

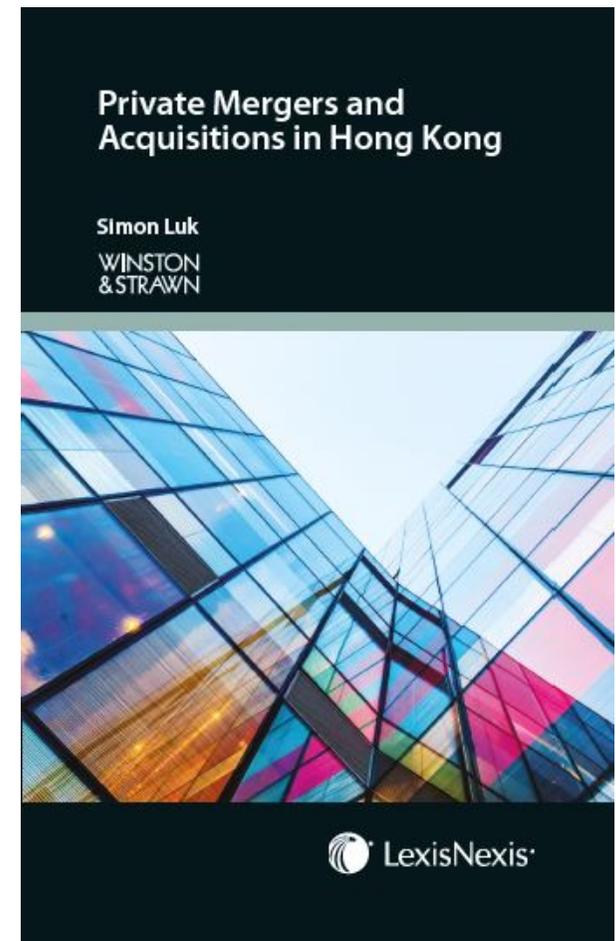
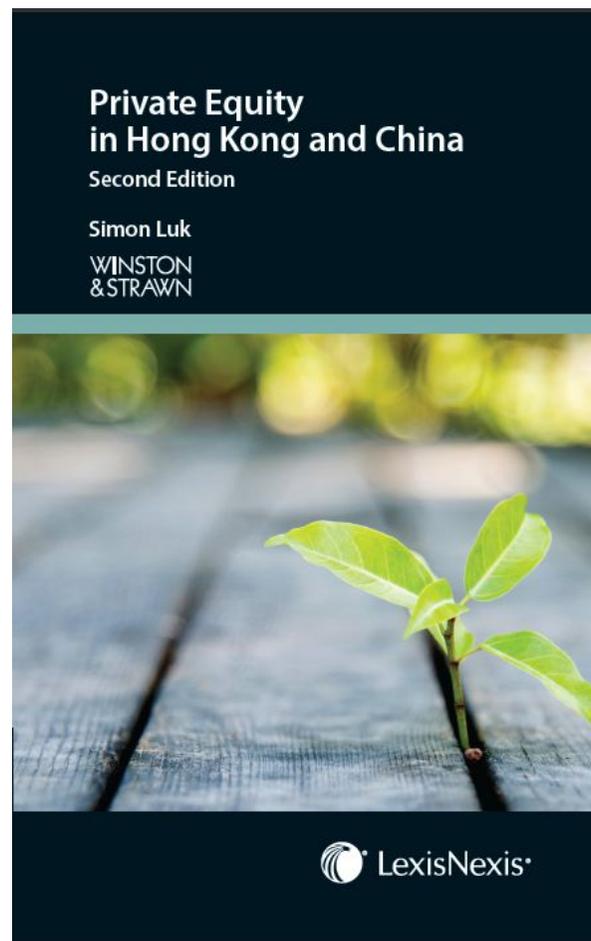
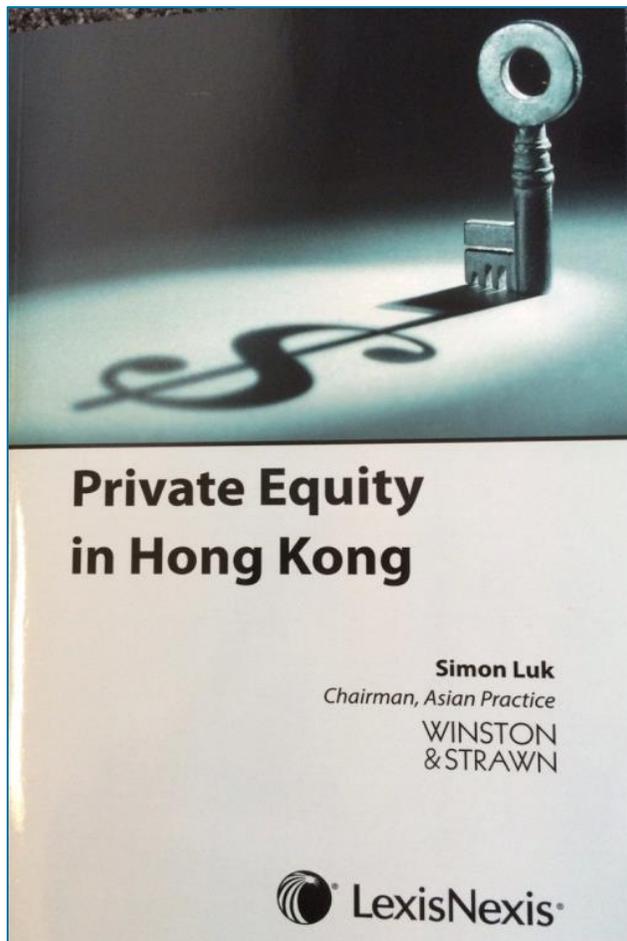
# Cross-Border Investment and Mergers & Acquisitions

Simon Luk | Chairman of Winston & Strawn's Asia Practice and Partner

Presentation to the Centre for Financial Regulation and Economic Development (CFRED) of The Chinese University of Hong Kong

