Global M&A

M&A activity in 2012 continued to be constrained by uncertain macroeconomic conditions, which have dampened dealmakers' confidence. Although there were several bright spots in transactional activity, momentum was difficult to sustain, and buyers and sellers are entering 2013 in a cautious mood. While the outlook for 2013 remains uncertain, we believe that a greater return of confidence to boardrooms and the executive suite should stimulate increased M&A activity. In this discussion, we review these trends and other factors likely to shape the M&A and private equity transaction landscapes in 2013.

The slowdown in M&A activity in Europe has provided limited opportunity to fully test the EU Directive on Takeover Bids, which was intended to consolidate EU takeover law and level the playing field for companies across Europe. We examine the basic principles of the directive and identify areas for potential improvement to foster harmonization of the takeover rules in Europe.

Despite global economic conditions, transaction activity in high-growth markets increased slightly in 2012, and we are cautiously optimistic that these markets will remain attractive options for opportunistic dealmaking in 2013. We discuss the factors that could impact M&A activity in these markets generally, as well as recent trends and developments affecting M&A in China, including the drive toward outbound transactions by state-owned enterprises, the going- private trend by listed Chinese companies and the potential impact that China's evolving regulatory framework could have on M&A activity.

We also review the recent trends of aggressive antitrust and competition scrutiny of M&A transactions and national security reviews of foreign investments in U.S. businesses, which we expect to continue in 2013.

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US M&A: Overcoming 'Confidence Crisis' Remains Key to a Healthy Market

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The sluggishness in U.S. deal activity that began in the second half of 2011 extended into 2012, as the macroeconomic climate continued to weigh heavily on investor confidence. Despite a few bright spots, 2012 U.S. M&A activity, as measured by both dollar deal volume and number of transactions, finished below 2011 levels.

In light of ongoing economic uncertainty, buyers and sellers are entering 2013 in a cautious mood. Many corporations have scaled back capital expenditures, and exports to markets such as China and Europe have slowed. Moreover, there is widespread concern in the business community that pending tax code changes could further depress business investment. Although corporate cash balances remain at historically high levels and financing for acquisitions is available on attractive terms, companies may continue to delay M&A activity until confidence returns to boardrooms and the executive suite. However, the strategic imperative for growth remains strong, and a further return of such confidence should stimulate increased M&A activity.

General Observations

Difficulty Sustaining Momentum. Despite several relatively strong periods of deal activity in 2012, momentum was difficult to sustain. Factors contributing to this lackluster activity included uncertainty about the U.S. "fiscal cliff"; more rigorous antitrust scrutiny; volatility in the securities and commodities markets; the sovereign debt crises in Europe and related unease over the fate of the euro; concern over the Chinese economy; and instability in the Middle East. There were, however, several bright spots as strategic buyers, who accounted for the majority of U.S. M&A activity in 2012, engaged in "add-on" acquisitions and spin-off transactions to focus on their core businesses, and private equity firms actively bought and sold mid-cap portfolio companies.

Decreased U.S. Activity. The dollar value of announced M&A transactions with U.S. involvement declined by approximately 3.8 percent in 2012 compared to 2011, according to Thomson Reuters data. However, activity picked up late in the year with a flurry of large transactions announced during the fourth quarter, including in the financial services sector with InterContinental Exchange's $8.3 billion acquisition of NYSE Euronext and GETCO LLC's $1.4 billion acquisition of Knight Capital Group. The small number of large public company acquisitions is noteworthy — only five transactions involving U.S. public company targets with consideration in excess of $5 billion were announced last year.

Energy and Power Sector Drove Dollar Deal Volume. The energy and power sector was the greatest contributor to dollar deal volume during 2012, with companies in this sector seeking to gain greater scale, reduce costs and diversify geographically. According to Thomson Reuters, transactions involving U.S. companies in the energy and power sector represented 18.5 percent of the dollar deal volume.

Health Care Sector Remained Active. Companies in pharmaceuticals, managed benefits and health insurance administration also were active M&A participants last year. Consolidation in the benefits management sector reflected the health care industry's focus on cost containment. Following the June 2012 U.S. Supreme Court decision upholding the Affordable Care Act, several companies, particularly those administering

Medicare- and Medicaid-related plans, announced mergers. In addition, pharmaceutical companies, many with large stockpiles of cash available for acquisitions, used M&A transactions to refresh their pipeline of product offerings (see Regulatory/"Health Care and Life Sciences: Affordable Care Act Upheld, but M&A and Enforcement Trends Reflect Uncertainty").

Tech Sector Led Deal Activity. The largest number of 2012 U.S. transactions were in the technology sector, according to Thomson Reuters, as targets in the social, mobile and cloud computing space were particularly attractive to buyers seeking to expand their portfolio of products and services.

Cash Was Preferred Form of Consideration. Cash continued to be the preferred form of consideration in acquisitions, although there was an increase in the number of transactions with stock as a component in the latter half of the year. The majority of acquisitions involving U.S. public company targets were one-step mergers, with approximately 24 percent structured as first-step tender offers followed by second-step mergers.

Strategic Buyers and Sellers Focus on Core Businesses

Strategic buyers — in particular, companies with substantial amounts of cash on their balance sheets and access to financing on favorable terms — focused on "add-on" acquisitions, which expand the buyer's existing product and service offerings, customer base and geographic footprint faster than an organic growth strategy. These less difficult acquisitions may be more attractive to corporate boards unwilling to engage in transformative deals in uncertain times.

> "For companies seeking to divest noncore businesses, a spin-off transaction continued to be a popular alternative to a traditional business unit sale."

Strategic sellers shed noncore business units to focus on businesses with more attractive prospects for growth and profitability. Divested business units were sold to both strategic buyers (*e.g.*, the sale by Pfizer of its infant nutrition unit to Nestlé S.A.) and financial buyers (*e.g.*, the sale by DuPont of its automotive coatings business to The Carlyle Group). For companies seeking to divest noncore businesses, a spin-off transaction continued to be a popular alternative to a traditional business unit sale, particularly among larger companies as a means to unlock value for shareholders on a tax-free basis, while avoiding deal execution challenges and valuation issues associated with a business unit sale. Some companies that considered the divestiture of a business opted for a dual-track approach, pursuing a sale while simultaneously preparing the business for a potential spin-off. This approach provides a potential seller with negotiating leverage in the sale of a business and an alternate path if the sale process is not successful.

Strategic and Financial Buyers Continue to Use Hostile Tactics

Fifteen hostile offers for U.S. targets by strategic buyers were announced in 2012 as those buyers continued to use an unsolicited approach to acquire companies presenting growth opportunities at relatively attractive valuations. Again, this activity was fueled by historically high levels of cash on corporate balance sheets and the availability of financing at low interest rates. In addition, hedge funds and other financial buyers with significant cash have demonstrated a willingness to act on a unilateral basis. According to a recent *Financial Times* article, the dollar deal volume of hostile activity, however, declined approximately 33 percent below 2011 levels in yet another sign of lack of confidence among corporate dealmakers.

Many U.S. companies have found themselves vulnerable to unsolicited approaches, particularly if their shares are trading at depressed prices or if management is perceived to be underperforming. In some situations, activist shareholders have pushed corporate boards to consider a sale process and have attempted to use proxy contests as a mechanism to replace unsupportive board members. Companies without staggered boards are especially susceptible to this tactic.

Hostile transactions have not been uniformly successful and, in several noteworthy situations last year, the target succeeded in remaining independent. For example, Roche Holdings AG attempted to use a proxy fight to force negotiations with Illumina Inc., but ultimately dropped its offer when Illumina won the support of shareholders for its slate of directors. More recently, Carl Icahn abandoned his unsolicited bid to acquire Oshkosh Corp. after Icahn's tender offer received lackluster support from the company's shareholders. In other situations, the target has commenced a process to find an alternative buyer following the receipt of a hostile offer. While not always successful, the sale process may cause the initial offeror to raise its bid. For example, after receiving an unsolicited offer from GSK, Human Genome solicited interest from alternative buyers. Ultimately, the price at which it agreed to be acquired by GSK was well above GSK's initial offer.

During the second half of last year, several unsolicited management-led buyout proposals were announced, with hedge funds and other financial buyers backing management teams seeking to take public companies private. The most notable is the request by Best Buy's founder and former chairman for access to financial information to enable a group of private equity investors and him to bid for the company. Although Best Buy's board granted the request and a subsequent extension of the due diligence period, a public offer to acquire the company had not been made prior to year-end.

