets and liabilities, given the greater flexibility in determining the effective timing.

Not all jurisdictions provide for statutory mergers. For example, in the United Kingdom, the process of combining the operations of a redundant legal entity after a business combination is more often accomplished through a transfer of assets and liabilities, followed by the liquidation of the redundant entity. Although France does provide for a statutory merger, many companies often choose to follow the *transmission universelle de patrimoine* (TUP) process, instead of a merger. The TUP process allows for a relatively expedited and straightforward transfer of assets and liabilities and the liquidation of the redundant entity.

COORDINATING LEGAL EFFECTIVENESS WITH ACCOUNTING EFFECTIVENESS

Some jurisdictions do differentiate between "legal" and "accounting" effectiveness, raising planning issue that companies should discuss with their auditors.

Certain countries, such as Germany and Spain, require the merging companies to submit financial statements alongside a request for merger approval. In Germany, the “accounting effective date” of the merger will be the closing date of the balance sheet of the redundant entity filed with the commercial register, which will precede the legal effective date. In Spain, the “accounting effective date” will be the first day of the fiscal year in which the merger was approved.

McDermott Will & Emery

KOREA NEWSLETTER

Cross-Border Direct Investing

Mark Selinger (New York)

As the mid-market private company transaction market heats up, family office investors will find themselves competing for deals with strategic acquirers and private equity funds, not to mention independent sponsors and other family office investors who have entered the market in recent years. This may compel some of the most sophisticated investors to look abroad for investment opportunities. Investing abroad is not, however, for the weak of heart. While unusual opportunities may indeed be available, at attractive valuations, conducting the due diligence and implementing and operating those opportunities present unique and, for some, unsurmountable challenges. There are those investors who say that cultural considerations are overrated and that in the increasingly flat, inter-connected world we live in, analysing a cross-border transaction is no different than a domestic transaction. This may be the case, as far as financial models are concerned, but an Excel spreadsheet cannot tell you how your actions will be perceived in a different culture.

BE PRESENT

Family office investors may have an advantage over strategic acquirers and investment funds in cross-border mid-market deals. Many target companies will themselves be family-controlled businesses, and may take comfort from a transaction with another family-controlled entity, as opposed to an institutional acquirer; private equity funds, in particular, have a bit of a bad name in Europe these days.

To capitalise on this advantage, a family office investor must make it clear that it is different from an institutional investor, in particular by connecting not just with the seller, but with senior management, employees and other constituencies, such as local government officials. A willingness to meet in the target's home jurisdiction and to spend time there (rather than just flying in and out), helps establish credibility. After the transaction is closed, some senior managers may secretly want the new owners to stay far away from the company, but seasoned investors know that a portfolio company investment cannot be managed entirely from afar.

In many countries, a business enterprise is expected to reflect the owner's values, and ultimately this can't be accomplished if the owner is hidden from view or poorly represented by a local partner or senior management. This may require some family investors, who cherish their privacy and prefer to remain in the background, to leave their comfort zone, because what would be considered a mid-market deal in the United States is often a very big deal in a non-US jurisdiction; you can expect local newspaper articles, TV and radio coverage and other unwanted attention. Also, in some cultures, particularly if the investment is in a strategic or culturally significant industry, a foreign investor can be seen as foreign interloper, or worse. All the more reason, therefore, to establish personal credibility and maintain a strong local presence.

CHOOSE A LOCAL PARTNER YOU CAN TRUST

Whether it is someone who is familiar with the company, a local attorney, accountant, business advisor or co-investor, having a local presence who is both respected by the portfolio company and trusted by you is a major asset for a successful investment.

KNOW YOUR MANAGEMENT

Even with a local presence, there is nothing that will cause a cross-border investment to succeed or fail so much as the quality of the management team. You must be confident that the management team shares your family office's values, philosophy and vision, because it will be the management who will be entrusted with implementing your strategy and presenting your public face. Without a trusting relationship, complemented with regular visits and communication, the foreign investor may be seen as a distant, somewhat malign force. This perception can quickly spread through the company and poison the relationship between you and your management.

Cross border direct investing can be an exhilarating and profitable experience, but it must be entered into knowledgably, with

experienced advisors and partners. As direct investing becomes an increasingly common part of many family office portfolios, cross-border direct investing will no doubt become an active, and competitive, investment area in the years to come.

The Rising Popularity of M&A Transactions in the Life Sciences Sector

Emmanuelle Trombe (Paris), Rachel Monjou (Paris)

Botox and Viagra would have made a perfect match, but the US Treasury stepped in to tighten up US tax laws and put a hold on what was expected to be the largest M&A deal in the history of life sciences and also the biggest tax "inversion" ever attempted. This cancelled merger brought life sciences M&A into the limelight, but this was well-deserved, as 2015 was a prolific year for the sector. While 2015 was characterized by a large number of M&A deals across all industries, the life sciences sector had the largest share.

