Directors & Boards

Assessing Acquisition Offers from Chinese Buyers

CFIUS and related considerations for technology company boards.

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Notwithstanding reports earlier this year of transactions that either failed to close (GO Scale / Lumileds; Tsinghua Unisplendour / Western Digital), lost out to competing U.S. bids (China Resources / Fairchild) or were abandoned following frenetic bidding, the pace of Chinese M&A in 2016 remains remarkably strong. As of May 10, 2016, Chinese acquirors had made $110.8 billion in offers for overseas targets, up from $106.8 billion in all of 2015, according to Dealogic. Billion-dollar deals drive the trend, with 17 Chinese acquirors spending $83.4 billion in aggregate, compared to six deals worth $16.5 billion during the same period in 2015.

The reality behind the headlines is that a U.S. target board that receives a bid from a Chinese buyer can face a fundamental dilemma: whether to accept a higher-valued offer from the Chinese side that may also carry greater risks to deal completion than bids presented by U.S. buyers. As a result, target directors must weigh the attractiveness of the Chinese buyer's higher (often cash) price against the potential risk that the deal, if accepted, may ultimately not close, and negotiate effective terms to cause or encourage the Chinese buyer to close and/or compensate the target for a failure to close.

This summary reviews key considerations for target directors that are reviewing a Chinese acquisition offer. We focus below on certain regulatory and practical closing issues that a target board should bear in mind. These issues tend not to be present, or are less prominent, with a U.S. acquiror.

CFIUS

Does target hold critical technology? Potential review of the deal by the Committee on Foreign Investment in the United States (CFIUS) often tops the issues list in a Chinese buyer's bid (or, as GO Scale / Lumileds showed, for a foreign target with technology assets in the U.S.). While CFIUS has a broad mandate to determine what U.S. businesses might affect national security, this is particularly true when the target is engaged in the development of an "advanced technology" such as the design and production of semiconductors or of goods and services involving network and data security, that may be useful in defending or in seeking to impair U.S. national security. Since CFIUS also reviews U.S. government-related activities of the target, target boards should conduct their own due diligence at the outset of the transaction to determine the extent of potential CFIUS issues.

CFIUS to date has rejected only a very few transactions, but a CFIUS review can create potential delays and increased closing risks. Since the CFIUS review process is confidential, it may be difficult to predict how certain it is that clearance will be granted, and CFIUS may not be in a position to ever state precisely what its concerns are.

To address CFIUS risk, target boards may consider:

• appropriate covenants from the buyer to take action needed to gain CFIUS clearance. Examples include selling a sensitive manufacturing facility, or adopting mitigation protocols to limit access to sensitive information;

• a reverse termination fee (RTF) payable by the buyer if CFIUS clearance is not forthcoming. Specific fee amounts depend on perceived risk and the parties' negotiating leverage, but CFIUS-based RTFs have ranged between 3% and 7 % of the purchase price in recent transactions; and

• whether any RTF should be escrowed in advance or secured by a letter of credit from a U.S. bank or U.S. branch of a major PRC bank, to address potential breach / payment issues.

Other Regulatory Issues

Does the buyer have all of the regulatory approvals it needs to close? Recently announced PRC reforms would require Chinese buyers to make only a notice filing (rather than obtain pre-closing approval) for outbound transactions not involving investment into a sensitive country or industry or deal sizes of US$2 billion or more.

However, other regulations and policies may be applicable to an acquisition by a Chinese buyer. For example:

• Antitrust review (in China or the U.S.) can postpone or (in terms of conditions imposed) otherwise complicate a closing.

• The PRC State Administration of Foreign Exchange (SAFE) and Chinese banks have recently slowed the process for foreign currency conversions and transfers.

Target directors should thoroughly diligence applicable regulatory requirements, and negotiate terms to address the related risks.

Taiwan Assets

Does target hold significant Taiwan assets? Currently, the Taiwan government will not allow PRC state-owned enterprises to acquire certain kinds of assets in Taiwan, and acquisitions by even privately held Chinese buyers may require the approval of Taiwan regulators.

Target directors should review any business and assets that are located in Taiwan and, if necessary, require the buyer to prepare to sell the relevant assets to a third party acceptable to Taiwan regulators or to take other steps.

Certainty of Payment

Acquisition finance sources may be abundant in China currently, but in light of potential regulatory and other issues, can the Target board be certain that the purchase price will be paid at closing? A U.S. target may encounter challenges in seeking to enforce an acquisition agreement against a buyer in China. As with payments of RTFs noted above, target boards may want to ask the buyer to provide a U.S. source of payment (such as the U.S. branch of a Chinese bank).

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Chinese buyers understand that they may need to pay more to win, and are also generally more willing to take a longer term view on the ultimate success of the acquired business. Target directors should thus not prematurely dismiss a Chinese bid. Appropriately structured, it may represent the best deal for shareholders. ■

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