Reverse-Termination Fees

A resurgence in antitrust challenges by the U.S. Department of Justice's Antitrust Division and the Federal Trade Commission has resulted in buyers and sellers spending more time negotiating regulatory provisions in merger agreements, as well as higher reverse-termination fees (averaging in excess of 5 percent of deal value) if antitrust approvals are not obtained. Twelve transactions announced in 2012 involving strategic buyers of U.S. targets had a reverse-termination fee equal to 6 percent or more of deal value, including three transactions announced in December with a reverse-termination fee equal to 9 percent or more of deal value. For example, the merger agreement between InterContinental Exchange and NYSE Euronext includes a reverse-termination fee (9.3 percent of deal value) payable by ICE if antitrust and other regulatory approvals are not obtained (see "Antitrust and Competition: Surveying Global M&A Enforcement Trends").

Reverse-termination fee provisions tied to a financing for financial buyers have gotten tighter, as sellers increasingly are more focused on deal certainty. In strategic transactions, the majority of merger agreements include the traditional model of specific performance and full recourse against the buyer if the buyer fails to satisfy the closing conditions. In private equity transactions, the trend has been toward stricter provisions that permit a buyer to pay a reverse-termination fee and avoid closing only if the buyer's

debt financing is unavailable, notwithstanding the buyer's efforts. If the buyer fails to close for any other reason once the conditions to closing have been satisfied, the seller has the ability to require the buyer to draw upon its financing and close the transaction. This is in contrast to reverse-termination fee constructs during the private equity boom, where the reverse-termination fee was the seller's sole recourse if the buyer failed to close for any reason (see "Private Equity: Positive Signs for 2013").

Shareholder Activism

Shareholder activism continued into the 2012 proxy season, with well-known activist investors pushing for corporate changes, including transformative M&A transactions. Many shareholder activists apparently remained motivated primarily by short-term profits, focusing on companies with excess cash, companies that they believe were undervalued or companies with corporate governance issues. Although the number of activist campaigns was relatively steady in 2012 as compared to 2011, the average market capitalization of the companies targeted by activists increased. Notable companies targeted by activists in 2012 included household names such as Procter & Gamble, Hewlett Packard, Yahoo! and Clorox. Activists also targeted large diversified companies, which they believed might be worth more if split into their parts. Their efforts were a catalyst to the split-ups of McGraw-Hill and Fortune Brands, among others.

Activist shareholders often use companies' annual shareholder meetings as platforms for effecting corporate changes through the election of director nominees who will support their proposals. In part to avoid public battles with activist shareholders and the significant costs associated with proxy fights, companies often negotiate and reach settlements with activists. This is the case particularly when a board already has a plan underway that would address the activists' concerns.

Current market conditions may encourage increased shareholder activism in 2013. Companies with an inefficient capital structure, with corporate governance issues or that underperform their peers will be particularly at risk during the 2013 proxy season (see Governance/"US Corporate Governance: Sense of Déjà Vu Masks New Emphasis on Shareholder Engagement").

Europe M&A: The Evolving Takeover Landscape

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The European and global economic crises have encouraged limited takeover activity in the past few years, providing little opportunity for the EU Directive on Takeover Bids (the Takeover Directive) to be fully tested outside of the United Kingdom. While the grounds for a takeover system are in place across Europe, it is apparent that substantial progress and adjustments need to be made now to continue the process of harmonization and to promote takeover activity.

Basic Principles of the Takeover Directive

The Takeover Directive was intended to harmonize EU takeover law and foster consolidation among EU companies through the adoption of a pan-European takeover code modeled after the U.K. Takeover Code.

The Takeover Directive establishes general principles that are common to most takeover systems worldwide: equal treatment of target shareholders, ability of target shareholders to make informed decisions on bids, and prohibition of market manipulation or abuse. It introduced a broad framework that is heavily reliant on the mandatory bid rule, effective involvement by national supervisory authorities and, in several cases, board passivity/neutrality.

At the same time, however, the Takeover Directive made the adoption of guiding principles on the ability of target boards to defend against takeover bids optional, allowing member states to choose whether to implement the following provisions:

- **The board neutrality rule**, which provides that, from the time a target board is informed of a bid until the end of the offer period, the target board may not take any "frustrating action" that might cause the offer to fail, other than seeking alternative bids, without obtaining prior shareholder approval; and
- **The breakthrough rules**, designed to render unenforceable clauses in the articles of association of target companies and agreements between targets and target shareholders, or among target shareholders, that could limit the ability of target shareholders to tender into a bid or vote at shareholders meetings.

Takeover Directive Implementation

Mandatory Bid Rule

The mandatory bid rule is the cornerstone of the European takeover regulation model. Intended to prevent creeping takeovers, the rule provides that when a person — acting individually or in concert with other persons — acquires shares in a company above a specified percentage of voting rights in that company, giving him/her control of that company, such person is required to make a bid for the entire company and offer the same terms to all shareholders. In many EU jurisdictions, the mandatory bid rule is the only statutory defense mechanism available to target companies. It is therefore crucial that the mandatory bid rule provide an effective defense against any form of acquisition of control that does not involve a full offer to all shareholders, particularly where the board neutrality principle has been adopted.

> "In many EU jurisdictions, the mandatory bid rule is the only statutory defense mechanism available to target companies."

The system, however, is in need of adjustment:

- **The threshold is too high.** The threshold adopted by member states (between 30 and 33 percent) is set too high because, in many cases, shareholders are able to control a European company (and either block or have a nearly insurmountable advantage against other bidders) by accumulating ownership of shares just below the threshold. In most U.S. jurisdictions, mechanisms with similar objectives (*e.g.,* poison pills or anti-takeover statutes) are triggered at far lower thresholds (between 15 and 20 percent), providing a more effective structural defense against creeping takeovers.
- **The mandatory bid rule is flawed in several member states.** As was proven by the coercive takeover of German construction company Hochtief AG by Spanish rival Grupo ACS a few years back, if the mandatory bid rule is not propped up by additional rules, including requiring (1) any voluntary tender offer to obtain a mandatory minimum acceptance threshold set at 50 percent or (2) additional mandatory tender

offers upon further accumulation of stock after passing the mandatory bid threshold, the system can be gamed to the detriment of all shareholders.

- **"Acting in concert."** Another significant issue concerns the definition of "acting in concert" for the purpose of calculating the control threshold and determining whether two or more persons are subject to the mandatory bid rule. The definition of acting in concert is not harmonized among member states. Some jurisdictions (*e.g.*, the U.K., the Netherlands and Italy) have adopted the Takeover Directive's definition, while others (*e.g.*, France and Germany) have combined the Takeover Directive's definition with the more stringent definition contained in the EU Directive on Transparency. Moreover, each national supervisory authority has more or less developed its own interpretation of acting in concert, and several national supervisory authorities reserve the right to decide whether shareholders are engaging in this behavior on a case-by-case basis using a facts-and-circumstances analysis. This situation causes significant uncertainty and does not permit shareholders to adopt consistent strategies across jurisdictions in Europe. However, it allows sophisticated national supervisory authorities to prevent parties from acting together while circumventing the spirit of the law through strategies that fall outside strictly defined parameters for "acting in concert."

Optional Takeover Defense Rules (Portuguese Compromise)

Harmonization of the board neutrality and breakthrough rules remains the most serious obstacle to consolidating pan-European takeover rules and the establishment of a level playing field across member states.

The board neutrality rule has been adopted by 19 member states, including the U.K., France and Italy. Most of these states had a board neutrality principle in their pre-existing legal framework before the Takeover Directive became effective. By contrast, eight member states (including Germany and the Netherlands) have opted out of the board neutrality rule — none of these countries had a board neutrality principle in their pre-existing legal framework.

As for the breakthrough rules, they have been adopted (in full or in part) only in three member states.

Accordingly, the takeover landscape is widely inconsistent across Europe, including in the five jurisdictions where most of the takeovers have taken place historically (the U.K., Germany, France, Italy and the Netherlands).

Moreover, in the face of the economic crisis and the resulting weakness in the share price of many European companies, certain member states have made full use of the flexibility available under the Takeover Directive and changed their approach to board neutrality (in some cases multiple times) since the Takeover Directive's implementation to (1) provide shelter to their national champions, (2) safeguard employment and (3) protect strategic assets, even where such member states previously were staunch supporters of systems that did not allow takeover defenses. Certain member states have changed national regulation to reduce board neutrality, introduce industry-specific or ad hoc protectionist legislation, or otherwise raise procedural obstacles for bidders.

While a discussion of the merits of board neutrality and breakthrough rules can be complex, we believe that Europe would benefit from a uniform set of rules in this area.

