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Considerations for the Acquisition of a Non-U.S. Company by a U.S. Public Company

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When it is time to sell a company, there are a number of financial and legal steps a business should consider to ready itself for a merger or acquisition. When the potential buyer is a U.S. public company, that list may get longer. The following are some common issues that arise in the context of a U.S. public company acquisition of a non-U.S. company. Being familiar with, and prepared for, the pressure points facing a U.S. public company will make for a smoother acquisition process for both sides.

1. PURCHASE PRICE ADJUSTMENT VS. "LOCKING THE BOX"

In most U.S. acquisitions of a privately-held target company, the purchase price agreed to at the signing is subject to a closing adjustment and/or a post-closing adjustment based on the closing date amount of certain financial accounts; typically, cash, indebtedness, and net working capital. This differs from the "locked box" approach that is more common in Europe, whereby a buyer and seller agree on a fixed purchase price that is calculated based on a "locked box balance sheet", which is fixed at an agreed upon pre-signing "locked box date", and is coupled with representations and warranties from the seller that protect the buyer against the "leakage" of value from the target company to the seller between the time of the locked box date and the closing.

The U.S. approach generally requires more time be spent negotiating the complex accounting methodologies and accounts that will be used to adjust the purchase price (e.g., which assets and liabilities shall be applied to the adjustment and how will they be measured). Although the "locked box" approach is occasionally used in U.S. acquisitions, it remains a minority position and non-U.S. sellers of a privately-held target company should thus be prepared to have to negotiate these complex provisions when dealing with a U.S. buyer.

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2. FINANCIAL STATEMENT REQUIREMENTS – THE "SIGNIFICANCE TEST"

U.S. public companies have certain reporting requirements with the Securities and Exchange Commission (the "SEC") which may require historical financial statements and pro forma financial information for a target. Rule 3-05 of Regulation S-X requires the filing of separate pre-acquisition historical financial statements when the acquisition of a significant business has occurred or is probable. This means the target will need to have audited financial statements that can be filed by the buyer with the SEC if the business being acquired is "significant". In addition, in certain securities offering documents that the buyer may be preparing, the buyer may also be required to include pro forma financial statements for the target. Even if the target is not a U.S. public company, financial statements would still be required to be audited by an accounting firm registered with the Public Company Accounting Oversight Board and prepared in accordance with U.S. GAAP or IFRS, which may cause delays as both parties work to prepare compliant financial statements.

In most instances, these financial statements will need to be filed within 75 days after closing a transaction and a U.S. public company buyer will be considering whether or not a target will be able to meet such a deadline if financial statements are required. Being prepared for these reporting requirements and being aware of whether or not the target would be a significant acquisition for a potential U.S. public company buyer will help the target prepare for additional potential financial statement requirements. In addition, this advanced planning will better position a target for a quick sale and may provide a useful background for purchase price negotiations.

There are three tests to determine significance; an asset test, an investment test and an income test. The asset test compares the buyer's share of the acquired business's total assets to the buyer's consolidated total assets. The investment test compares the total GAAP purchase price of the acquired business, as adjusted, to the buyer's consolidated total assets. Finally, the investment test compares the total GAAP purchase price of the acquired business, as adjusted, to the buyer's consolidated total assets. For purposes of the "investment" test, "cost of the acquired entity" or "cost of a business combination" is adjusted to include the liabilities incurred by the acquirer to the former owners of the target, but exclude pre-acquisition debt and other liabilities of the acquired business assumed in the business combination and include any contingent consideration (such as potential earnout payments) that represents additional purchase price as part of the total investment in the target unless the likelihood of its payment is remote. If the significance level of the acquired business under any of the three tests exceeds 20 percent, some level of financial reporting and audited financial statements will be required by the target; and these measurements should thus be carefully considered when considering purchase price and potential buyers.

3. ACCOUNTING AND CONTROLS

U.S. public companies are subject to a number of rules adopted by the SEC in connection with the Sarbanes-Oxley Act of 2002. After closing, the target company will be subject to the buyer's next audit and will be part of the buyer's test for adequacy of its disclosure controls and procedures. Since the buyer's executive officers will be responsible for the target company's financial statements, public company buyers will be concerned with integrating operations and making sure the target is complying with the requirements of the Sarbanes-Oxley Act and the related rules. U.S. public company buyers will be concerned with fair presentations of financial conditions, off balance sheet transactions, controls over financial reporting, personal loans to officers and directors, and corporate governance policies, among other things. Target companies that have systems in place to comply with these various controls and procedures may be more attractive to public company buyers. In addition, to the extent that a target can be flexible on the closing schedule, target companies should also be aware that public company buyers may be interested in scheduling a transaction to close immediately after the buyer's latest audit to give the buyer and target time to integrate its audit controls and procedures before the next scheduled audit. In all cases, targets of a U.S. public company should prepare for enhanced review of financial statements, internal controls and procedures and involvement by the buyer's independent registered public accounting firm early on in the process.