WHY IS M&A SO POPULAR

There are a number of reasons why, when compared with other heavily-regulated and research-oriented sectors such as oil, gas or automotive, so many M&A deals have recently occurred in the life sciences sector. The most obvious reason is the "patent cliff". The number of very profitable, blockbuster pharmaceutical products is diminishing as a result of key patents reaching their expiration date, which leads to decreased profits resulting from the entry into the market of generics, that new medicines often target narrower segments of population, meaning their potential market is relatively small. As a result, even if the R&D stage is successful, it is uncertain how profitable these new medicines will be. As a result, when pharmaceutical companies find it difficult to innovate, or lack the resources to fund R&D, they buy products that are at a less risky stage. The sellers are often smaller companies that have specific expertise in R&D, but have no late stage development or commercialization expertise, or do not have the financial capability to fund it.

TYPES OF DEALS

Two specific types of M&A transaction have seen an increase in recent years: the selective acquisition of strategic businesses and the divestiture of non-core businesses. A number of these transactions have been implemented through asset swaps.

This trend is illustrated by GlaxoSmithKline's swap of oncology assets in exchange for Novartis' vaccine division and Sanofi's contemplated trading of Merial, its animal-health unit, for Boehringer's consumer health care business.

These asset swaps often create opportunities for other transactions, for example, when divestitures are required as a clearance condition by antitrust authorities. As part of its transaction with GlaxoSmithKline, Novartis had to divest two of its late development stage immune-oncology products, Encorafenib and Binimetinib, to Array Pharmaceuticals, which in turn entered into an agreement for the development and commercialisation of these products in Europe with Pierre Fabre.

In order to refocus on their core businesses, pharmaceutical companies have also tended to outsource manufacturing and even, to some extent, early R&D, and to divest non-core programmes into spin-out companies, which may be financed by investors. These trends multiply opportunities for M&A and other type of transactions.

LICENSING AND COLLABORATION

By far the most popular transactions in life sciences, however, are still licensing and collaboration; 65 per cent of externally sourced pipeline value comes from co-development, joint ventures and licensing, while only 35 per cent from "pure" M&A.

The number of licensing and collaboration deals has dramatically increased for the same reasons as M&A deals: the patent cliff and risk sharing. Unlike M&A, collaboration and licensing transactions often allow the pharmaceutical company to retain the benefit of its partner's expertise and the ability to innovate fast. They also allow pharmaceutical companies to access expertise outside their core business, whether in biotechnology, medical devices or digital health, which is perceived as a key area of growth.

PRICE STRUCTURES

The price structure of M&A and licensing deals tends to converge in life sciences since earn-out clauses are quite common in M&A transactions. In an earn-out structure, the ultimate price is based on the performance of the target or its assets following the closing. In life sciences, the earn-out triggers are often linked to the development or the commercialization of the acquired products. This mechanism is intended to bridge the valuation gap between the value expected by the seller and the price that the buyer is willing to pay at any given stage of the life cycle of the product. This alignment is of the utmost importance considering the intrinsic uncertainty of R&D, coupled with the heavy regulatory and market access constraints, which make it difficult for the buyer to pay full price until the acquired assets are de-risked. It is therefore not surprising that more than 50 per cent of life sciences M&A deals contain earn-out provisions. This mechanism is used both in private M&A and in public M&A, in the form of contingent value rights.

Since the achievement of earn-out -triggering events depends on the management of the acquired business by the buyer, there is a risk of litigation when the buyer fails to meet the targeted performance. In most cases, the share purchase agreement states the anticipated level of diligence that is expected from the buyer in pursuing the triggering events. In life sciences, however, there are so many uncertainties out of the parties' reasonable control that it is difficult to request firm commitments from the buyer.

The compromise is often to agree on a very qualified definition of "commercially reasonable efforts" or "diligent efforts". This must take into account the level of effort and resources consistent with those used by the buyer or a similar company, for a similar product, with a similar market potential, at a similar stage in its development or product life, balanced against a number of factors, such as market exclusivity, competitiveness of alternate products, profitability and, sometimes, provisions referring to all other relevant factors.

These earn-out systems are very likely to lead to disputes as a result of their complexity and the amounts usually at stake. When disputes occur, it is often difficult to determine the damages suffered by the seller. In licensing agreements, one of the remedies for the licensee's breach of its obligation to diligently develop and commercialize the licensed product could be that the license is terminated and the licensor obtains the product back along with all improvements generated by the licensee, so that it is able to exploit the product itself or to find a better partner. This reversion is more difficult to implement in an M&A context, where the sellers may not be willing, or have the capacity, to take the assets back.