The Key Role of (National) Supervisory Authorities

The Takeover Directive establishes a system that, as opposed to the U.S. disclosure-based system, requires a significant amount of oversight and involvement by national supervisory authorities at every stage of the takeover process. Any material announcement made or document published by the bidder or target during a takeover process is subject to clearance by the supervisory authority, which also has a significant say on the actual terms and conditions of the bid. Accordingly, efficient regulation or ad hoc decisions by the supervisory authority are a significant factor affecting target shareholders' ability to maximize the value of their investment.

Where national takeover authorities are constituted by practitioners or career regulators highly experienced in takeover matters, the system can guarantee a smooth process and minimize the opportunity for litigation post-takeover (disclosure-based systems typically rely heavily on pre- or post-takeover judicial scrutiny). However, in member states where takeovers occur less often or even rarely — *i.e.*, the vast majority — and where unsolicited offers are, at most, an annual or biannual occurrence, or have yet to occur under the current legislation, the reaction of national supervisory authorities to complex fact patterns is uncertain and can vary significantly from member state to member state.

Squeeze-Out Rules

The Takeover Directive requires member states to adopt a mechanism that allows bidders to "squeeze out" shareholders if the bidder reaches a certain ownership threshold (between 90 and 95 percent). France, Germany, the Netherlands and Italy opted for a 95 percent threshold, whereas the U.K. opted for 90 percent.

While the introduction of squeeze-out mechanisms has given bidders a tool to close takeover bids that previously was unavailable in many jurisdictions, it is the only practical way of achieving full control of a target in the vast majority of cases.

The high threshold required to squeeze out minority shareholders in several member states, particularly those requiring 95 percent thresholds, poses a significant practical hurdle for bidders. We believe that the high threshold, coupled with the lack of alternatives to achieve full control, is one of the reasons takeover bids are not as frequent in certain member states.

The European Commission's Review

Review of the Takeover Directive is currently under way — five years after the transposition deadline of April 2006, the European Commission was due to examine the Takeover Directive in light of the experience gained in applying it and, if necessary, propose revisions. In June 2012, the European Commission published a report on the application of the Takeover Directive, identifying the following key areas where the Takeover Directive would benefit from review (all focused on the correct functioning of the mandatory tender offer system):

- **The definition of acting in concert**, viewed by the European Commission as too broad and potentially inconsistent, could be clarified to provide more legal certainty to investors as to the extent to which they can cooperate with each other without running the risk of triggering the mandatory bid rule;

- **The wide range of national derogations to the mandatory bid rule** gives rise to concerns as to whether this rule adequately protects minority shareholders in situations of change of control. Some clarifications are expected in the scope of application of national derogations to the rule and the interaction between these derogations and the existing mechanism to protect minority shareholders;
- In several markets it has been acknowledged that there is an increasing number of **offerers obtaining de facto control of a target company without triggering the mandatory bid rule** by acquiring a stake that remains just below the triggering threshold; and
- **The exemption to the mandatory bid rule** for situations where the control threshold has been exceeded following a voluntary bid for all shares of the company has created a potential loophole. This enables offerors to subvert the intention of the rule by acquiring a stake close to the mandatory bid threshold and then launching a voluntary bid for a low price (where the consideration consists of shares) to breach the threshold without being required to make a mandatory offer (and without giving shareholders a fair chance to exit the company). As mentioned earlier, such concerns were raised in the context of the bid by ACS for Hochtief. The European Commission has indicated it will take steps to discourage the use of this technique, such as through bilateral discussions with concerned member states or through Commission recommendations. Possibilities to limit the use of this technique may include additional mandatory bid thresholds or minimum acceptance conditions to takeover offers.

A Missed Opportunity

The limited scope of review proposed by the European Commission does not address some of the most critical shortcomings of the Takeover Directive.

- **Harmonization of takeover defenses.** Despite the political debate that inevitably would ensue, the European Commission should propose a system that harmonizes the approach to takeover defenses.
- **Mandatory tender offer rule.** The European Commission should consider additional rules proposed by certain member states to enable the mandatory bid rule to operate more effectively and supplement the Takeover Directive to reflect these provisions; the European Commission also should consider proposing a lower threshold — there is no apparent reason why shareholders should be able to accumulate 30 percent of a company's stock before making a tender offer.
- **95 percent squeeze-out threshold.** Where squeeze-out thresholds are set at 95 percent, they should be lowered to 90 percent. Further, where a company reaches a dominating ownership through a tender offer that is lower than 90 percent but still delivers overwhelming majority, there should be an alternative mechanism to cash out minority shareholders (in several U.S. jurisdictions, for example, the alternative is the long-form cash merger).
- **Enhanced disclosure rules.** The European Commission should consider enhancing disclosure rules, including requiring a description of the process and negotiations leading to the bid.

- **National supervisory authorities.** The European Commission should consider a system that requires national supervisory authorities to coordinate their interpretations of takeover laws — at least on the principles that are common to all systems.

More progress is required to harmonize takeover law. Until the issues above are tackled head on, the system will remain fragmented.

China M&A: Looking Ahead to 2013

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China M&A 2012 Market Overview

The upsurge in both deal volume and value of Chinese M&A transactions that followed the height of the global financial crisis in 2008 and 2009 did not extend to 2012. Because of its myriad interconnections with global finance, China's economy was brought down to earth last year.

In addition to the effects of the global economic slump, China was impacted by several other circumstances, including, among others, the flight of capital, unstable inflation, rising cost of wages, a still-unclear regulatory approval system and collapsing black market loans. All of these factors caused a slowdown in GDP growth from 9.2 percent in 2011 to less than 8 percent for 2012, resulting in, among other things, muted investment interest into China:

- The total number of announced Chinese M&A transactions (inbound, outbound and domestic transactions) for the first half of 2012 declined 33 percent compared to the corresponding period for 2011. Deal value declined by 10 percent over the same period. The number of inbound M&A transactions suffered the most, with a decrease of 42 percent. (PricewaterhouseCoopers)
- For the third quarter of 2012, the number of closed transactions in the China M&A market decreased 28.1 percent compared to the same period in 2011, and disclosed transaction value declined by 48.4 percent. Among the reported 233 completed transactions in the third quarter of 2012, only six were inbound M&A deals, reflecting a 64.7 percent decrease in deal volume compared to the same period in 2011 and a 60 percent quarter-on-quarter decrease. (Zero2IPO Research Center)
- Despite the decline in inbound M&A activity, a handful of deals are noteworthy for both their size and their structure, including General Electric Company's acquisition of a 15 percent stake in Shanghai-listed China XD Electric Group for $535 million.

Amid the overall gloomy statistics, two trends continued and are expected to do so for the foreseeable future:

- China continues its emergence as a force in the global M&A market with the conclusion of several landmark outbound transactions. Its increasing energy consumption, championed by China's state-owned enterprises (SOEs), has solidified investment outflow into natural resources and energy supplies, despite the country's slowdown in economic growth.

- Lingering questions regarding accounting irregularities and other factors causing Chinese-listed companies to trade at a discount continue to stimulate the going-private trend.

Regulatory Framework and Implications

China's regulatory regime is a vital consideration for the feasibility and success of any M&A transaction with a Chinese component. The multilayer approval and registration process may affect the timeline for the completion of the transaction and, to a certain extent, could become the most critical — and problematic — step in deal consummation. While direct acquisition of a Chinese target is subject to stricter scrutiny, outbound M&A deals and certain indirect offshore acquisitions are not immune to regulatory restrictions or requirements.

Access to China's Industry or Market. Not all industries in China are open to direct foreign investment. The Chinese government regulates foreign access to the various industries and markets through its foreign investment guidelines and catalogues, adjusting them from time to time in accordance with the state's overall economic plan.

Foreign investments in China are divided into four categories that determine the relevant approval authority and level of scrutiny the transaction will receive: "encouraged," "permitted," "restricted" and "prohibited." The *Foreign Investment Industrial Guidance Catalogue* (Catalogue) specifies the sectors and activities under the encouraged, restricted and prohibited categories; those not covered in the Catalogue are deemed to be in the permitted category. Subject to the Catalogue, certain acquisitions of shares may be limited to only a minority interest given the requirement for a Chinese partner to hold the controlling or majority equity interest.

The relevant approval authority also depends on the scale and nature of the proposed transaction. In general, the two main authorities for acquisition approval are the National Development and Reform Commission (NDRC) and the Ministry of Commerce (MOC) (or their local counterparts). In addition, investment or acquisition into certain industries also may require further approval by the specific industry's responsible authority. Examples include the Ministry of Industry and Information Technology for telecommunications, Internet and online commerce; the China Banking Regulatory Commission for banking; and the China Securities Regulatory Commission for securities investment. Other regular authorities likely to be involved in a foreign investment-related deal include the State Administration of Foreign Exchange (SAFE) for financing matters requiring conversion between RMB and foreign currencies and the State Administration of Industry and Commerce for company registration and reporting formalities.