4. EXPORT CONTROLS

U.S. companies are subject to various export controls and trade sanctions. Generally, U.S. persons are prohibited from exporting goods, or facilitating the export of goods, to certain countries. This would include exports to sanctioned countries by non-U.S. subsidiaries if any resources or persons at the U.S. company were involved in facilitating such exports. If a target has significant contacts or business with sanctioned countries, the buyer will likely seek to terminate those business relationships and/or seek indemnification for any compliance issues. In addition, targets should be aware of regulations that require U.S. public companies to disclose transactions in certain areas of the world that may otherwise be permitted in the target's non-U.S. jurisdiction and consider whether those relationships can be terminated. For example, the Iran Threat Reduction requires specific disclosure of certain transactions and dealings in Iran. However, if a U.S. company acquires another company that had dealings in Iran but those activities were terminated before the acquisitions was closed, those transactions will generally not be required to be reported in the company's filings.

5. CONFLICT MINERALS

U.S. public companies are also required to report on their use of certain “conflict minerals” which include tantalum, tin, tungsten or gold that are sourced from the Democratic Republic of the

Congo and surrounding countries[2]. If a target uses any of these conflict minerals, it should be prepared to represent and warrant that the conflict minerals are sourced from somewhere other than the Democratic Republic of the Congo or surrounding countries, are certified conflict free, or originate from scrap or recycled sources. In preparing for a potential sale to a U.S. public company, a target should reach out to its suppliers and manufacturers regarding the use of conflict minerals in order to prepare for due diligence inquiries from a buyer.

6. FOREIGN CORRUPT PRACTICES ACT

U.S. companies are subject to the Foreign Corrupt Practices Act ("FCPA"), which prohibits businesses from making unlawful payments to foreign officials in exchange for influence or favors. The FCPA also requires companies to maintain internal controls and procedures to ensure that (i) its books and records are accurately maintained, (ii) transactions are executed in accordance with the specific instructions of management, (iii) transactions are recorded in a manner to allow for financial statements to be prepared in conformity with GAAP and to maintain accountability over the company's assets, (iv) access to assets is permitted only in accordance with specific instructions from management and (v) recorded accountability for assets is compared with existing assets regularly and action is taken with respect to any differences.

In some instances, acquirers can be held liable for violations of the FCPA committed by the target company prior to an acquisition, and after the closing of an acquisition a U.S. buyer will want to ensure that its newly acquired business will be in full compliance with the FCPA immediately following closing. Target companies should be prepared for U.S. buyers to evaluate the ability to implement compliance procedures after a closing and to conduct a thorough due diligence process on all matters related FCPA requirements.

7. REPRESENTATIONS AND WARRANTIES

When drafting and/or negotiating an acquisition agreement with a U.S. buyer, it is important to remember various key differences between U.S. and non-U.S. buyer expectations with respect to the type and scope of the representations and warranties that the target company will be expected to make. Although some of these differences may seem rather technical at first glance, they have potentially broad implications for the target company and thus should be considered carefully by both the target company's management and its legal counsel when negotiating the representations and preparing the related disclosure schedules. For example, sellers in both U.S. deals and European deals typically make a representation that the target's financial statements "fairly present" the target's financial situation (99% of U.S. deals and 88% of European deals, according to 2015 M&A Deal Point Study findings).[3] A key difference, however, is that over half (58%) of the 2015 European deals that contained this representation qualified it by requiring that

[2] On January 31, 2017, the acting chairman of the Securities and Exchange Commission directed the staff of the SEC to reconsider implementation of this reporting requirement. As of the date of this publication, the reporting requirement is still in place.
[3] The percentages referenced in this article are based off of the findings in the 2015 European M&A Deal Points Study and the (U.S.) 2015 Private Target M&A Deal Points Study, as applicable. Both studies are available at http://apps.americanbar.org/dch/committee.cfm?com=CL560003.