1 December, 2016

# Expert Insight Shared in a Number of Publications



# China Outbound Investment – Rectification Process and Timeline

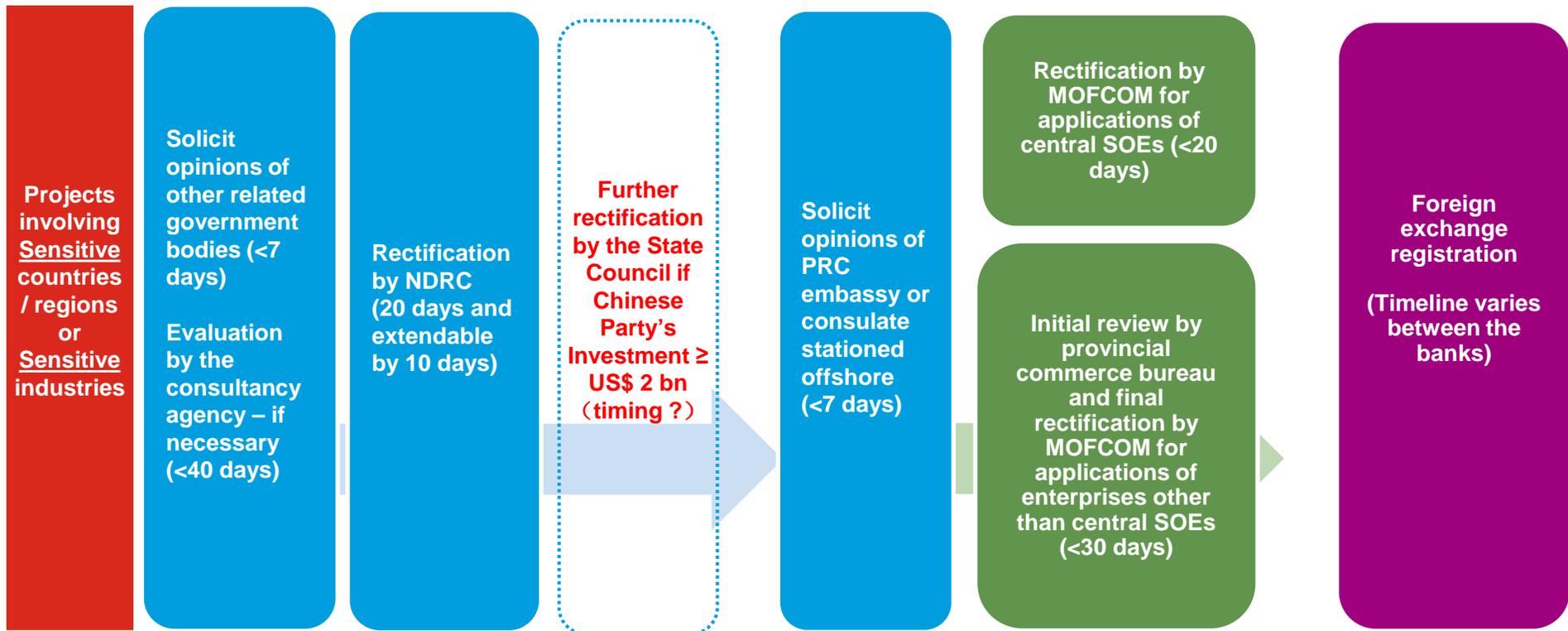


## Step 1 – NDRC



## Step 2 – MOFCOM

## Step 3 – Banks



# China Outbound Investment – Recordal Process and Timeline

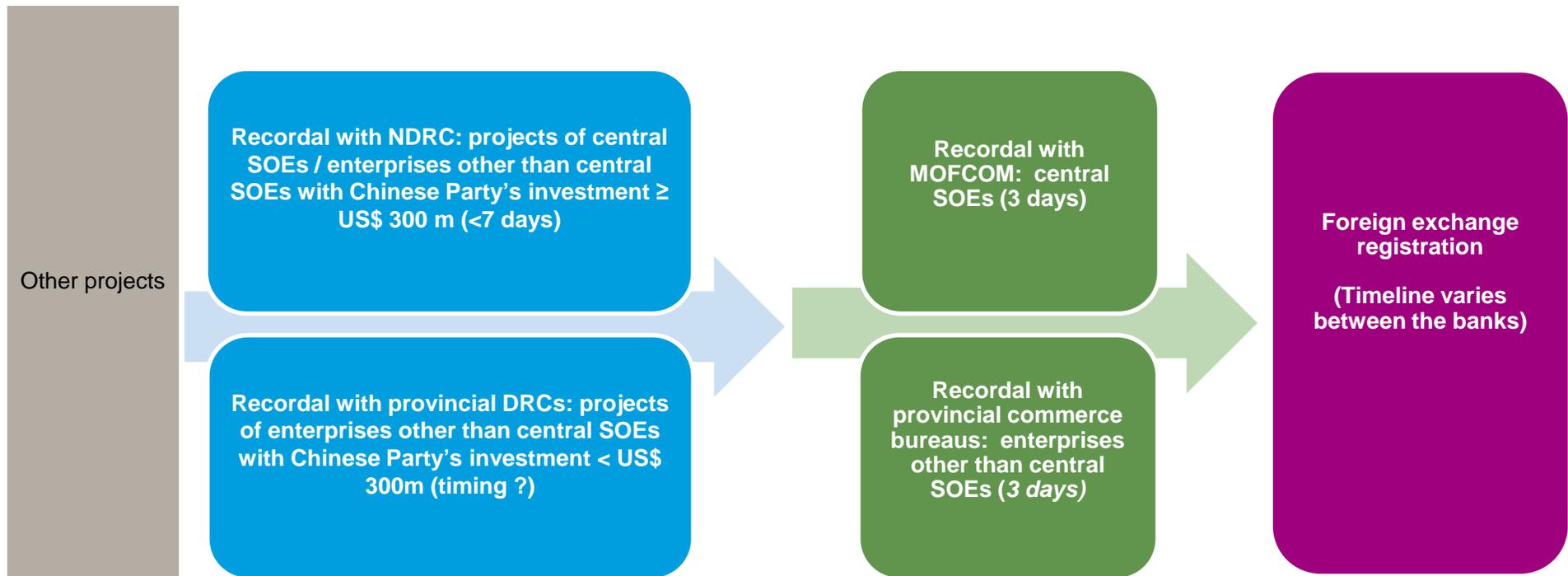


## Step 1 – NDRC

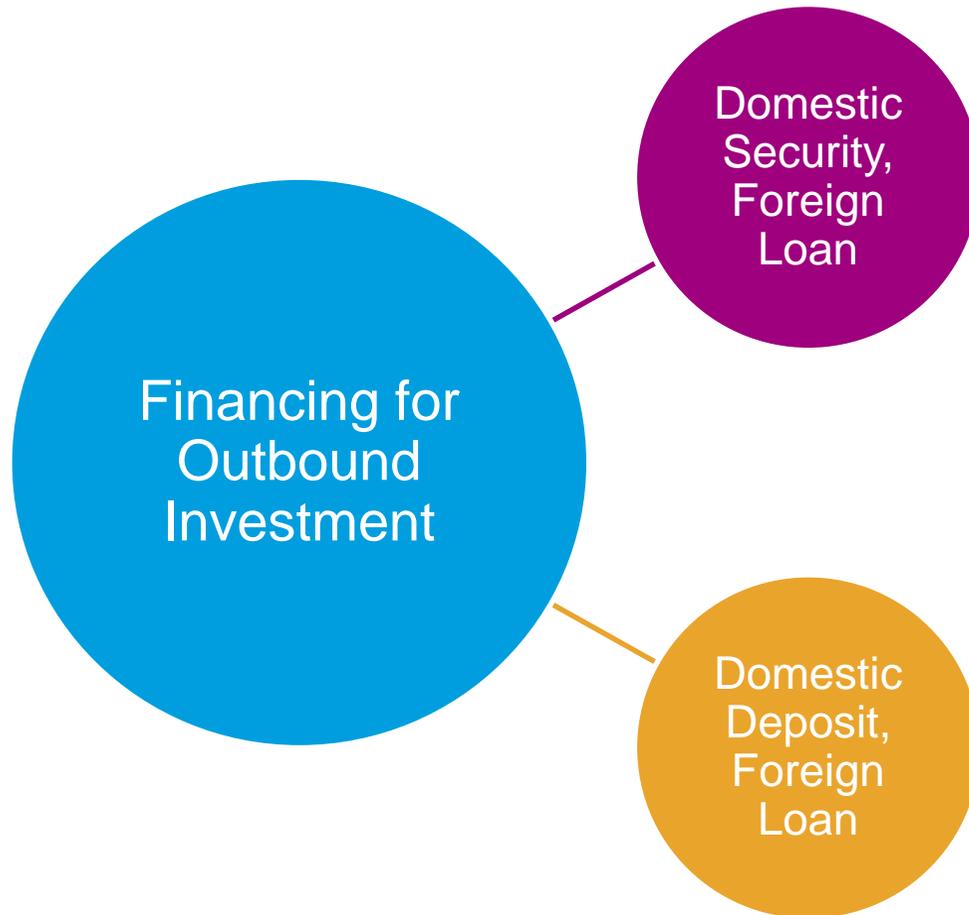


## Step 2 – MOFCOM

## Step 3 – Banks



# Financing for Outbound Investment



- SAFE's "balance administration"
- Recent Examples

# Government's Positions towards China Outbound Investment



## Chinese government

- Encourages Chinese private entities' outbound investment
- Issues a number of opinions and notices
- Needs more detailed rules



## U.S. government

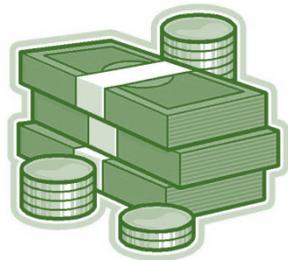
- Encourages more foreign investment
- But political issues affecting China's investments in the U.S.

# Challenges for Investing in the U.S.

- Political impediments and regulatory concerns in the U.S.
- Lack of local information/intelligence and deal experience
- Weak management and operational capabilities for overseas projects
- Market trend forecast
- Analysis of the industry chain
- Understanding of complex U.S. laws and tax environment
- Cultural and language barriers

# China Outbound Investment – Case Study

Earlier examples: moving production base to China, buying U.S. garment retail chains and jean brand name.



## The Acquirer |

A 50/50 joint venture owned by foreign and PRC investors



**The Transaction |** Acquisition of all issued and outstanding shares of U.S. hotel group, which would be delisted



## The Acquired |

A publicly traded U.S. hotel real estate group

## Case Study (con't)



Joint venture acquisition vehicle



Legal due diligence



Design a tax efficient structure



Financing issues



PRC government approvals



Draft and negotiate transaction documents

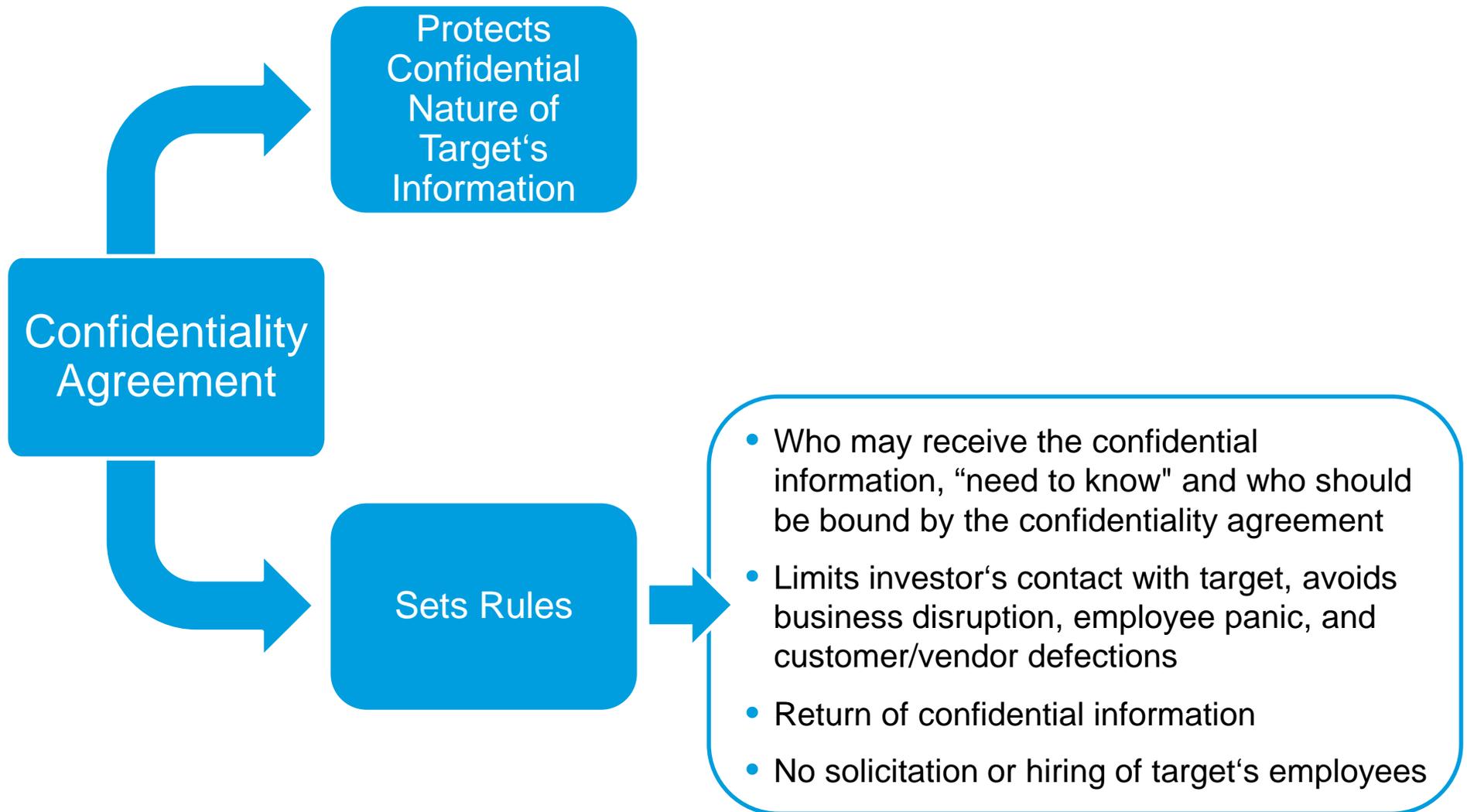


De-listing under U.S. securities laws/stock exchange rules;  
PRC acquisition compliance issues