As a comprehensive overview of specific regulatory approvals is not available, a foreign investor in China likely will need a thorough analysis of the required approvals. Because of these various regulatory approval hurdles, flexibility in structuring a direct inbound acquisition is limited and potentially time-consuming. For acquirers or investors to execute a deal quickly and minimize approval risks, the most straightforward strategy generally is to acquire or invest into the target's offshore holding company.

In terms of approvals, acquisition of an offshore holding company typically does not require governmental approval. However, in recent years, the advent of China's national security review scheme and anti-monopoly scheme has added another layer of barriers to the successful completion of the transaction.

National Security Review. In 2011, the Chinese government established a new type of process closely analogous to the Committee on Foreign Investment in the United States (CFIUS) for reviewing the national security implications of foreign investments in Chinese companies. The Security Review Committee, an interministerial committee led by the NDRC and MOC, must be notified to approve a transaction if it is deemed to (1) involve a foreign investor merging with or acquiring Chinese enterprises in (or supporting) the military sector or located near key or sensitive military facilities, and other entities relating to national defense; or (2) lead to the foreign investors taking control of Chinese enterprises in other sensitive sectors (including key agriculture products, key energy resources, important infrastructure, important transport systems, key technology and critical equipment manufacturing) that have a bearing on China's national security.

Circumventing the review by any means (including contractual arrangements) is explicitly prohibited. The implication of a catchall effect is widely thought to have had a significant impact on the current structuring and estimated completion time of M&A transactions involving targets or assets in China. In sectors where China has imposed stringent access restrictions (*e.g.*, telecommunications), foreign investors commonly utilize a variable interest entity (VIE) structure, through which the foreign investor can exercise effective control over the Chinese operations, even though it does not invest in a form of direct ownership. It is unclear whether one of the actual objectives of prohibiting any attempts, whether direct or indirect, to bypass the national security review is to take account of the VIE structure and its ability to avoid other regulatory reviews and approval process. For now, however, the national security review mechanism has forced investors and acquirers to be more wary of the scrutiny the VIE-related transactions may face.

Anti-Monopoly Clearance. Ever since the PRC Anti-Monopoly Law came into effect in 2008, the anti-monopoly filing with the MOC has been one of the key considerations in any M&A transaction, since it may affect the timeline of the transaction, and the authority may impose additional restrictions. This requirement may apply to both inbound and outbound M&A transactions, as well as transactions that are entirely between foreign entities with some revenues derived from China. A filing will be triggered if (1) in the previous financial year, the combined worldwide turnover of all parties to the transaction is more than ¥ 10 billion, and at least two of the parties each has turnover in China of more than ¥ 400 million; or (2) in the previous financial year, all parties to the transaction have a combined turnover in China of more than ¥ 2 billion, and at least two parties each had turnover in China of ¥ 400 million.

In addition, even if the above thresholds are not reached, the MOC may initiate a review if it views the concentration from the merger as affecting, or likely to affect, competition through elimination or restriction.

Since the adoption of the anti-monopoly clearance scheme in 2008, the MOC, as the authority responsible for merger control, has reviewed more than 450 transactions, 95 percent of which have been approved without additional conditions. At least 15 transactions were approved with additional conditions, and one deal, the proposed $2.5 billion bid by Coca-Cola Enterprises, Inc. for China's top domestic juice-maker, China Huiyuan Juice Group Limited, was blocked in 2008.

Important Developments in 2012

The VIE Structure Under the Regulatory Magnifying Glass. In August 2012, the MOC issued a decision on the conditional anti-monopoly approval of Walmart's acquisition of Yihaodian, a major China online retailer, which expressly precludes Walmart from engaging in value-added telecommunications business (VATB) services currently provided by Yihaodian via the VIE structure. This is the first time that the MOC explicitly prohibited the use of a VIE structure. One interpretation of this decision is that the ministry was concerned over Walmart getting access to the restricted VATB business without obtaining the requisite regulatory approval. Another interpretation is that the MOC's primary concern was competition in the online retail market and its position on the use of the VIE structure has not changed. However, despite this recent development and questions that continue to surround the long-term viability of the VIE structure, for now, it continues to be an important structuring tool for transactions that otherwise would not trigger the anti-monopoly filing threshold.

The Revised Catalogue for Market Access. The 2011 edition of the Catalogue provided further liberalization of several industry sectors in China. The change of market access is in line with China's latest national policy, reflected in its 12th five-year plan for national economic development, from 2011 to 2015.

> "China's regulatory regime is a vital consideration for the feasibility and success of any M&A transaction with a Chinese component."

The number of "encouraged" business activities was increased while the number of "restricted" and "prohibited" activities was reduced. More activities are now encouraged in sectors relating to environmental protection, renewable energy, high-technology and services. Restrictions have been removed from activities, including wholesale and retail of drugs and automobiles; operation of medical institutions, financial leasing companies and franchise management companies; importation and distribution of publications; and certain mining activities in a form of equity joint ventures. In contrast, activities added to the "prohibited" category include construction and operation of residential villas and domestic express delivery of mails.

Applicability of Share-Swap Mechanism. Use of equity as investment capital is not prohibited by Chinese law, per se. However, due to the absence of specific rules regarding such "share-swap" structures, inbound investments utilizing this structure have faced substantial regulatory obstacles.

In general, it has been practically impossible for foreign investors to either directly contribute equity to their Chinese subsidiary or joint venture, or directly use equity as consideration for purchasing shares in a Chinese company. This has forced parties to be creative in structuring transactions containing share-swap elements. One such new approach is to cross-invest with cash — whereby a foreign investor makes a cash investment into a Chinese company, and the Chinese company makes a corresponding cash investment into the foreign investor's offshore entities.

However, the regulatory situation on share-swap transactions may be improving following the MOC's October 2012 notice on this topic, which provided a clearer approval procedure and policy basis with respect to investment in a foreign-invested enterprise in the form of the equity of a Chinese onshore enterprise. The notice clarifies the type of equity that is ineligible to be used as capital contribution (*e.g.*, unpaid-up equity, pledged equity, the equity interest of real estate enterprise, a foreign-invested holding company or a foreign-invested venture capital company). As to the value of the contributed equity,

the parties can agree to an amount based on the appraised value of the equity, with a maximum capped at the appraised value. While the notice is directly addressed at investment into China by way of establishing a foreign investment enterprise or executing a capital increase in an existing enterprise, it also applies to circumstances in which shares are used as consideration for the acquisition of a Chinese company.

Although the notice does not further expand on how its guidance should be interpreted in share-swap transactions (and thus its practicability remains to be tested), it seems to provide greater flexibility for deal structuring. It can be expected that following the MOC's notice, ancillary rules from other regulatory authorities such as SAFE may be promulgated to further elaborate on the relevant procedures for consummation of equity contribution or share-swap-based transactions.

Looking to 2013

Two trends likely will continue. First, consistent with Chinese national macroeconomic interests, the SOEs will continue to take the lead in outbound M&A transactions, in particular, in the traditional energy and resources sectors. Second, given the announced going-private offers, these transactions will continue to account for a considerable share of China's M&A market. The SEC recently filed charges against China affiliates of the Big Four accounting firms for refusing to produce the audit work papers and other documents related to China-based companies, which sparked market speculation of a stronger wave of China-based U.S. companies opting for delisting in the coming years (see Capital Markets/"Hong Kong Equities Look for Brighter 2013").

At the same time, efforts are being made to encourage inbound investment into China. With the launch of a series of implementing guidelines under China's 12th five-year plan in 2011, the Chinese government signaled its proactive support for mergers and acquisitions and reorganizations. This provides a more positive policy environment for M&A transactions and cross-border investment in the relevant sectors.

In addition, the transition of China's top leadership in November 2012, together with statements issued from the new leaders regarding accelerating economic reform and liberalization, herald a new wave of domestic growth and, coupled with improving global market outlook, are stoking a positive outlook for Chinese M&A.

High-Growth Markets: Despite Economic Uncertainty, Dealmaking Opportunities Continue

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M&A activity in high-growth markets accounted for 28 percent of global deal volume in 2012, with the total value of announced M&A deals reaching approximately $723 billion, according to Thomson Reuters.[1] This activity represented a 9 percent increase compared to 2011, mainly due to strong activity in the fourth quarter of 2012 attributable to greater investor confidence in spite of the lingering effects of the euro crisis, the threat of the U.S. fiscal cliff and lower GDP growth, which affected activity in the first three quarters. Country rankings remained generally consistent compared to 2011, with China and Russia dominating all high-growth nations as the most targeted in terms of both deal volume and deal value, followed by Brazil, Mexico, India and Malaysia (see "China M&A: Looking Ahead to 2013").[2] Dealmaking in these markets was strongest in the energy and power sector (which represented 24.2 percent, with $174.9 billion in deal activity, according to Thomson Reuters), followed closely by the materials, financial and industrial sectors.