"fair representation" be in accordance with an applicable accounting standard (e.g., GAAP or IFRS). U.S. deals in 2015, on the other hand, only contained such a qualification approximately 17% of the time. A non-qualified representation does not provide the seller the benefit of any limitations that may be inherent to the applicable accounting standard (e.g., losses that were considered "remote" at the time of transaction), and thus may provide the buyer additional opportunities to make a post-closing indemnification claim if the target is privately-owned.

In addition, U.S. buyers are far more likely to insist that the target company make a "no undisclosed liabilities" representation than their European counterparts (93% of 2015 U.S. deals and 44% of 2015 European deals). Such a representation is often considered by sellers to be a "catch-all" for the buyer, as the buyer is often able to allege a breach of this representation even when the target company has not breached any of the other, more focused and specific, representations. As a result, the relative risk allocation for undisclosed and/or unknown liabilities is significantly shifted from the buyer to the seller. A seller should try to limit its risk under a "no undisclosed liabilities" representation with a "knowledge" qualifier (i.e., only those liabilities that are known to the seller) and/or a "GAAP balance sheet" qualifier (i.e., only those liabilities which would be required to be disclosed on a balance sheet prepared in accordance with GAAP, or alternative standard). Although "knowledge" qualifiers are rare and thus unlikely to be accepted by a U.S. buyer, the use of "GAAP balance sheet" qualifiers is steadily increasing, albeit still a minority position (up from 22% of 2013 U.S. deals to 41% of 2015 U.S. deals).

Lastly, it is important to note that U.S. buyers are far less likely to accept a seller-friendly "anti-sandbagging" provision (which expressly limits the buyer's remedies for an inaccuracy in, or breach of, the target company's representations or warranties by prohibiting indemnification in respect of any matter of which the buyer had knowledge before the closing) than buyers outside the United States. For example, 47% of 2015 European deals contained anti-sandbagging language, compared to only 9% of 2015 U.S. deals. Sellers and their counsel should obviously keep this in mind as they negotiate the representations and warranties in the deal documents and prepare the related disclosure schedules.

8. DISCLOSURE SCHEDULES

The process of qualifying representations by disclosures in the United States is often considered to be generally more buyer-friendly than in non-U.S. jurisdictions. It is common outside of the U.S. for sellers to be able to rely on "general disclosures" that deem disclosed for purposes of the acquisition agreement all information that is available from certain publicly available sources, or the entire data room. In the United States, however, buyers almost universally require sellers to make specific, rep-by-rep disclosures. A disclosure made in one section of the disclosure schedules will often only be deemed to qualify a different section if there is an explicit cross-reference therein. "General disclosures" are not an accepted practice in the United States, and non-U.S. sellers thus need to be aware of the extra time and effort that will likely be required in order to prepare disclosure schedules that will both be acceptable to a U.S. buyer and that will fully and properly disclose all relevant information to minimize the seller's risk exposure.

U.S. practice is, however, slightly more seller-favorable with respect to the seller's ability to update the its disclosures after the signing of the acquisition agreement. Twenty-six percent of 2015 U.S. deals allowed the seller to update their disclosure schedules between signing and closing *and* for such updates to limit the buyer's indemnification rights with respect thereto. Only 4% of 2015 deals in Europe permitted such updates and resulting limitations on the buyer's indemnification rights.

9. U.S. DISCLOSURE LAWS AND CONFIDENTIALITY

When selling to a U.S. public company, a seller should keep in mind various U.S. securities laws and requirements that impact the seller's ability to discuss and disclose the transaction prior to the formal press release that is typically released some time shortly after the closing of the acquisition. Generally, when a U.S. public company enters into a "material definitive agreement" (which is somewhat of an opaque concept lacking any bright-line rules, but a significant acquisition agreement would likely qualify), the U.S. public company is required to disclose, within four days after entry into such agreement, certain information concerning the agreement and related transaction. U.S. public companies are restricted, however, by "Regulation FD", which generally requires that when a public company discloses material nonpublic information to certain individuals or entities (e.g., stock analysts) the company must *publicly* disclose such information. As a result of these regulations, and others of a similar subject matter, the U.S. company will almost certainly require the seller to agree to various confidentiality agreements (and/or provisions in the acquisition documents themselves), restricting the seller from disclosing the transaction or related discussions until after the formal press release, so that the buyer does not face any issues with complying with its strict disclosure obligations. Note that the seller's level of input or consent on the press release is a negotiated matter. Sellers outside the United States should be aware of the strict laws and requirements surrounding disclosures by U.S. public companies and should be prepared to have to keep the transaction strictly confidential until after the formal press release.