In conclusion, despite a strong convergence between M&A and licensing, with more and more back-end-loaded M&A transactions, licensing and collaboration remain the preferred methods for life sciences companies to expand their product portfolios.

Rewarding Long-Term Shareholders: European and U.S. Loyalty Share Programs

Tom Conaghan (Washington, DC), Lionel Lesur (Paris), Lindsey Reighard (Dallas), Louis Leroy (Paris)

"Long-term oriented shareholders, who hold on to their shares during the difficult but critical time the company is facing will thus be rewarded." This is how the CEO of the tire manufacturer *Michelin* explained the motivation behind the issuance of loyalty shares (commonly referred to as L-shares) in the form of a warrant by his company in 1991. Loyalty shares, or shares that provide a reward to shareholders (typically in the form of additional shares or dividends) if they hold their shares for a certain period of time, and other similar loyalty share programs have become increasingly popular in European countries as a way to incentivize long-term shareholding and are slowly making their way into the United States.

LOYALTY SHARE PROGRAMS IN EUROPE

Rewarding long-term shareholding is no novelty in Europe, where it has been subject to regulation by the European Union since the financial crisis of 2007. The European Parliament passed Directive 2007/36/EC to regulate the exercise of certain rights of shareholders in listed companies, and amended the Directive on July 8, 2015. However, these pieces of legislation provide a limited framework for encouraging a higher level of monitoring and engagement by institutional investors and asset managers, and instead leave these issues in the hands of the individual EU Member States.

The French legal system offers several mechanisms to support long-term shareholding, the latest being implemented on March 29, 2014 with the adoption of the so-called "*Loi Florange*". French listed companies must automatically grant double voting rights to shareholders who hold their shares in registered form for at least 2 years (Art. L.225-123§3 of the French Commercial Code), and non-listed companies may grant double voting rights to their shareholders who hold their shares in registered form for the same period (Art. L.225-123§1 of the French Commercial Code). Listed and non-listed French companies may also issue L-warrants (Art. L.228-91 et seq. of the French Commercial Code) to certain shareholders, or grant loyalty dividends (an additional dividend) under certain conditions (Art. L.232-14 of the French Commercial Code). These loyalty schemes have been implemented by many major French listed companies, such as L'Oréal, Electricité de France and Crédit Agricole (loyalty dividend), or Vivendi, Engie, and Air France KLM (double voting rights).

Other European countries have adopted similar mechanisms. The Netherlands permits companies to grant multiple voting rights to certain categories of shareholders, provided that such companies register their shares in a "Loyalty Register". This scheme was notably used by Ferrari NV in its IPO and by Fiat Chrysler Automobiles NV upon completion of the cross-border reverse merger by Chrysler-Fiat with and into Fiat Investments NV in 2014. In Italy, a Legislative Decree of January 27, 2010 allowed listed companies to pay increased dividends to shareholders that hold common shares for a certain period (at least one year). In August 2014, a reform authorized both listed and non-listed Italian companies to issue shares with multiple voting rights. These rewarding schemes have been a success, and a number of Italian companies, including in particular Campari and Amplifon, have awarded loyalty shares to certain categories of shareholders.

LOYALTY SHARE PROGRAMS IN THE UNITED STATES

Despite the popularity of programs in Europe designed to reward long-term shareholders, U.S. companies have been slow to implement these types of programs. The U.S. stock market is generally characterized by "short-termism," a focus on short-term results at the expense of long-term performance, driven in part by the need to report quarterly earnings. U.S. shareholders, many of which are institutional investors, tend to hold their shares for a short period of time. According to the 2016 NYSE Group turnover statistics, the annualized turnover for shares listed and traded on the NYSE at the end of 2016 was 70%, indicating that a majority of shareholders held their shares for less than one year.

A common example of short-termism in the United States is short selling. Generally, a short sale is the sale of a security by a seller that does not own the security. The seller typically borrows the security that it has sold for delivery to the buyer with the expectation that the seller can buy back the same security at a later date for a lower price and turn a profit. A "naked" short sale occurs when the seller does not borrow the security in time to deliver it to the buyer within the standard three-day settlement

period. Naked short selling, which can send misleading signals to the market and decrease share prices, came under intensified scrutiny in the wake of the 2008 financial crisis following speculation that it had contributed to the collapse of certain U.S. financial firms.

Facing the rising backlash among companies against short sellers, the U.S. Securities and Exchange Commission ("SEC") has taken a variety of regulatory, enforcement and emergency actions to address concerns regarding failures of delivery and abusive naked short selling, including amendments to Regulation SHO and Regulation M.