Following a lackluster first three quarters of 2012, fourth quarter M&A deal value for high-growth markets totaled $254.4 billion, up 69.4 percent from the third quarter of 2012 and 9.1 percent from the fourth quarter of 2011, thus proving the enduring attractiveness of high-growth markets for companies from both developed and high-growth markets alike. Supported by strong domestic consumption and a growing middle class, high-growth markets have proven durable and self-sustainable. Despite an environment of greater caution, opportunities remain, particularly in the retail and consumer products, technology, health care and pharmaceuticals sectors.

Encouraging Signs

We expect M&A activity in high-growth markets to be largely opportunistic in 2013, driven primarily by inbound acquisitions and heightened private equity activity. Lower valuations and the depreciation of local currencies have made businesses in high-growth markets particularly attractive, which may lead to increased inbound transactions in 2013. For example, the Brazilian real depreciated 10.4 percent against the U.S. dollar in 2012, while the Indian rupee depreciated 1.7 percent during the same period. Managers seeking a bargain may seize acquisition opportunities in high-growth markets in the near term.

Global buyout firms and sovereign wealth funds, flush with cash, also should propel M&A in high-growth markets in 2013. Following a decline in private equity investment in anticipation of decreasing prices, private equity funds remain highly liquid, with significant amounts of unspent funds earmarked for high-growth market investments. For example, private equity funds raised a record $6.3 billion for their Brazil investments in 2011, primarily slated for investments in retail, consumer goods and infrastructure, which were postponed due to the unstable economic conditions in 2012. Fueled by persistent investor demand, we expect much of this capital to be deployed in 2013, as prices stabilize and domestic measures to revive growth become more visible. In

[1] Statistics refer to Thomson Reuters' "emerging market" M&A category, which includes most of the world other than North America, Western and Central Europe, Japan, South Korea, Australia and New Zealand.

[2] Thomson Reuters, *Emerging Markets M&A Review: Financial Advisors, Full Year 2012* (Jan. 2013).

addition, due to generally dormant IPO markets in many high-growth nations, we also expect to see an uptick in high-growth market M&A in 2013, as private equity investors exit their existing high-growth market investments through M&A deals rather than capital markets transactions (see "Private Equity: Positive Signs for 2013").

In addition, the ongoing crisis has prompted many companies to accumulate cash on their balance sheets. Following the hopeful stabilization of local and global conditions, many of these multinationals, with high liquidity, access to cheap financing and limited growth opportunities in their main markets (U.S. and Europe), may seek strategic opportunities in high-growth markets more aggressively.

Potential Deterrents

Despite cautious optimism, we also remain cognizant of the ways in which local challenges may threaten high-growth market M&A activity even if global economic stability improves. For example, in Brazil last year, concerns about high valuations, some perceived signs of increasing state intervention (particularly in the banking, telecommunications and power utility sectors) and initial uncertainty surrounding the introduction of a new antitrust regime contributed to a three-year low in Brazilian M&A activity. In addition, we have witnessed a general slowdown of financial reforms in many high-growth nations, particularly in India, which struggles with inadequate industrial input and a significant account deficit. The ability of governments in high-growth nations to promptly and adequately address macroeconomic challenges and develop sound policies and financial reforms will be critical to the return of robust dealmaking in these markets.

> "Although high-growth market M&A activity decreased in 2012, these markets remain attractive options for companies from both developed and high-growth markets."

Regional Highlights

With no single high-growth economy driving global demand, we expect to see a greater diversity of high-growth and frontier nations shaping the M&A landscape in 2013. In Latin America, Colombia and Mexico are becoming especially attractive to investors. Foreign investment in Colombia has surged in recent years as the government has become increasingly forceful in curtailing organized crime, and Mexico's change in government is seen as an opportunity for forthcoming structural reform. While overall Asia deal volume remains relatively flat, Southeast Asian companies and sovereign wealth funds, with strong cash positions and vigorous growth, are aggressively pursuing outbound M&A opportunities, particularly in the energy, financial and retail sectors. In addition, we also are seeing an increase in M&A activity in the Middle East and North Africa, especially in Turkey and Egypt, as Western banks retreat and sell their local subsidiaries.

Over the past decade, the continent of Africa has continued to be one of the fastest growing regions in the world, second only to emerging Asia. The region's aggregate GDP expanded by 4.8 percent in 2012, according to the McKinsey Global Institute. Natural resource transactions continue to dominate deal activity in the region, in terms of both deal volume and deal value. This activity is driven in part by new or recent natural resource discoveries on the continent, such as natural gas discoveries in Mozambique and Uganda and the offshore Jubilee Field in Ghana. South Africa's renewable energy program provided significant deal activity in 2012 with the closing of 28 transactions in round one of an anticipated three-round process. We believe round two will close in the first half of 2013 with 19 transactions. Electricity privatization in Nigeria also will contribute to activity in 2013.

Increasingly, the agribusiness, telecommunications, retail and banking sectors are driving more deal activity on the continent. We believe this trend will continue, given the projected growth in Africa's consumer class, the primary driver of interest in these sectors. Global food security concerns continue to combine with Africa's heavy concentration of arable land (compared to the rest of the world) to drive deal activity in agribusiness.

* * *

Given the headwinds in developed markets, M&A and other deal activity in high-growth markets may well account for a greater percentage of global activity in 2013 than 2012. If that occurs, it will be the result of investors' search for yield, which will be tempered by execution and political risk concerns. Comprehensive due diligence on the targets, co-investors and sellers, coupled with an understanding of tax, and convertibility or remittance of currency issues, are critical factors for those investors seeking to make the most of their opportunities in these high-growth markets.

Private Equity: Positive Signs for 2013

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While U.S. and global private equity (PE) investment activity remained somewhat stagnant in 2012, the deal environment for leveraged acquisitions recently has been more favorable. Although economic uncertainty, particularly the debt celing resolution in the U.S., may continue to negatively affect overall M&A activity, we view the outlook for PE investing as more positive because of continued confidence in credit availability and the reported trillion-dollar level of PE purchasing power (or "dry powder") worldwide. Some of the key topics likely to shape the PE deal landscape in the year ahead include (1) PE fundraising/fund formation trends, (2) the impact on PE activity of the substantial dry powder, (3) the prevalence of limited partner (LP) co-investment in PE deals, (4) the decreased number of "mega/club deals" and (5) other trends, including increased "add-on" investments and secondary buyouts as well as use of standardized deal terms to allocate financing risk.

- **Fund Formation.** The PE fundraising environment seemingly has stabilized, with the aggregate number of new funds raised (by number and amount of capital) remaining constant in 2010, 2011 and 2012, according to Preqin data. However, recent fundraising levels still are substantially below the peak years. We expect this trend to continue in 2013, and we expect that PE sponsors will continue to form geographic-specific and industry-specific funds. In addition, although investors in PE funds may plan to cut the number of fund managers they commit to over the near term, many investors continue to be bullish on the asset class generally.

- **Dry Powder.** Some reports indicate that the dry powder, or callable capital reserves, of PE funds could be as high as $400 billion worldwide in 2013 (with $200 billion required to be invested this year) — which equates to more than a trillion dollars of purchasing power applying conservative leverage assumptions. PE funds have a strong incentive to invest this capital before the expiration of their fund investment period — at which time, without an extension from their limited partners, the PE funds lose the ability to call this committed capital and earn the corresponding carry. At the same time, due to the financial crisis and other market factors limiting exit alternatives, PE funds typically have held portfolio companies for longer than the

usual holding period and are actively seeking exit opportunities. The confluence of these factors, along with greater availability of credit, should provide a meaningful backdrop for increased PE activity in 2013, including through "secondary buyouts."

> "While some observers have predicted that the need for PE funds to invest in new deals could result in a revival of the mega-buyouts, there are many countervailing factors that may continue to impede this re-emergence in 2013."