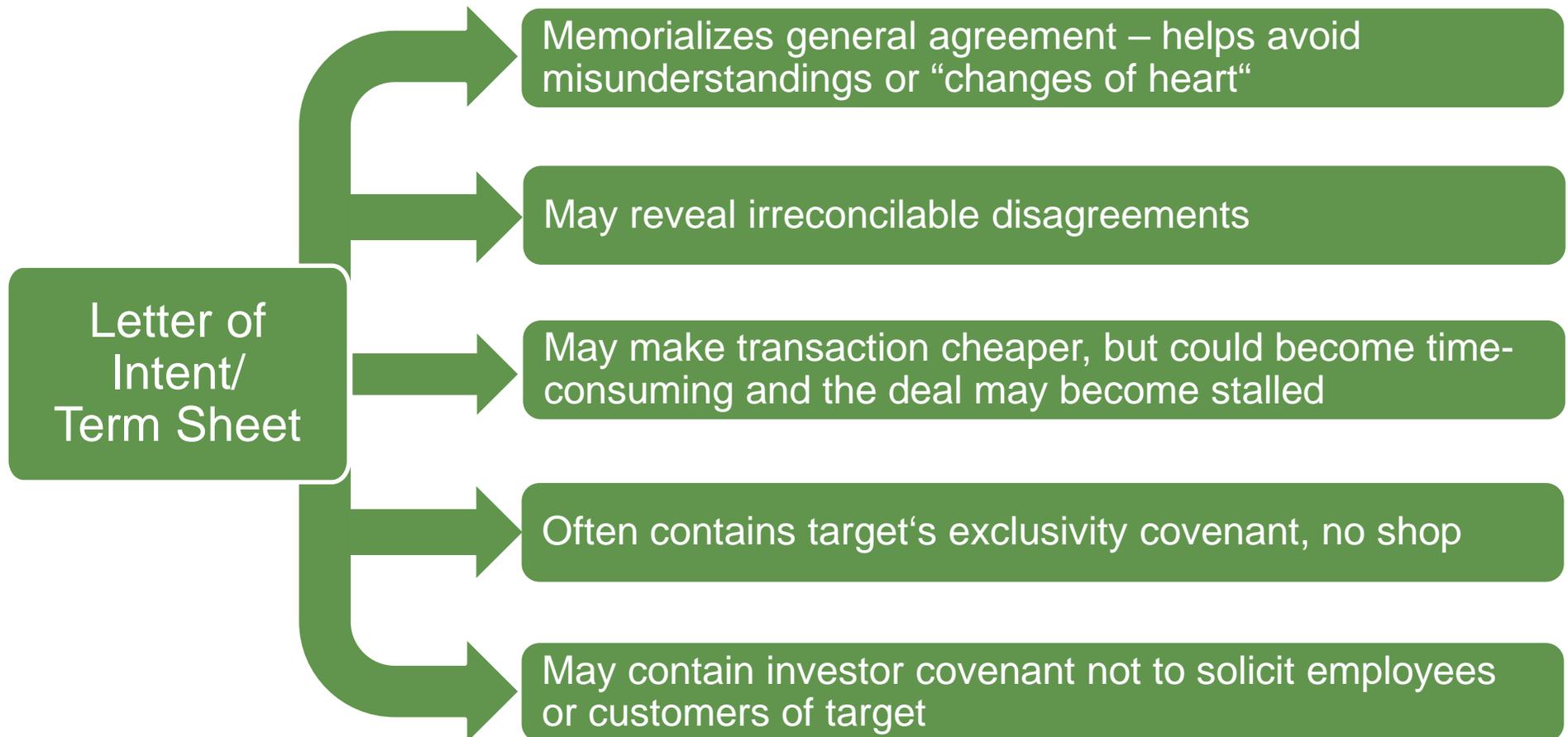


Ongoing operation issues: management, tax, labor, environmental

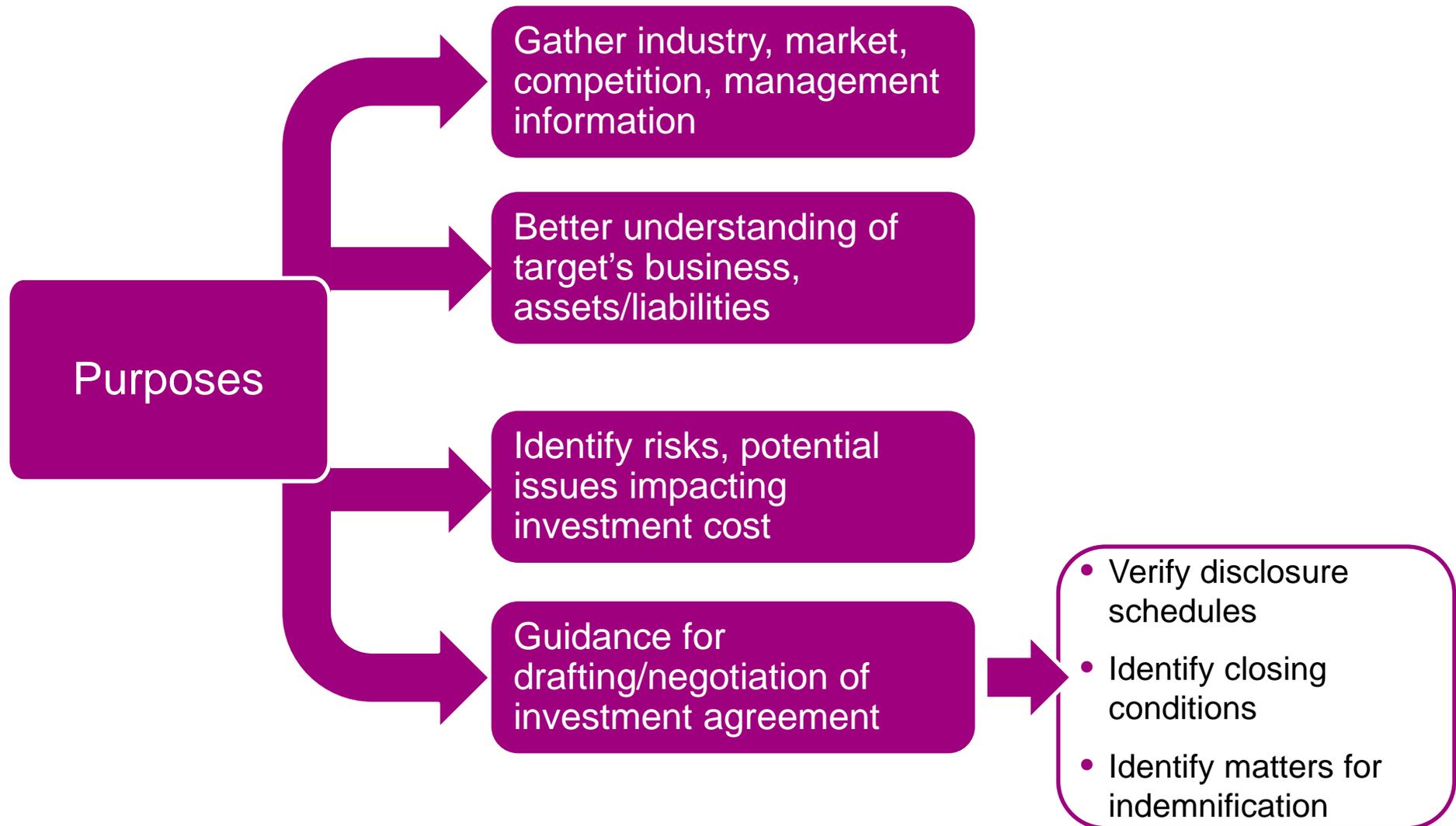
# Due Diligence - Initial Consideration



# Due Diligence - Initial Consideration



# Due Diligence - Initial Consideration



# Due Diligence – a Crucial Step in the Process

## Types of Due Diligence

Legal	Financial	Environmental	Social	Real Estate	Intellectual Property
<ul style="list-style-type: none"><li>• Contract review</li><li>• Litigation</li><li>• Lien</li><li>• Judgment searches</li></ul>	<ul style="list-style-type: none"><li>• Audited Financial statements</li><li>• Forecast projections vs. Actual</li><li>• Management report</li><li>• Capital expenditures</li></ul>	<ul style="list-style-type: none"><li>• Air</li><li>• Water</li><li>• Waste</li><li>• Sewage</li><li>• Lands</li></ul>	<ul style="list-style-type: none"><li>• Employee benefits</li><li>• Insurance</li><li>• Coverage</li><li>• Claims history</li></ul>	<ul style="list-style-type: none"><li>• Properties</li><li>• Titles</li><li>• Surveys</li></ul>	<ul style="list-style-type: none"><li>• Patent</li><li>• Trademark</li><li>• Copyright searches</li></ul>

# Due Diligence – Legal Issues

Is target's business subject to any contingent liabilities not reflected on its balance sheet?

- Litigation Claims
- Governmental Investigations, Audits or Claims: Labor & Employment; Environmental; Health & Safety; Antitrust; Securities; Criminal Investigations
- Tax Audits or Disputes
- Intellectual Property Claims
- Insurance Coverage Disputes
- Shareholder, Employee, Customer, Supplier or Other Disputes

# Due Diligence – Legal Issues

Is target subject to any change of control payments to management, creditors or any other party?

Is target subject to any contractual restrictions affected by the transaction?

- Are there any non-assignability or change of control restrictions in target's contracts with customers and suppliers, labor agreements, debt instruments, joint venture agreements, governmental authorizations, retirement plans, non-compete provisions with suppliers, customers, equity holders, or partners, debt incurrence or other structuring limitations in material agreements?

# Due Diligence – Legal Issues

Is the target or buyer required to obtain approvals to enter into a transaction? Time needed for the approval process?

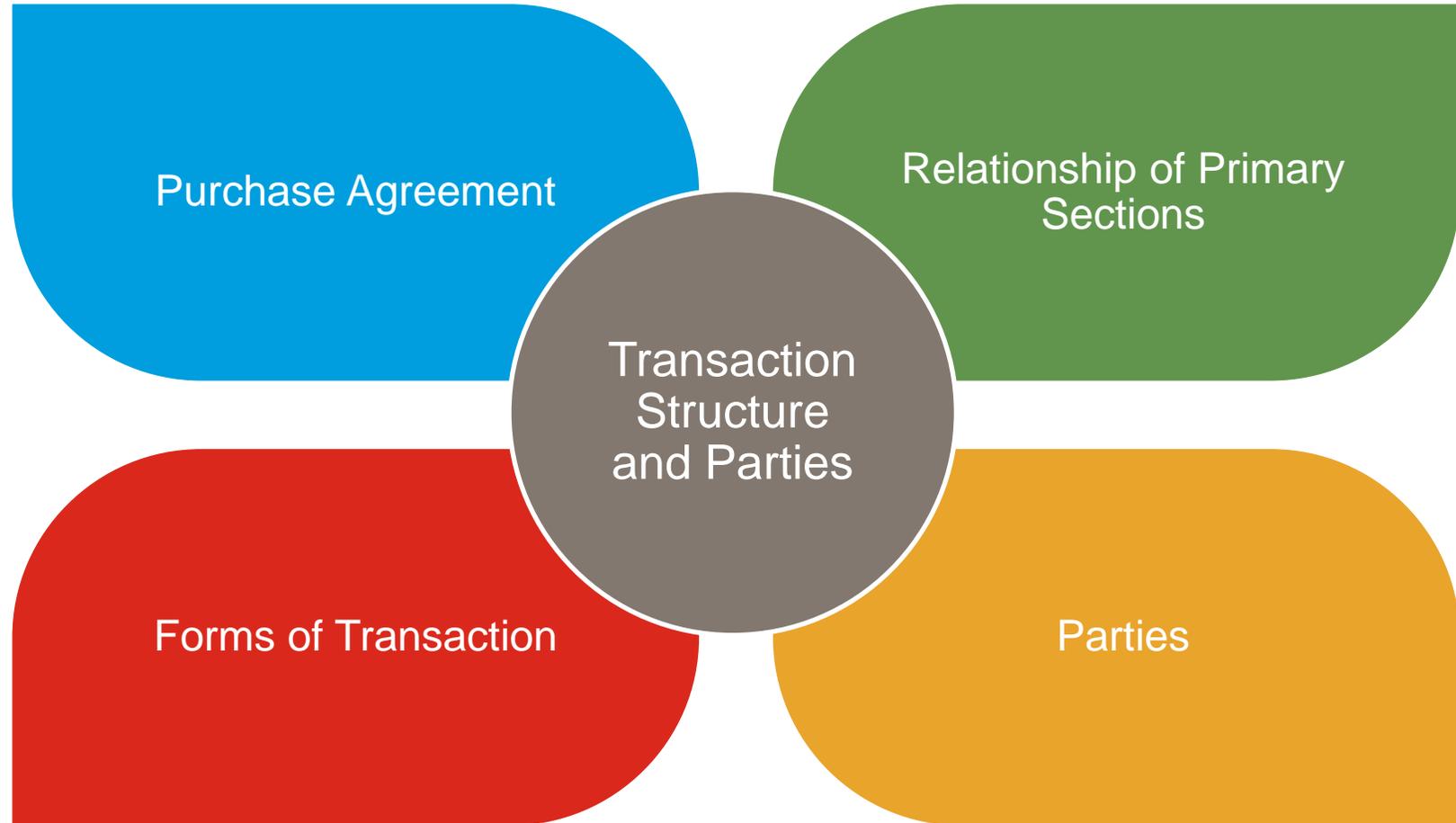
Approvals from:

- Governmental Agencies
- Right of First Refusal or Similar Provisions in Shareholders' Agreement
- Shareholders, including Percentages Required