The SEC attempted to promote long-term shareholding by proposing a rule that would have provided shareholders who held a significant amount of company stock for at least 3 years the right to include in the company's proxy statement their own director nominees. The rule was ultimately invalidated by the U.S. courts, but that did not stop many companies from voluntarily (or in response to demands from shareholder activists) their own proxy access bylaws. Proxy access provisions can now be found in the bylaws of a majority of the Fortune 500, and, generally, they also require at least 3 years ownership in order to be eligible to nominate director candidates for inclusion in the company's proxy statement. However, unlike its European counterparts, the SEC has yet to adopt mechanisms expressly permitting loyalty shares, voting rights and dividends.

Given the lack of regulatory framework to guide companies when implementing loyalty share programs, it is not surprising that these types of programs remain a novelty in the United States. Nonetheless, some U.S. companies have ventured into these relatively uncharted waters. For example, The J.M. Smucker Company has adopted "time phased voting," allowing each share that has been held for more than four years to have 10 votes per share (instead of one vote) on certain matters, and NexPoint Credit Strategies Fund has offered or offers a 2% match through NexPoint Advisors, L.P., its investment advisor, to shareholders that buy and hold the fund's common shares for at least one year. Other companies have offered warrants to purchase shares that are exercisable at a certain period of time in the future, like Check-Cap Ltd., an Israeli company, that issued warrants to its U.S. IPO purchasers in 2015 that permitted such purchasers to acquire common shares at a fixed purchase price if they held their IPO shares for a minimum of 1-2 years.

REGISTRATION OF LOYALTY SHARES

If a company decides to pursue a loyalty share program for U.S. shareholders, it should consider whether the loyalty share program constitutes a "sale" or an "offer to sell" a security that requires registration under the Securities Act of 1933, as amended (the "Securities Act"). Section 2(a)(3) of the Securities Act defines a "sale" as a "…disposition of a security or interest in a security, *for value*." (emphasis added) As a result, a "typical" dividend does not require registration because it is not given "for value." Additionally, in the context of a corporate "spin off" transaction, the SEC Staff has stated that a parent spinning off the shares of its subsidiary to its shareholders does not have to register those spun off subsidiary shares under the Securities Act as a sale as long as certain conditions are met, including the condition that the spin off must be pro rata to the parent's shareholders (SEC Staff Legal Bulletin 4 (1997)). This condition is important because, as the SEC Staff stated, "[i]f a spin-off is not pro rata, the shareholders' relative interests change and some shareholders give up value for the spun off shares."

Depending on the relevant facts and circumstances, the distribution of loyalty shares might therefore be characterized as a "sale" of securities that requires registration. The SEC might view a loyalty share as being more similar to a "right" issued in a rights offering, in that the holder can elect to exercise that right by foregoing the legal right to transfer its underlying shares, thereby accepting investment risk in exchange for receiving the loyalty share. Even though there is no exercise price for a loyalty share (as you would see in a typical rights offering or with a warrant), there could be "value" flowing back to the company in the form of loyalty, lack of volatility and other indirect benefits that long-term shareholders provide to the company. The SEC might also take a "remedy-based" approach, by stating that the holder who chose to "register" his "intent" to be loyal is really making an investment decision, and, if he is damaged for holding the underlying shares (i.e., the share price drops while he is trying to make it to the loyalty date), he should be entitled to receive, as damages, the "consideration" he "paid" for registering into the loyalty share program.

Given the novel and unique structure of loyalty share programs in the United States and the lack of precedent or specific support for loyalty shares without registration, companies would be prudent to either register such shares or, at a minimum, seek no-action relief from the SEC.

FIDUCIARY DUTIES

When approving a loyalty share program, directors of a company should be careful to ensure that they comply with their fiduciary duties to the company and its shareholders. Directors of Delaware corporations are generally protected by the business judgement rule and the presumption that the board acted in the best interest of the corporation; however, one of the situations in which this presumption may be rebutted, thereby shifting the burden to the directors to show the entire fairness of the transaction, is when self-dealing is present. A classic example of self-dealing is non pro-rata distributions, where a majority shareholder receives a dividend that is not paid to minority shareholders. Depending on the structure of the loyalty share program and the ownership of the corporation, issuing loyalty shares or additional votes to shareholders who have held their shares for a longer period of time (which in many cases may be majority shareholders) could subject directors to breach of fiduciary duty claims.

STEPS FORWARD

The article highlights only a few of the issues that a company should consider before implementing a loyalty share program for U.S. shareholders. Because of the lack of regulatory guidance in the United States (unlike in Europe), companies should tread carefully if they decide to proceed with such a program in the United States.

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