- **Increase in LP Co-Invests.** We have seen a significant increase in the number of transactions in which LPs have participated in PE buyouts as direct co-investors. Co-investment transactions serve many important purposes for their participants. For the PE fund, co-investments can help fill funding gaps created by tight debt markets, reduce the fund's risk exposure in any particular deal, increase the deal size the PE firm can pursue and solidify relationships with important LPs. For co-investors, these investments offer diversification, a chance to achieve better investment returns (including by investing capital into a PE fund on a no-fee (or very low-fee) basis), the acceleration of capital deployment, the ability to invest larger amounts in deals they find particularly attractive, and the opportunity to deepen relationships with the PE funds and benefit from the sponsors' diligence and expertise in executing the investment. Given the dynamics in the PE industry that we see for 2013 (*e.g.*, dry powder, absence of mega/club deals, LPs having increased bargaining power during fundraising), we would expect these co-investments to continue, as the participants seek to capitalize on the associated benefits.

- **Decreased Number of Mega/Club Deals.** Multibillion-dollar, mega-size buyouts that captured headlines during the peak of the credit bubble did not reappear in 2012 and are unlikely to return in the foreseeable future. PE investment activity largely has settled into — and been concentrated within — deals between $100 million and $5 billion, with an overwhelming percentage of deal volume occurring within the $100 million to $1 billion range. While some market observers have predicted that the need for PE funds to invest in new deals could result in a revival of the mega-buyouts since these deals allow more money to be deployed faster, there are many countervailing factors that may continue to impede the re-emergence of the mega-buyout in 2013 and beyond, including (1) smaller size of PE funds and corresponding inability (or hesitancy) to allocate large percentage of fund capital to any one deal, (2) reluctance of PE funds to participate in club deals, given the difficulty in managing the investment with multiple sponsors and view from the LPs that club deals undermine their diversification objectives, since they may be invested in each member of the club, and (3) LPs increasingly limiting the PE fund's ability to make investments over certain dollar thresholds.

- **Other Trends.**
  - **"Add-on" Investments.** PE firms are continuing to invest in add-on acquisitions involving businesses that are complementary to existing portfolio companies or investing in smaller companies in closely related businesses to increase the scope of their presence in an industry.
  - **Secondary Buyouts.** PE firms increasingly have been selling portfolio companies to other PE firms. These secondary buyouts accounted for 30 percent of 2012 aggregate PE deal value (up from the record level of 25 percent in 2011), according to Preqin data. This increase likely is driven by uncertain IPO markets and the pressure on PE firms to return capital to investors on deals made during the buyout boom. While secondary buyouts are vulnerable to criticism (*e.g.*, lack of investment thesis to improve results obtained by prior PE owners), given the

normal uncertainties surrounding the IPO market and lack of other available exit alternatives, we would expect secondary buyouts to continue to represent a significant portion of PE deal activity in 2013.

– **Standardized Financing Risk Allocation.** In 2011 and continuing into 2012, PE deals significantly trended toward a "standard" set of deal terms to allocate financing risk — no financing-out, a reverse-termination fee (ranging from 3-9 percent) as the sole remedy if debt financing is not available despite the buyer's efforts, and a limited specific performance right to force the buyer to close only if the debt financing is available. While there have been (and will continue to be) certain exceptions — *e.g.*, competitive auctions where PE firms may be willing to take more risk with a higher reverse-termination fee, more expansive "flex" provisions, a requirement to increase the equity portion of financing or an obligation to "take-down" bridge financing in lieu of bond financing, etc. — we expect this standardized set of deal terms to continue in 2013 and beyond.

National Security Reviews of Foreign Investments in US Businesses: An Enduring Trend?

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Two events over the past year underscored the increased importance of advance planning for national security reviews in a transaction involving a foreign investor in a U.S. business. First, in September, President Obama formally blocked an acquisition of a U.S. company, which was the first time this has occurred in 22 years. In that transaction, a Chinese-owned company sought to purchase four small wind farms in Oregon, one of which abutted restricted U.S. naval airspace used for unmanned aerial vehicle testing and training. The transaction's parties failed to notify CFIUS of the sale, and were compelled by CFIUS to file a post-closing notice when a CFIUS member agency learned of the deal.

Second, in its most recent annual report to Congress (which covers its activities through 2011), CFIUS officially declared for the first time that "the U.S. Intelligence community judges with moderate confidence that there is likely a coordinated strategy among one or more foreign governments or companies to acquire U.S. companies involved in research, development, or production of critical technologies for which the United States is a leading producer." Prior CFIUS annual reports described such a threat as "unlikely"; the revised analysis indicates heightened U.S. government sensitivity to — and, ultimately, closer scrutiny of — transactions involving technology firms.

CFIUS continues to approve the overwhelming majority of transactions it reviews. However, such reviews have become one of the most important gating items in many proposed foreign investments in U.S. businesses. Reports of cyber incidents involving U.S. government and corporate networks have fueled concerns relating to transactions involving telecommunications networks and technologies and critical infrastructure (see Regulatory/"Network Security Threats and Cybersecurity Legislation and Regulation"). Consolidation in the natural resources, telecommunications and critical technologies industries, coupled with increased concerns over the security of the industrial supply chain and defense industrial base, also have led to rigorous scrutiny of transactions in

these sectors. Additionally, the geolocation of energy projects, as well as the diffuse nature of wind generation facilities and their communication with supervisory control and data acquisition (SCADA) systems, can create unique sensitivities in energy transactions, which may cause the U.S. government to require that the parties enter into security agreements prior to approval.

Trends in the CFIUS Review Process

The Foreign Investment and National Security Act of 2007 (FINSA) mandated that CFIUS report annually to Congress regarding its activity for the prior year. The report issued in December of 2012 covers CFIUS activity through the end of 2011. The 2012 report confirmed an increase in the number of transactions submitted for CFIUS review during 2011, and our experience working closely with CFIUS indicates that this trend continued in 2012. Additional trends include:

> "CFIUS reviews have become one of the most important gating items in many proposed foreign investments in U.S. businesses."

- **CFIUS investigated more transactions.** The CFIUS process consists of a mandatory 30-day review followed by a discretionary 45-day investigation period, which CFIUS can impose if it determines that the transaction may impair national security. CFIUS generally sends a transaction into investigation if it would result in foreign government control of a U.S. business or foreign control of "critical infrastructure" (as defined in the CFIUS regulations), or if the U.S. business has government contracts or access to classified information.
- **CFIUS required mitigation agreements in more transactions.** CFIUS enters into mitigation agreements with parties to transactions to address national security concerns identified during the review process. Mitigation agreements generally govern the foreign purchaser's access to sensitive information of the U.S. business and can affect operability and expected transaction synergies.
- **The Department of Defense increasingly recommended proxy agreements as the preferred mitigation instrument where the U.S. business required access to classified information.** While CFIUS does not publicly report the exact nature of mitigation it imposes in each transaction requiring mitigation, in our experience, the Department of Defense (a CFIUS member agency) has been more likely to recommend that proxy entities be set up to operate the U.S. business post-closing, particularly in cases in which a foreign government owns a significant interest in the acquiring company. Proxy entities are the most restrictive form of mitigation, and this trend reflects a growing requirement by the Department of Defense that its suppliers be cleared to access classified information. However, the Defense Security Service has been willing to discuss modifications to the standard form proxy agreement to provide the foreign parent with a greater and more versatile role in operating the U.S. business. We expect this trend to continue in 2013.
- **CFIUS made more demands for filings post-closing.** The CFIUS process usually is initiated by a voluntary notice made prior to closing. In 2011 and continuing in 2012, however, CFIUS became more active in requiring that filings be made post-closing when parties to sensitive transactions failed to file a notice, as was the case in the transaction blocked in September. Parties always are at a disadvantage when they fail to file with CFIUS; adopting a "chance it" mentality is not a viable option. We expect CFIUS to continue to step up its policing of non-notified transactions in 2013.

- **The length of CFIUS internal deliberations continued to increase.** FINSA requires that mitigation agreements must be approved unanimously by CFIUS member agencies. Because those agreements often reflect the concerns of one particular CFIUS member agency but not others, the unanimity requirement has resulted in more time being spent in internal deliberations. We expect this trend to continue in 2013, especially if the number of transactions subject to mitigation continues to increase.
- **Companies based in U.S. ally nations continued to file a significant number of transactions with CFIUS.** A significant plurality of transactions filed with CFIUS involve foreign purchasers based in countries considered to be an ally of the United States. This likely illustrates a greater willingness by such nations' companies to make investments in U.S. businesses — and highlights the interest CFIUS takes in transactions that might initially be perceived as "low risk."

As foreign investment in U.S. companies continues to increase, the competing policy goals of encouraging foreign investment while protecting against national security risks will continue to play out in the CFIUS review process and as a central issue in foreign investments in U.S. companies. Parties to cross-border transactions are encouraged to plan ahead for CFIUS reviews by consulting knowledgeable counsel as early as possible.

The Continuing Impact of Delaware Courts on US M&A

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The past year of M&A litigation in Delaware resulted in several decisions with important implications for parties engaging in or advising on M&A transactions.