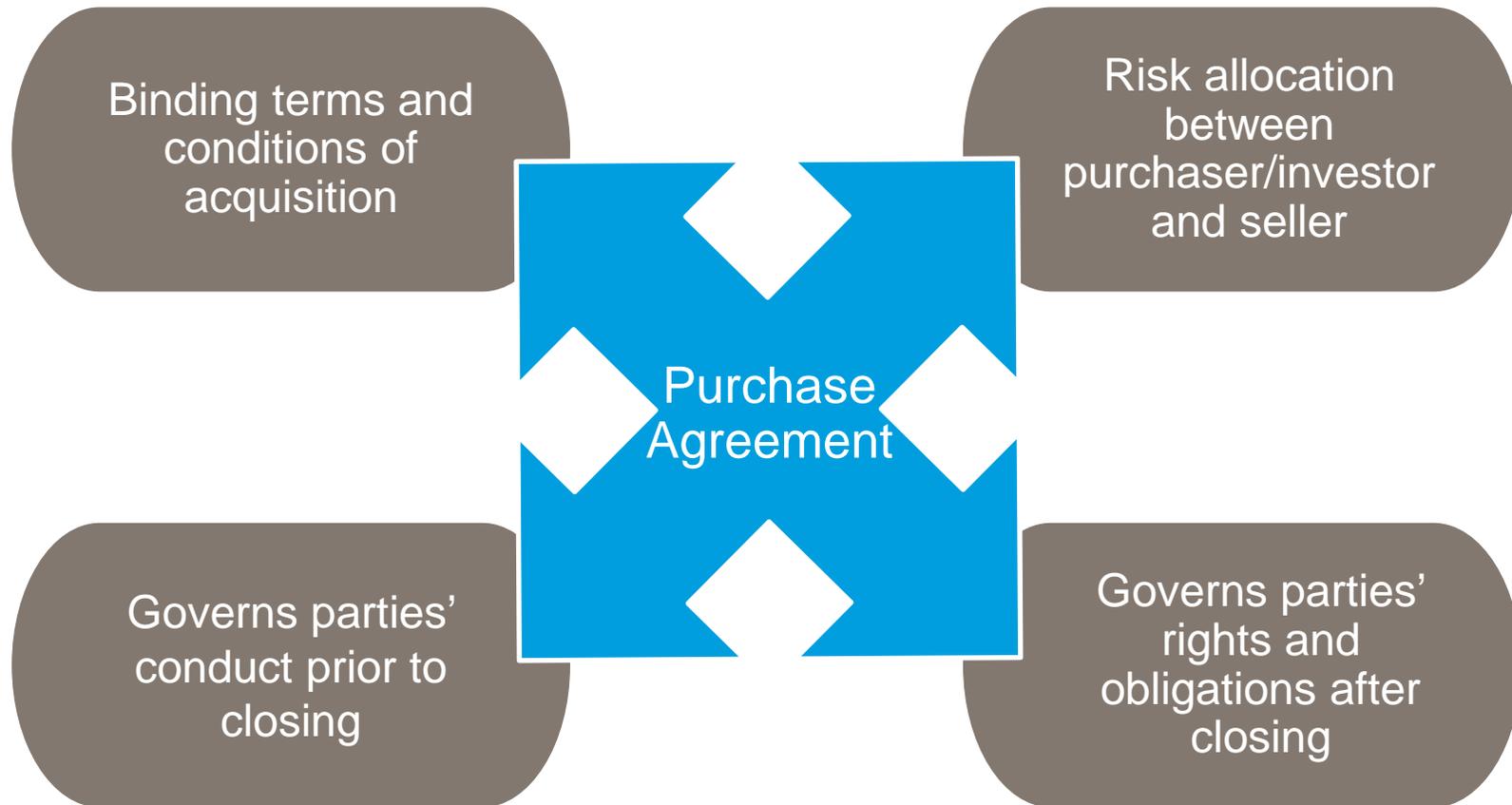
## Employee matters

- Employment agreements?
- Are there standard confidentiality, non-compete, or non-compliance agreements?