Controlling Stockholder Transactions

The 2012 Delaware Supreme Court opinion in *Americas Mining Corporation v. Theriault* provides dramatic evidence of the risks inherent in transactions in which a controlling stockholder stands on both sides of a transaction, thus implicating the entire fairness standard of review. In *Americas Mining*, the Supreme Court affirmed post-trial findings that "a focused, aggressive controller" extracted a deal that was "far better than market," resulting in "a manifestly unfair transaction." The court let stand a damages award of more than $2 billion against a controlling stockholder and its affiliate directors for breach of fiduciary duty, as well as an attorneys' fees and expenses award of more than $300 million.

Transactions involving companies with a controlling stockholder offer fertile ground for litigation, even where the controlling stockholder does not stand on both sides. In *In re Delphi Financial Group Shareholder Litigation*, the Court of Chancery declined to enjoin the stockholder vote on the Delphi/Tokio Marine Holdings merger, even though it concluded that a controlling stockholder likely breached his fiduciary duties by successfully demanding a premium for his high-vote shares. While confirming that a controlling stockholder generally is permitted to negotiate a control premium for its shares, the court found that, in this case, the controlling stockholder had already "sold his right to a control premium," via a provision in the company's certificate of incorporation that required equal consideration to be paid to the high-vote and low-vote shares in a

merger. As a result, the court found the controlling stockholder's attempt to "extract a *second* control premium for himself" at the expense of the minority stockholders likely to be a breach of fiduciary duty.

> "Transactions involving companies with a controlling stockholder offer fertile ground for litigation, even where the controlling stockholder does not stand on both sides."

The court, however, refused to enjoin the stockholder vote on the merger and permitted stockholders to decide for themselves whether to accept the 76 percent premium offered in the merger. The court noted the absence of evidence "that another suitor is in the wings or is likely to be developed at a greater, or even equal, price." In so holding, the court noted the similarities present in its prior decision in *In re El Paso Corporation Shareholder Litigation*. In that case, the court identified numerous "debatable negotiating and tactical choices made by El Paso fiduciaries and advisors," which were compounded by a lead negotiator and financial advisor with interests in conflict with those of the El Paso stockholders. Nevertheless, the court declined to issue an injunction and permitted the El Paso stockholders to vote on the merger in light of the 37 percent premium it offered and the absence of other bids. In refusing to enjoin the Delphi/Tokio Marine Holdings merger, the court noted that the 76 percent premium offered in the merger "dwarfs the premium percentage in *El Paso*." The claims asserted in the *Delphi* litigation were ultimately settled for approximately $50 million.

In contrast to the *Delphi* decision, in a case involving a merger between Synthes, Inc. and Johnson & Johnson, the Court of Chancery found that stockholder plaintiffs had not stated a breach of fiduciary duty claim against a controlling stockholder. In dismissing the stockholder plaintiffs' claims in *In re Synthes, Inc. Shareholder Litigation*, the court explained that "although the controller was allowed by our law to seek a premium for his own controlling position, he did not and instead allowed the minority to share ratably in the control premium paid by J & J." The court found that, as alleged, the controlling stockholder did not have:

> any conflict with the minority that justifies the imposition of the entire fairness standard. The controlling stockholder had more incentive than anyone to maximize the sale price of the company, and Delaware does not require a controlling stockholder to penalize itself and accept less than the minority, in order to afford the minority better terms. Rather, pro rata treatment remains a form of safe harbor under our law.

In another case, the Court of Chancery confirmed additional procedures by which certain transactions involving a controlling stockholder may avoid entire fairness review entirely. In *Frank v. Elgamal*, the court stated that when a corporation with a controlling stockholder merges with an unaffiliated company, minority stockholders are cashed out, and the controller receives a minority stake in the surviving entity, entire fairness will not apply if the transaction includes "robust procedural protections." The court explained that these protections include the recommendation of the transaction by an independent and disinterested special committee and the approval of the transaction by the nonwaivable vote of a majority of the minority stockholders. When such procedural protections are included in these types of transactions, business judgment, rather than entire fairness, is the applicable standard of review.

Increase in Deal Litigation and Other Observations

The frequency of stockholder lawsuits challenging M&A transactions accelerated in 2012. The Court of Chancery has noted this trend. For example, in March, Vice Chancellor J. Travis Laster noted in *Stourbridge Investments, LLC v. Bersoff* that:

> the past decade has witnessed a dramatic transformation in the nature of public company M&A litigation. In 2010, 84.2 percent of announced deals attracted lawsuits. In 2010 and 2011, according to Cornerstone Research, 91 percent attracted lawsuits. According to the data for 2011, in the same study, 96 percent of deals valued at $500 million or more attracted lawsuits. That's compared to 53 percent in 2007. As these volumes have increased, merits-related outcomes have decreased.

In addition to increasingly frequent M&A litigation in the Delaware courts, the plaintiffs' bar continues to file M&A-related litigation outside of Delaware, even when challenging transactions involving companies domiciled in Delaware. We see no indication this trend will reverse in 2013.

Finally, as noted above, a number of 2012 decisions confirm Delaware's continued commitment to informed stockholder franchise. So long as disclosures are materially complete and accurate, the Delaware courts appear reluctant to take from stockholders the opportunity to decide for themselves whether or not to accept a premium transaction.

Antitrust and Competition: Surveying Global M&A Enforcement Trends

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US: Obama's Antitrust Agenda Enters Second Term

Following the November elections, in 2013 the U.S. Department of Justice's (DOJ) Antitrust Division and the FTC (the Agencies) likely will continue the trend of the last four years of aggressive antitrust enforcement. Thus far under the Obama administration, the Agencies have initiated more enforcement actions, including litigations and consent settlements, and issued more second requests (as a percentage of HSR filings) than over the previous four years. During President Obama's first term, the rates for both enforcement actions and second requests were up approximately 50 percent from 2006-09, and the current rate of enforcement actions is nearly double that of 2002-05. Significant leadership changes are on tap at both agencies in the coming year, but we fully anticipate a continuation of this record of aggressive enforcement, along with increased emphasis on economic and data-driven analysis.

Department of Justice. On December 30, 2012, the U.S. Senate voted to confirm Bill Baer to lead the Antitrust Division. Baer, an experienced antitrust practitioner and former head of the FTC's Bureau of Competition, will bring to the division a respect for economic theory and its importance in antitrust analysis. Under Baer's leadership, look for the Antitrust Division to continue investigating patent acquisitions aggressively, as it did in its recent investigations into acquisitions by Google from Motorola Mobility Holdings; Apple, Microsoft and Research in Motion from Nortel Networks; and

Apple, Microsoft, Oracle and EMC from Novell Inc. Also look for the division to continue advancing its use of economic analysis, including reliance on the upward pricing pressure test (the most significant economic tool introduced by the revised Horizontal Merger Guidelines in 2010), which has been utilized increasingly by the Agencies in their merger investigations.

Federal Trade Commission. The status of the leadership at the FTC remains less certain. In the coming months, J. Thomas Rosch (an FTC commissioner since 2006), whose term expired in September 2012, will step down once his replacement is confirmed; Jon Leibowitz (currently the FTC chairman and a commissioner since 2004) is rumored to be stepping down in the near future. George Mason University School of Law professor Joshua Wright will replace Rosch. Wright, who has both a J.D. and a Ph.D. in economics, will be the only economist on the commission. Contrary to Rosch, who has advocated for more aggressive antitrust enforcement, Wright is considered to have a relatively narrow view of the FTC's enforcement role and is likely to insist on a higher evidentiary threshold and substantial economic analysis prior to authorizing enforcement action.

> "Under its new leadership, look for the DOJ's Antitrust Division to continue investigating patent acquisitions aggressively."

In addition to Wright's arrival, should Chairman Leibowitz resign, President Obama will need to replace him. For years, Leibowitz has focused his attention on antitrust enforcement in health care, and his departure comes at a time when economic pressures and the continuing rollout of the Affordable Care Act have driven record levels of industry consolidation. However, as a senior FTC merger enforcement official recently warned, regulators "are not viewing health care reform or the state of the economy as a blank check" to acquire a competitor. Regardless of who takes the helm if Leibowitz departs, the FTC likely will continue closely scrutinizing the pharmaceutical industry (see Global Litigation/"Antitrust and Competition: Antitrust Enforcement on Both Sides of the Atlantic") and health care consolidation, especially deals involving hospitals. In the past year alone, the FTC has challenged the proposed acquisitions by ProMedica Health System of St. Luke's Hospital, OSF Healthcare System of Rockford Health System, Universal Health Services of Ascend Health Corporation and Reading Health System of Surgical Institute of Reading LP. The FTC also has another hospital merger case, *Phoebe Putney Health Systems*, currently in front of the Supreme Court with the issue of state action immunity under review.

Nevertheless, the FTC proved in 2012 that it is willing to go against the political tide when the facts merit. For example, in its review of Express Scripts' acquisition of Medco, the FTC received a barrage of input from industry participants and Congress demanding a thorough investigation and, in the case of some, enforcement action. The FTC undertook a detailed review, but eventually determined that the proposed transaction would be unlikely to substantially lessen competition given the intensely competitive nature of the pharmacy benefit management business and the fact that the merging parties were not particularly close competitors.

Hart-Scott-Rodino. Further evidence of the administration's aggressive antitrust enforcement agenda came in the form of a criminal case against an executive for falsifying Item 4(c) documents submitted with a Hart-Scott-Rodino (HSR) notification and report form. In May 2012, the Antitrust Division announced that a Korean executive had agreed to serve five months in prison for altering Item 4(c) documents. The Antitrust Division pursued the matter, even though the parties abandoned the transaction a few

months after filing HSR and before the DOJ had made a decision about the merits of the transaction. This serves as a reminder of the seriousness with which the Agencies view companies' document production obligations pursuant to the HSR Act.

European Union

The recession continued in 2012 for a large portion of the European Union, as the sovereign debt crisis expanded beyond Greece. Against this background, the European Commission, and Competition Commissioner Joaquín Almunia specifically, have resisted calls for a more lenient implementation of merger control in the European Union. The EU commissioner for competition continues to view aggressive merger control enforcement as a key instrument for promoting growth and protecting consumers in the European Union.

Indeed, 2012 was characterized by an increased number of high-profile commission decisions adopted under the EU Merger Regulation (EUMR), reflecting a strict merger control policy. *Deutsche Börse/NYSE Euronext* was the second prohibition decision issued under Commissioner Almunia's watch, while the commission also opened nine Phase II investigations in 2012, five of which resulted in significant remedies, while two resulted in the parties abandoning the deal.

The continued recession in Europe has raised the question of whether the Commission should consider industrial policy and focus its merger enforcement on a more dynamic, forward-looking approach, as opposed to one relying mainly on pre-merger market conditions.

Industrial Policy Considerations: *Deutsche Börse/NYSE Euronext*

In *Deutsche Börse/NYSE Euronext*, the parties submitted that the merger would result in greater liquidity in Europe and would generate significant collateral savings. The Commission rejected these efficiency arguments on the basis that they were not sufficiently merger-specific and that it was unclear whether they would be passed on to consumers. Instead, the Commission prohibited the transaction, focusing on European exchange-traded derivatives. The Commission was concerned about the fact that the combination of Deutsche Börse's Eurex and NYSE Euronext's Liffe, the two leading European derivatives exchanges, would result in a "quasi-monopoly in exchange-traded financial derivatives based on European underlyings, where the two companies control more than 90 percent of the global market." As a result, the Commission requested the divestment of the whole of either Eurex or Liffe, which went beyond what the parties were willing to offer. The Commission blocked the merger, and Deutsche Börse appealed the prohibition decision in the General Court.

Counterfactual Analysis: *Olympic/Aegean*

The economic crisis, and its impact on the merging parties' ability and incentives to compete, has led some notifying parties in merger cases to claim that the Commission should adopt a more forward-looking approach in its merger analysis. The Commission in fact is required under the Horizontal Guidelines to compare the competitive

conditions that would result from the notified merger with the conditions that would have prevailed without the merger (the "counterfactual"). However, the Commission has continued to be very reluctant to consider a counterfactual that is significantly different from the pre-merger situation.

The *Olympic/Aegean* prohibition decision, which was published in 2012, provides a good illustration of the Commission's reluctance to adopt a more forward-looking approach in its merger analysis. In that decision, the Commission accepted that, given the financial situation of the two airlines in question and the state of the Greek economy, it was unlikely that the pre-merger situation would continue absent the transaction. However, the Commission rejected the counterfactual analysis of the parties, according to which that the declining demand in Greece no longer would be sufficient to sustain both parties' activities. The Commission instead established its own counterfactual based on the premise that both Olympic and Aegean would continue to operate in Greece and blocked the merger on the view that it would lead to a monopoly for certain Greek routes. Since then, both Olympic and Aegean appealed the Commission's prohibition decision. In addition, the companies are now attempting a new merger, which also will be reviewed by the European Commission.

The Commission's reluctance to adopt a more forward-looking approach stems from the view — endorsed by the General Court in recent judgments — that unless there is compelling evidence that the industry structure will change in the foreseeable future, it is prudent to base the competitive assessment of a transaction on current competitive conditions. This imposes a high threshold on merging parties, as the Commission always can take the view that the market could evolve in a way that is different from the parties' projections, as was the case in *Olympic/Aegean*.

Far-Reaching Remedies

The Commission also has been requesting far-reaching remedies. In *Universal/EMI*, the Commission obtained a divestiture package representing approximately two-thirds of EMI's European turnover, while the intellectual property rights contained in the package were worldwide in scope, so that the buyers could exploit the assets in a "viable and competitive" way. Similarly, in *Deutsche Börse/NYSE Euronext*, the Commission rejected the parties' original proposal to only divest the overlapping derivatives products, as they would be too small and not diversified enough to compete on a standalone basis, and requested the divestment of the entire Eurex or Liffe business.

Confidentiality

On the procedural front, the recent court judgments in *Odile Jacob* and *Agrofert* were a step toward preserving the confidentiality of the information provided by the merging parties during the Commission's merger investigations. In these cases, third parties had sought access to documents submitted by the notifying parties during merger investigations on the basis of Regulation 1049/2011 (the Transparency Regulation), which entitles private parties to seek access to Commission documents under certain conditions. The European Court of Justice upheld the Commission's refusal to provide the parties' documents and established a general presumption that disclosure of documents exchanged between the Commission and the merging parties during the course of the merger control proceedings should remain confidential.

China, Brazil and India

2012 was the fourth full year of enforcement of the Chinese Anti-Monopoly Law (AML) by China's Ministry of Commerce (MOFCOM). MOFCOM has continued to vigorously enforce the AML and clearly is one of the gateway merger control jurisdictions for global M&A transactions, often affecting the timing for closing in a significant way.

MOFCOM has not hesitated to impose far-reaching remedies that sometimes diverge from the practices of EU and U.S. agencies. Two of the most important examples were the Seagate/Samsung and Western Digital/Hitachi mergers in the hard disk drive (HDD) sector that were announced in 2011. After extensive review of both cases, MOFCOM, in early 2012, imposed extensive global behavioral remedies that were different from the outcome of the U.S. and EU merger reviews. Seagate/Samsung was cleared unconditionally in the EU and the U.S., but MOFCOM only agreed to approve the transaction subject to several commitments, including a one-year commitment by Seagate to operate Samsung's HDD business as a viable independent competitor worldwide, maintain and expand production capacity of Samsung, and invest at least $800 million in R&D in each of the next three years to continue to supply innovative products to consumers. In Western Digital/Hitachi, MOFCOM imposed similar commitments on Western Digital, but for a two-year period.

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On the procedural front, MOFCOM's increased expertise has not resulted in shorter merger reviews; in fact, review periods are now longer than in prior years. Pre-notification procedures have extended considerably, and MOFCOM opens Phase II investigations in the vast majority of cases, including those raising no competition concerns. As a result, even simple cases take several months to obtain MOFCOM's approval. Given that MOFCOM imposes a global bar on closing under the Chinese Anti-Monopoly Law, MOFCOM's, approval often is the last outstanding merger control clearance that can significantly affect the timing for closing global M&A transactions.

In Brazil, the new Brazilian Competition Law (Law No. 2529) entered into force on May 28, 2012. The new law marked the entry of a new merger control regime in Brazil, which imposes a bar on closing until the Brazilian competition authority (the CADE) approves the transaction. Certain CADE officials have taken the view that the bar on closing is global. Other significant merger control jurisdictions such as the EU, the U.S. and China impose a similar worldwide bar on closing. However, in contrast to China, the CADE has proven to be effective in terms of the timing of merger clearances. Under the new law, fast-track cases have been approved in less than 30 days, while non-fast-track cases have been approved in less than 50 days.

In India, the Competition Bill of 2007, which amends the Competition Act of 2002, introduced a mandatory pre-closing filing system that also applies to M&A transactions not involving Indian companies. The new regime entered into effect as of June 1, 2011. However, India has remained below the radar for many global M&A transactions, since the transitional *de minimis* exception relating to the target's sales and assets in India renders the Indian merger control inapplicable in many international transactions.