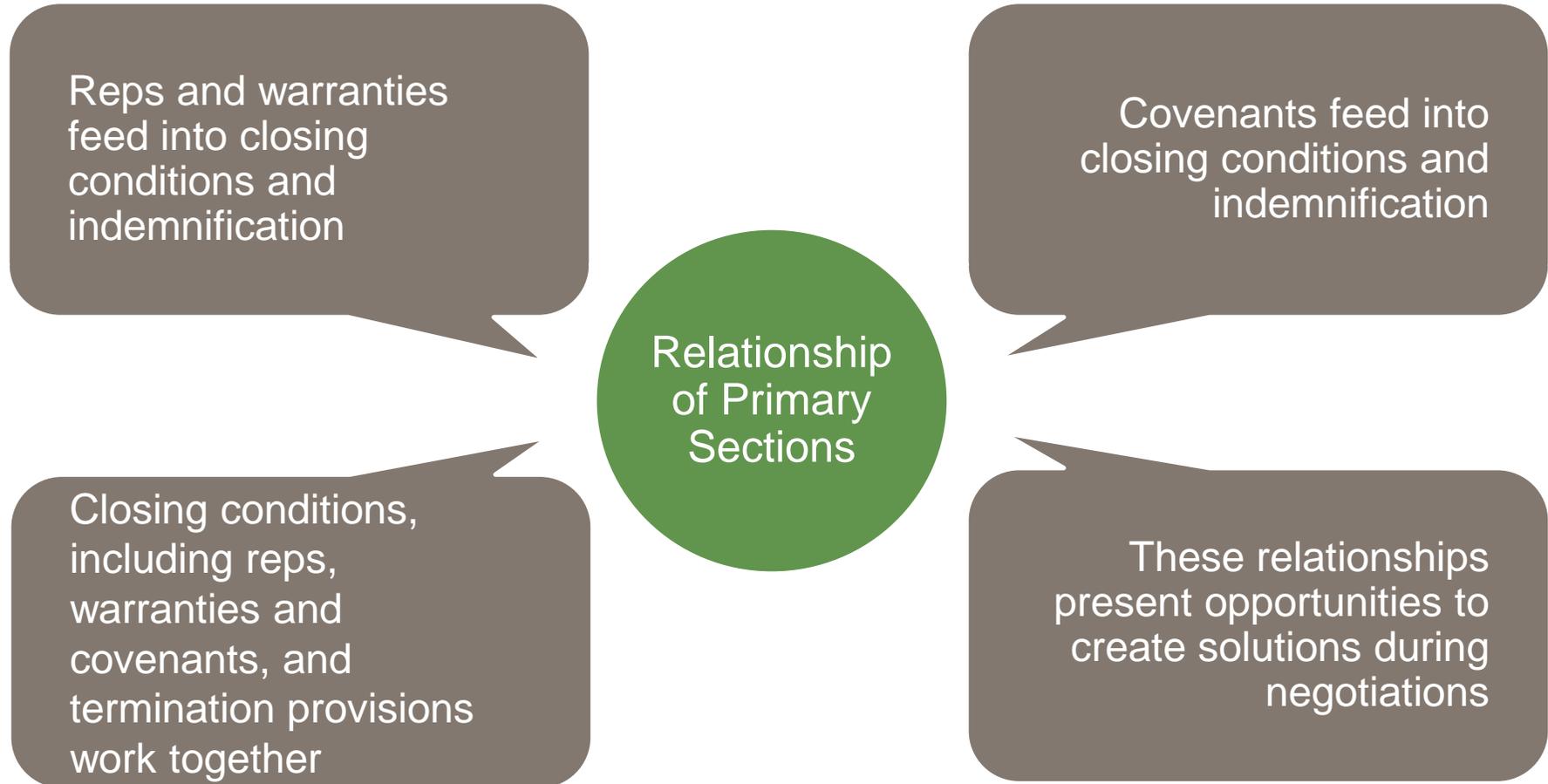
# Transaction Structure and Parties



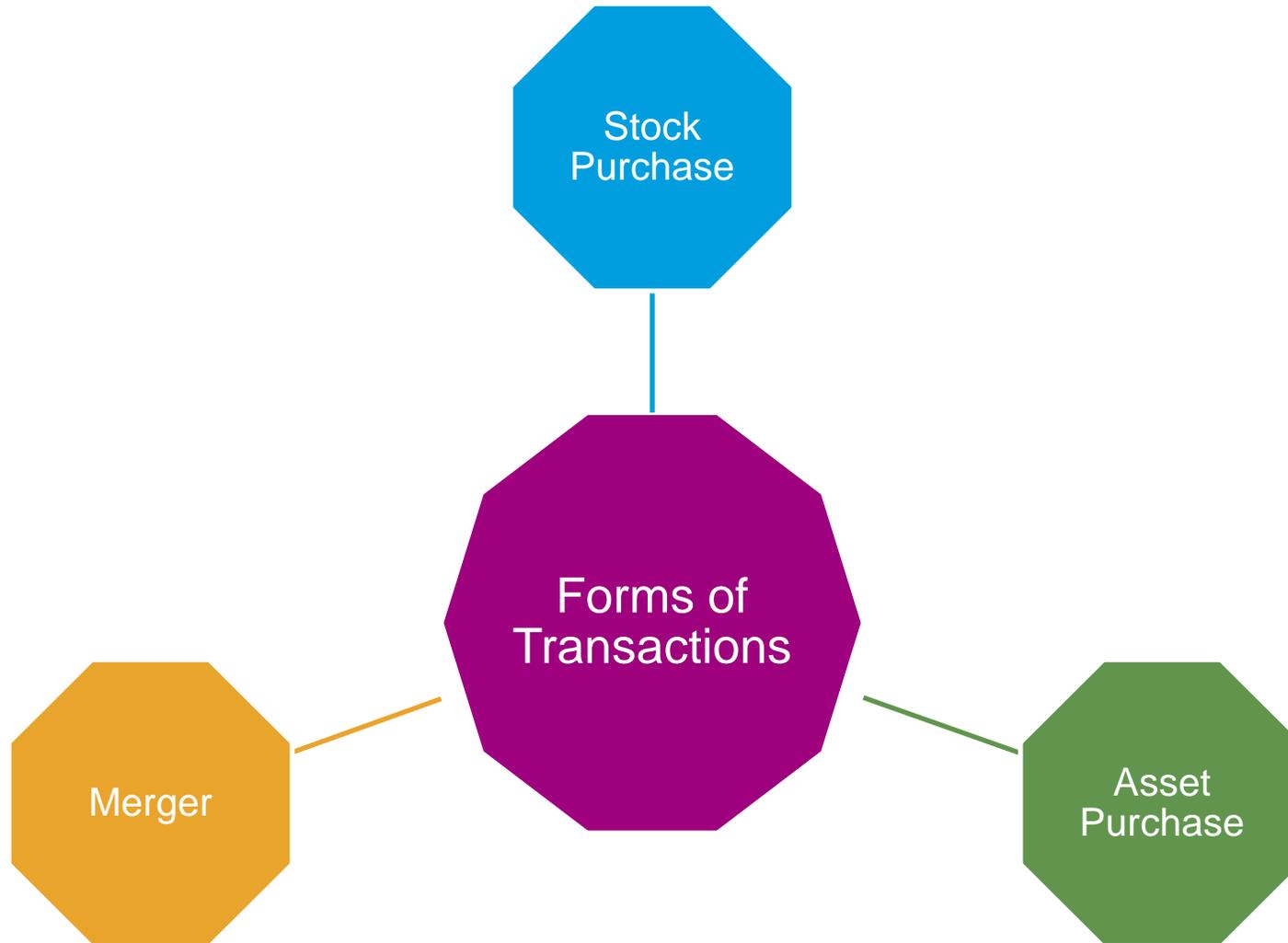
# Transaction Structure and Parties



# Transaction Structure and Parties



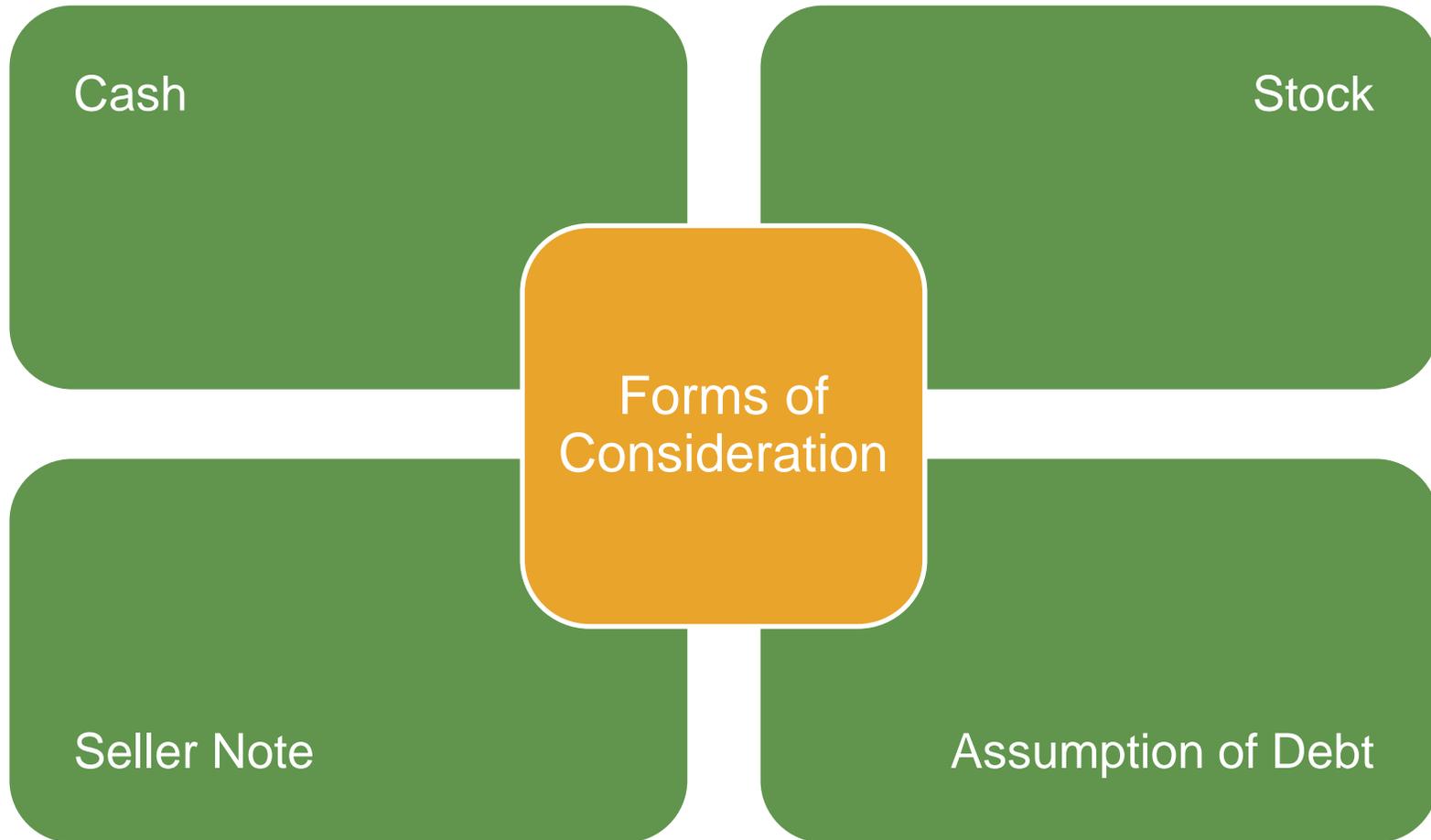
# Transaction Structure and Parties



# Transaction Structure and Parties



# Purchase Price Considerations



# Purchase Price Considerations

## Types of Purchase Price Adjustments

Working Capital/Net Assets Adjustment

Earn-out

## Purchase Price Adjustment Mechanism

One-way or two-way adjustment

Dollar-for-dollar adjustment

Adjustment with certain threshold

Adjustment subject to a maximum amount

# Representations and Warranties

Seller reps and warranties are statements of facts and assurances

## Purpose

1

To supplement due diligence

2

Pre-closing: form basis of closing condition

3

Post-closing: serve as basis for indemnification

## Customary Reps and Warranties

- Facts about the target company
- Facts about the equity being sold
- Assurances re the sellers' right/ability to sell the stock/assets

# Limits to Representations and Warranties

Materiality/MAE: note indemnification “materiality sweep”

Knowledge

Disclosure schedules

Time: reps made as of a certain time

- Do disclosures serve as exception to one specific rep vs all reps?
- Reasonably apparent standard

Attempts to limit reps and warranties to certain defined materials, i.e. electronic data room

# Representations and Warranties

Purchaser reps and warranties provide assurance to sellers that the purchaser can complete the transaction

## Purpose

1

Legal authority to acquire target/assets

2

Compliance with law such as securities laws

3

Assurance of funds sufficient to consummate transaction

## Note

- Require more detailed reps if purchaser uses equity as consideration

# Pre-Closing Covenants

## Pre-Closing:

### Basis of Closing Condition

### Preservation/Completion of Purchase Transaction

- Permit purchaser access to target premises, employees, information |
- Third party consents—obtain prior to closing
- No shop
- Pursue government approvals: Hart-Scott-Rodino in the U.S., overseas antitrust approvals, regulated industries, CFIUS etc.
- Confidentiality/publicity
- Tax matters

## Pre-Closing Covenants



### Preservation of business prior to closing—restrictions

- Conduct of business
- Incurrence of debt
- Long-term/material contracts
- Capital expenditures
- Hiring of employees/changes in compensation/benefits

### Post-Closing:

### Basis for Indemnification

# Post-Closing Covenants



Seller Non-Compete



Seller Non-Disturbance of Customers/Suppliers



Seller Non-Solicit/No Hire of Employees

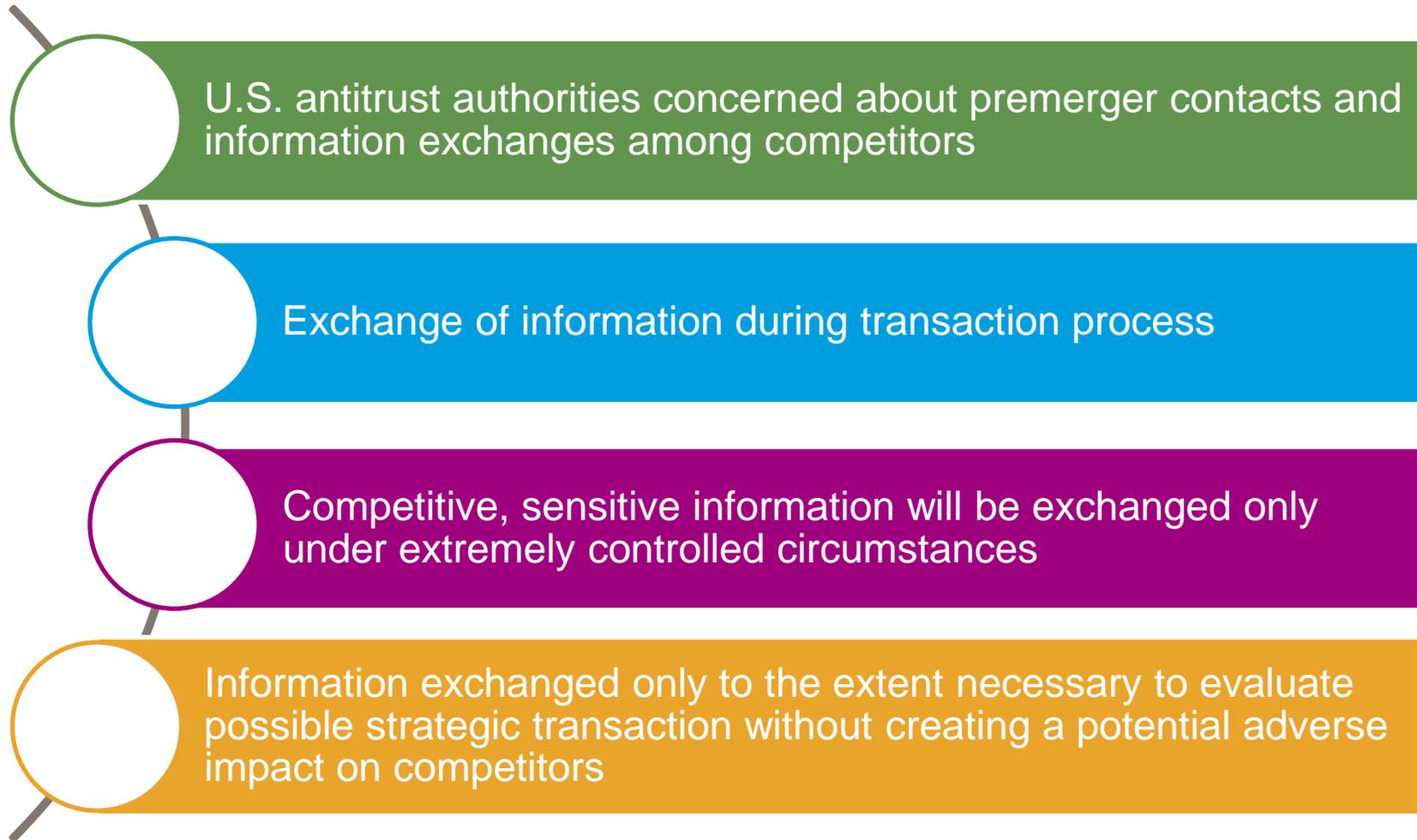


Purchaser to Maintain D&O Insurance



Purchaser to Maintain Employee  
Compensation/Benefits for Specified Period

# Covenants



# Covenants – Antitrust Concerns

Techniques to exchange sensitive information to minimize antitrust risks

Information kept out of the hands of individuals conducting day-to-day business operations — field sales force, marketing organization, purchasing specialists and engineering teams

Information aggregated for a large group of customers/suppliers v. Being presented individually

Third party advisors used to review information

“Jumping the gun”— conduct of businesses between signing and closing

Antitrust authorities do not want acquisition participants “controlling” businesses of each other prior to obtaining antitrust approvals

Parties careful not to engage in conduct that could be deemed to control the other party’s business—terms of definitive agreement analyzed

Integration planning important, if managed well should not pose antitrust issues

Will continue to compete up to a potential closing of a transaction

# Closing Conditions

Bring-down of reps and warranties

1

Compliance with covenants

2

Antitrust approvals

3

No injunction

4

5

Third party consents

6

Completion of employment agreements

7

Financing condition

8

No Material Adverse Change

# Closing Conditions

## FINANCING CONDITION

- Seller resistance – may accept some financing condition if purchaser provides equity and debt financing commitment letters
- Seller may request guaranty from parent company of purchaser

## NO MATERIAL ADVERSE CHANGE

- MAC Clause: attempt to allocate risk of something happening prior to closing that has or may have material adverse effect on target's business
- Stands apart from breaches of reps, warranties and covenants

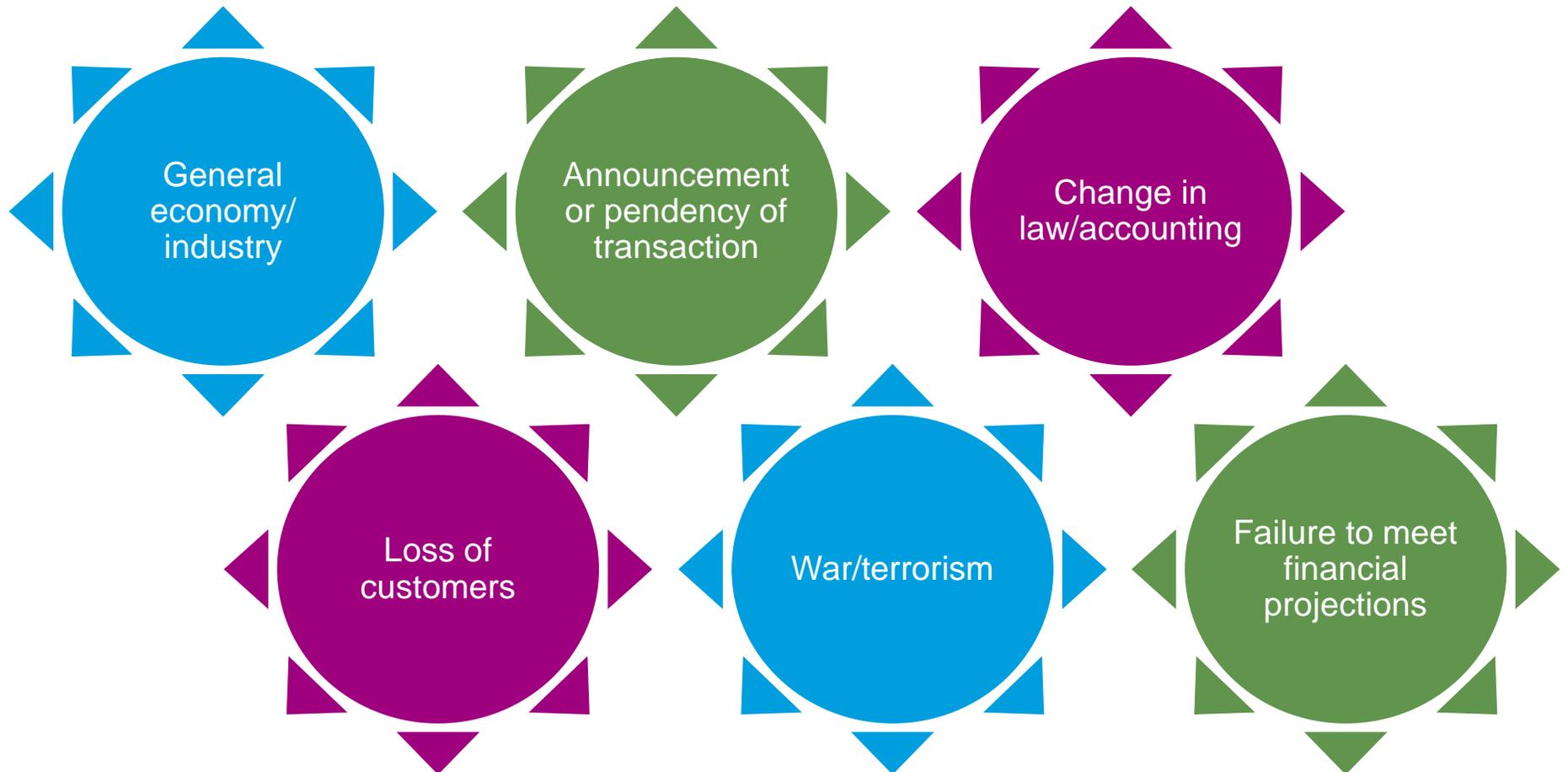
# Closing Conditions

## Primary MAC definition

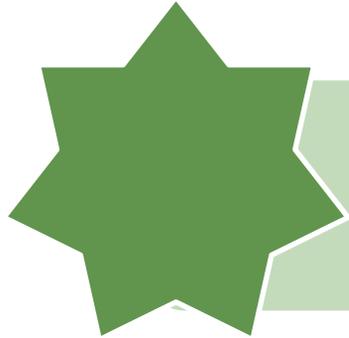
“Any event, circumstance, change or effect that, individually or in the aggregate, is materially adverse to the business, condition, financial or otherwise, assets, liabilities or results of operations of the Company and the Company subsidiaries, taken as a whole.”

# Closing Conditions

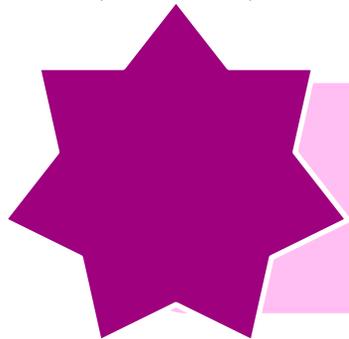
## Carve-outs: exclusions from MAC



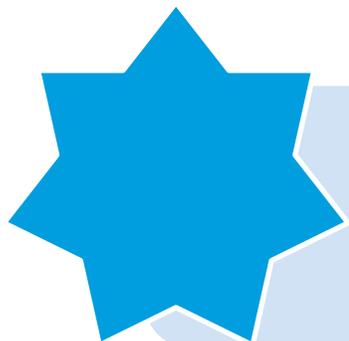
# Closing Conditions



**MAC clauses subject to significant negotiation**



**Traditional MAC language provides a purchaser with little real protection**



**Need specificity in defining what constitutes a MAC**

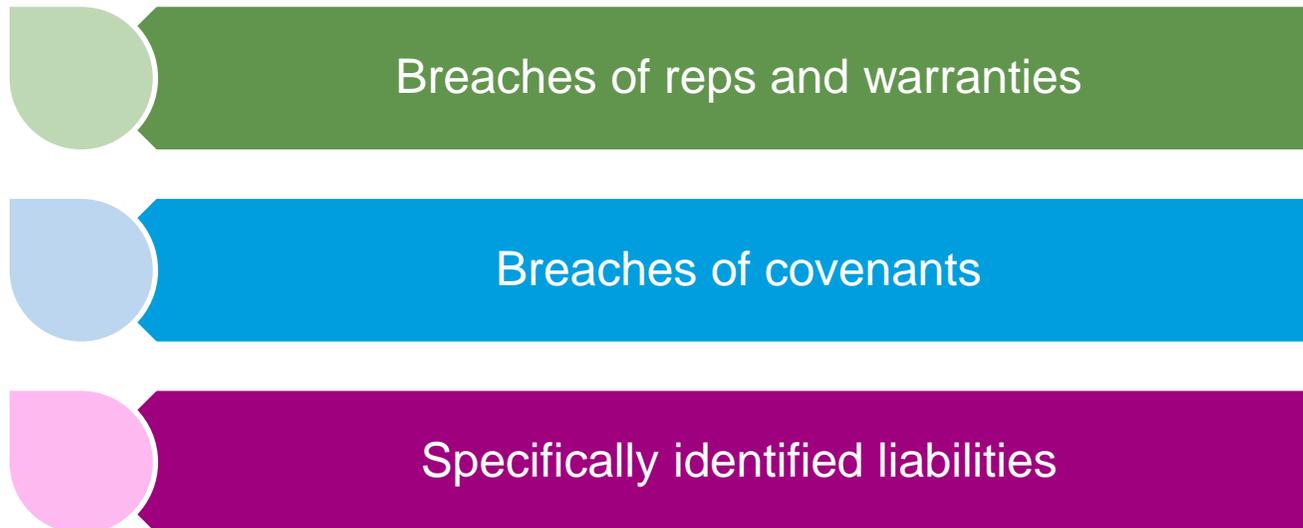
- *Specific separate closing conditions, e.g. specific metrics or financial milestones—not incorporated into the MAC definition*

# Termination



# Indemnification – General

Indemnification: post-closing remedy for damages incurred under definitive agreement arising from:



# Indemnification – Parties

## Indemnifying Party

- Parent of target
- Shareholders of target
- Target itself will not be indemnifying party in stock transaction

Joint and several liability

vs.

Several liability

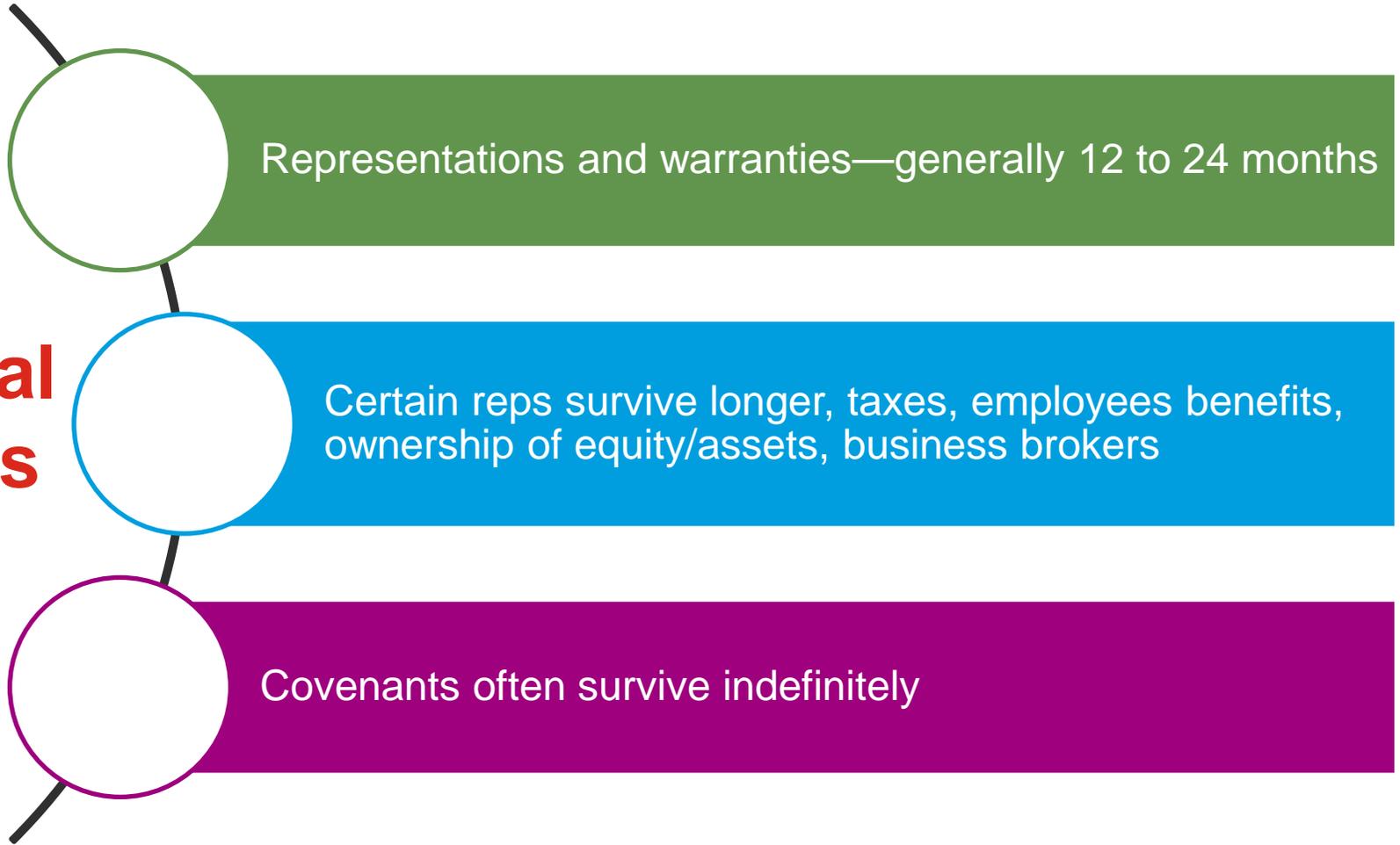
Each shareholder will severally, not joint and several, indemnify for breaches of reps applicable to such shareholder, e.g., title to shares or breach of non-compete.

# Indemnification – Materiality Sweep



# Indemnification – Other Issues

## Survival Periods



# Indemnification – Other Issues

## INDEMNIFICATION BASKET

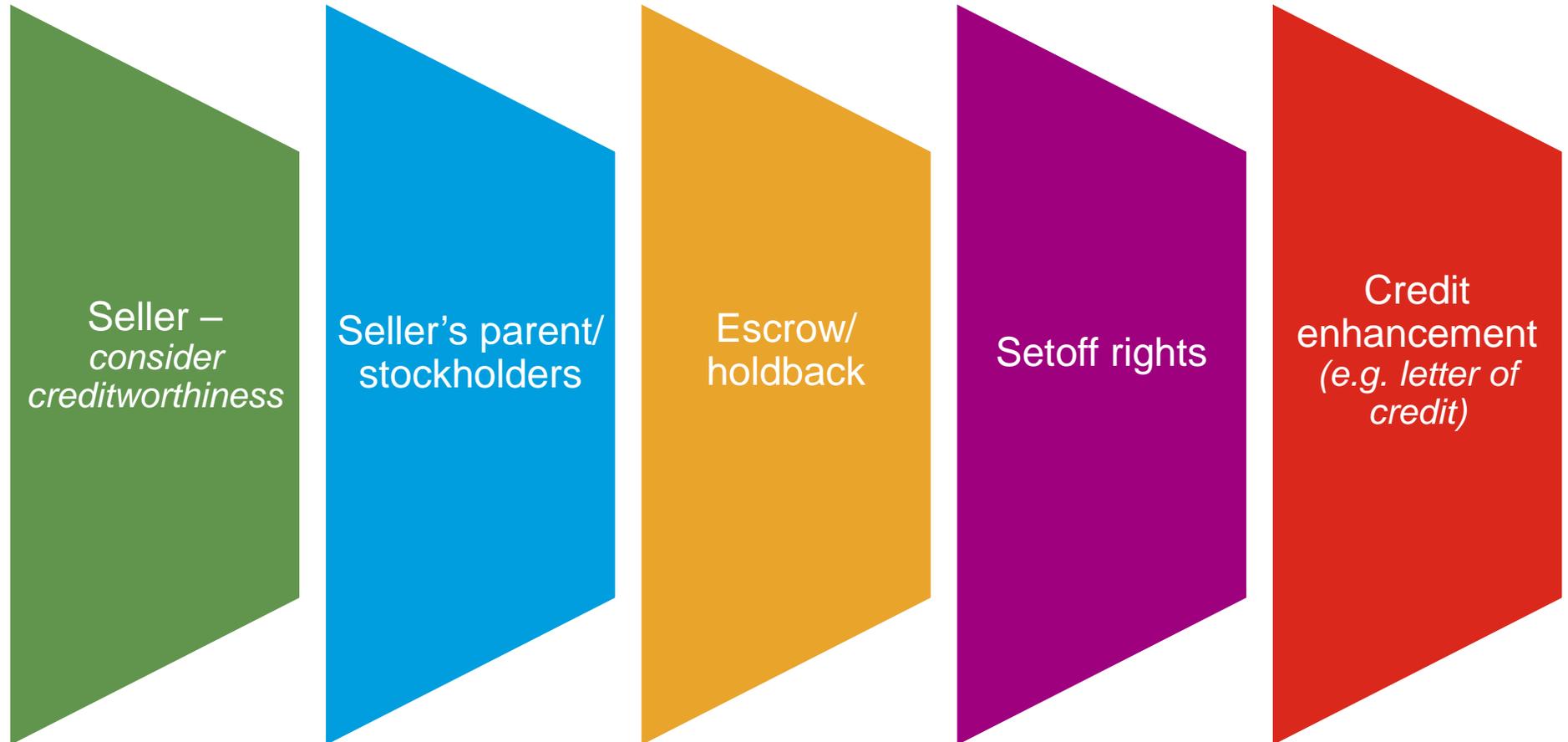
- Deductible v. Threshold
- Matters subject to indemnification basket
- Amount of indemnification basket—1% is good starting point
- Covenants often survive indefinitely
- De minimus claim threshold – no individual claim may be made unless the damages exceed a threshold amount, i.e. US\$25,000

## INDEMNIFICATION CAP

- Matters subject to indemnification cap
- Amount of indemnification cap

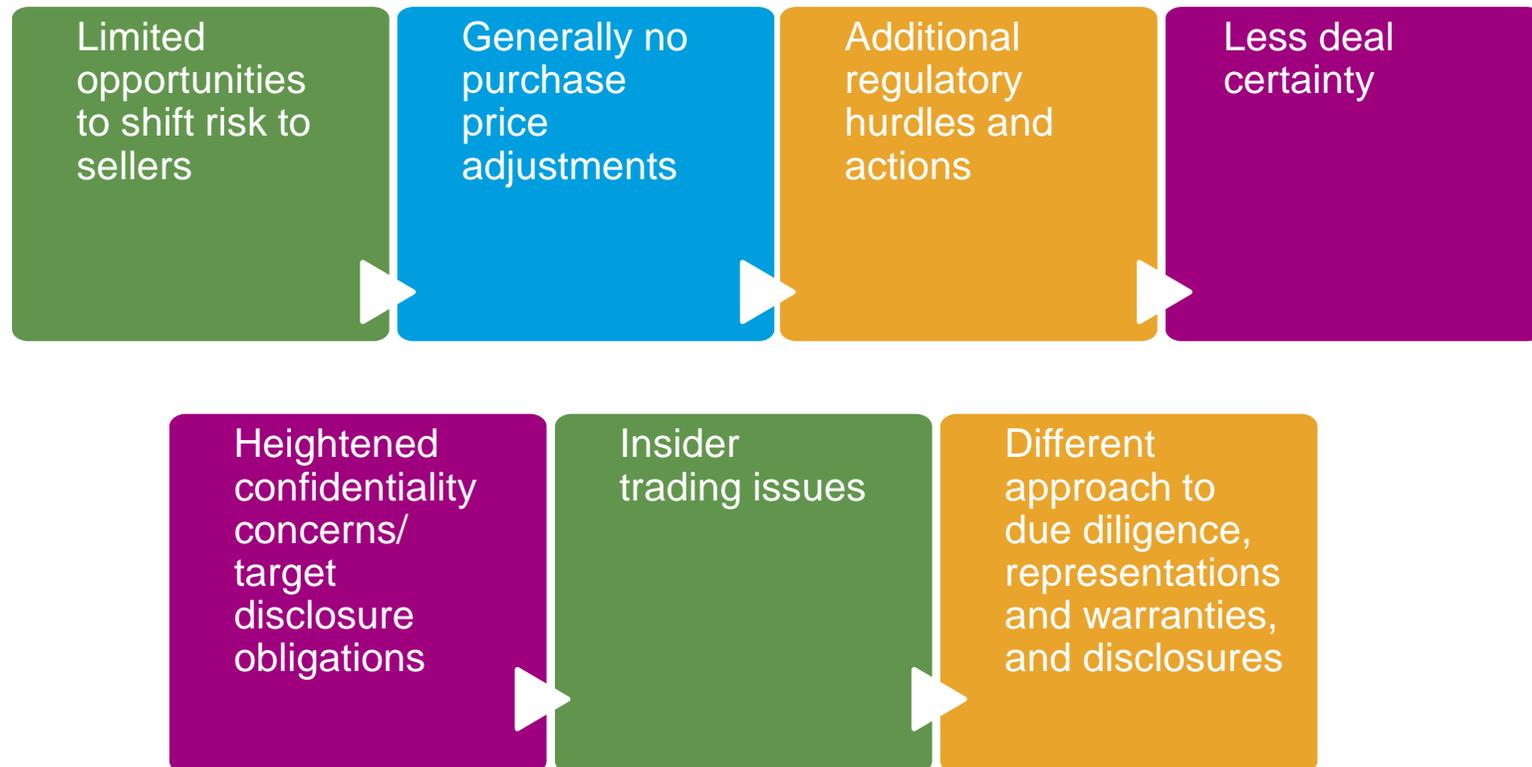
# Indemnification – Enforcement

## Sources of indemnification



# Public vs. Private Acquisitions

Acquisitions of public companies present many different issues and considerations:



# Public vs. Private Acquisitions

Limited opportunities to shift risk to sellers

Reps and warranties do not survive closing

**Indemnification is not available to purchaser post-closing**

- Single largest shareholder or group of large shareholders exist?
- Importance of due diligence and closing conditions with no post-closing protection

# Public vs. Private Acquisitions

## Purchase Price Considerations

Generally, no purchase price adjustments based on closing balance sheet or post-closing earn-outs

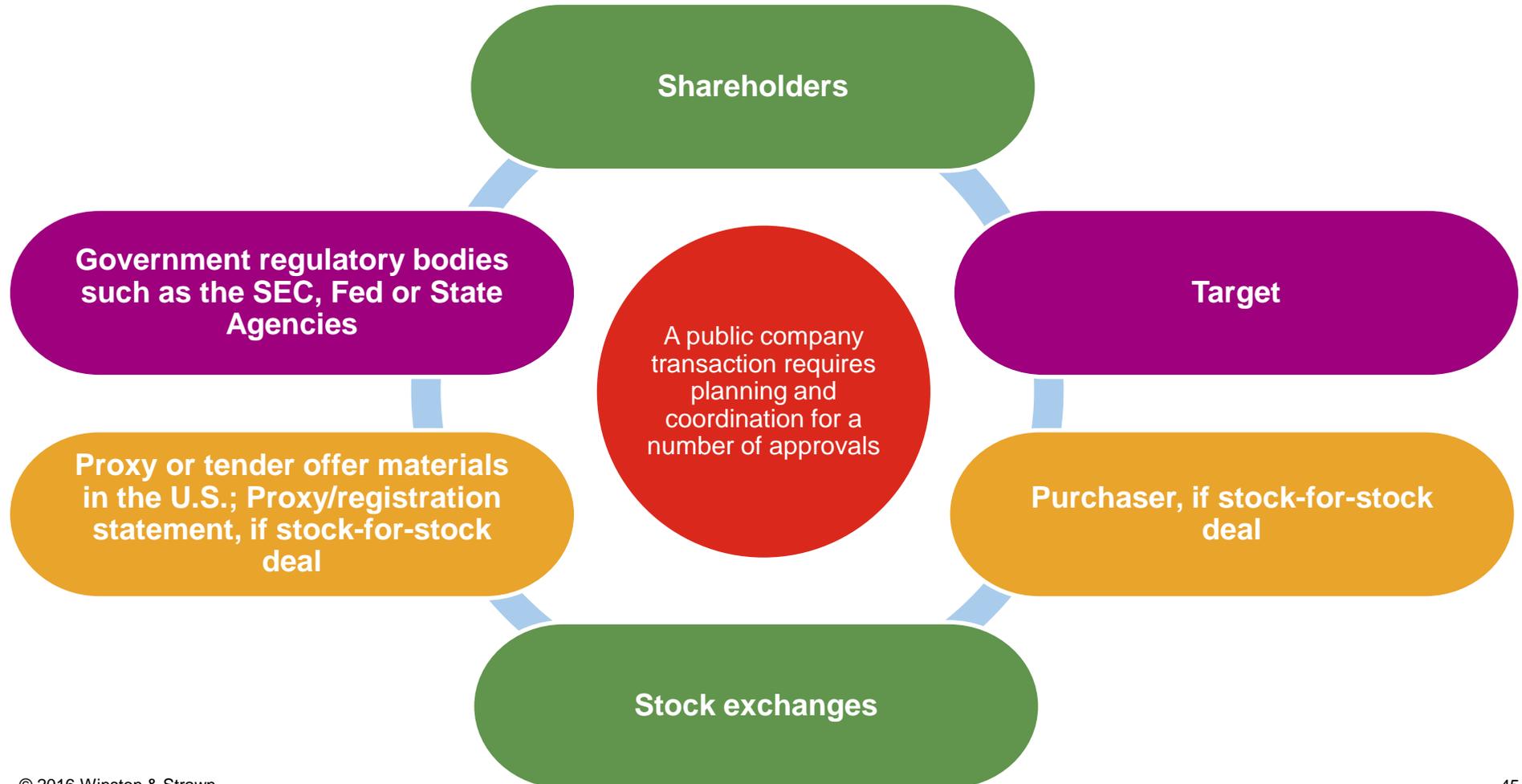
- Escrow
- Contingent payment rights

If stock as consideration:

- Dilution effect
- Exchange ratio, fixed/ floating
- Market risk – collars/caps/ walk-away provisions

# Public vs. Private Acquisitions

Additional regulatory actions and shareholder meetings



# Public vs. Private Acquisitions

Public company transactions – risk of increased competition from other potential purchasers

Even after merger agreement is signed until shareholder approval, not a “done deal”

Less deal certainty

- Always a period of time between signing and closing, at a minimum needs shareholder approval
- Generally targets can pursue and terminate to accept superior acquisition proposals
- Private transactions often structured to minimize the potential for competing bidders, if not eliminate them altogether

# Public vs. Private Acquisitions

**Risk of an interloping bidder means speed is important**

- Often leads to less extensive due diligence and less complicated acquisition agreements
- Tender offer may be preferable

**Prior to signing, confidentiality concerns require careful management of meetings, discussions and overtures**

- Limit deal teams and spokespersons them altogether

**Less deal certainty**

**Possibility of a hostile tender offer**

- Leaks prior to signing could put target “in play” – adds an additional dynamic in the tenor of the transaction

# Public vs. Private Acquisitions

**In addition to NDA obligations, leaks in a public deal have additional ramifications**

- May cause target to feel compelled to disclose/respond pursuant to SEC reporting obligations
- Generally, pre-agreement discussions prior to definitive agreement will not be required to be disclosed to the public
- May give competing bidders a head-start to react
- May drive price up so transaction is not economically feasible

**Confidentiality concerns are heightened**

**Insider trading concerns**

# Public vs. Private Acquisitions

## Several factors give purchasers comfort concerning public targets

- SEC's mandatory filing and reporting obligations
- Extensive Sarbanes-Oxley act (SOX) requirements
- Antifraud provisions of the federal securities laws
- Requirements of the various securities exchanges

## Due Diligence

## Public company due diligence reviews usually proceed at a quicker pace than that of a private company

- Request list should be shorter; list tailored to areas of concern from review of public documents

# Public vs. Private Acquisitions

Relying on target's SEC reports and filings for material information

However, additional representations regarding SEC filings

Reps and warranties and disclosures often less extensive and less negotiated

Tend to be more standardized as reps and warranties do not survive the closing and the parties want to finalize negotiations quickly to lessen the risk of leaks

Often more liberal use of materiality qualifiers

# Types of Private Funding: Huge Returns to PE Investors in Facebook and Shanda

“Seed”  
Financing

“Family and  
Friends”  
Investors

“Angel”  
Investors

Incubation  
Funds

Strategic  
Investors

Venture Capital  
Investors

# Funding of Private Equity Investments

## “Seed” Financing

- Investment by founders
- Invest in common stock in an off-shore company
- Investment size
- Shareholders' agreement

## “Family and Friends” Investors\*

### Advantages

- ✓ Close allies, fast
- ✓ Invest in common stock with few preferential rights, small investment size

### Disadvantages

- ✗ Not available for additional capital
- ✗ Few contacts or valuable business input
- ✗ Compliance with securities laws

\* Mostly “Accredited Investors” defined under US securities laws

# Funding of Private Equity Investments

## “Angel” Investors

- Small investment amount, use of non-disclosure agreement
- Invest in common stock and involves certain preference rights
- More aggressive and will seek additional rights
- May provide some contacts and expertise
- Subscription agreement, shareholders' agreement, and registration rights agreement

## Incubation Funds

### Advantages

- ✓ Provide money and services to portfolio companies
- ✓ Generally invest in preferred stock
- ✓ Subscription agreement, shareholders' agreement, and registration rights agreement

### Disadvantages

- × Same as “Seed Financing”

# Funding of Private Equity Investments

## Strategic Investors

### Advantages

- ✓ Use of non-disclosure agreements
- ✓ Expand brand name
- ✓ Validate business idea
- ✓ Terms of business relationship
- ✓ Can boost valuation significantly

### Disadvantages

- ✗ Issues with significant strategic investor: competition, conflicts, confidentiality
- ✗ Need strategic investor's approval for expansion and inability to operate joint venture efficiently
- ✗ Chilling effect on potential acquisition by others
- ✗ Possible delays in further funding

# Funding of Private Equity Investments

## Venture Capital Investors

### Advantages

- ✓ Possible source of further funding
- ✓ Provide expertise and experience
- ✓ Provide valuable network of professionals

### Disadvantages

- × Expensive money
- × Seek more control of company
- × Time-consuming process

# Funding of Private Equity Investments - Documents and Information Required

Executive summary

Business summary and description

Management team

Scalability of products and services

Target market description

Revenue sources and generation

Proposed investment amount

Use of investment proceeds

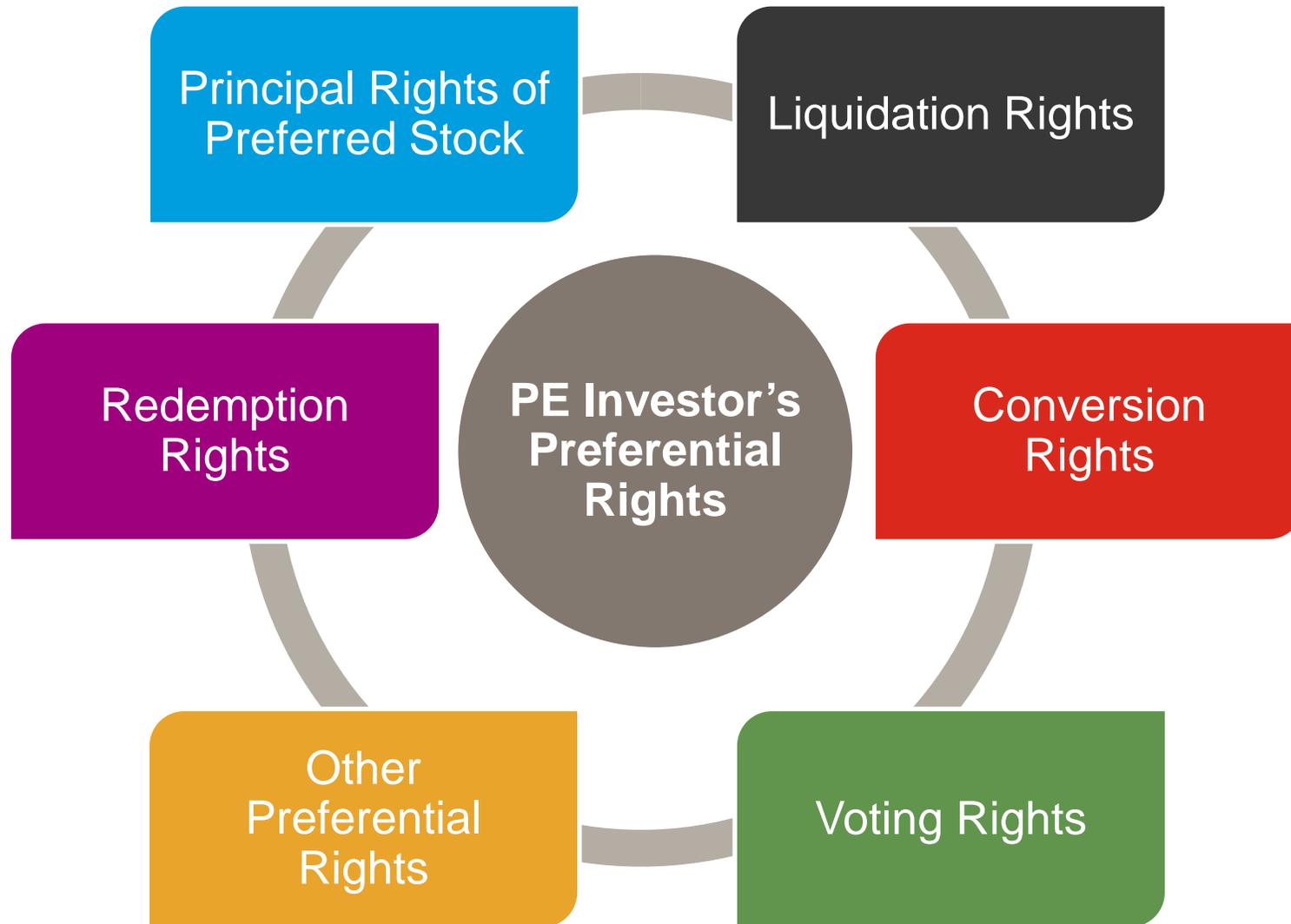
Advantages, time or path to profitability, etc.

Risk factors

Strategic parties' beneficial ownership table

Exit timing/exit format

# Private Equity Investor's Preferential Rights



# Exit Strategies: Mergers and IPOs

## Sale or Merger

- Part of a larger organization
- Tax considerations
- Cash vs. stock
- Stock vs. assets
- Continuing role of management

# Exit Strategies: Mergers and IPOs

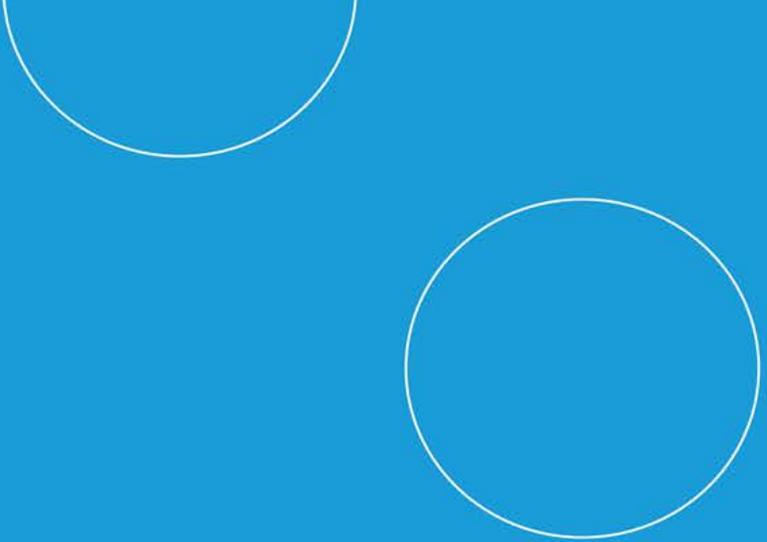
## Public Offerings (IPO)

### Advantages

- ✓ Access to public equity markets will enable companies to secure
- ✓ Better valuations
- ✓ Less dilution than private equity
- ✓ Avoid interest costs and debt financings

### Disadvantages

- ✗ Loss of confidentiality
- ✗ Increased expenses
- ✗ Management time associated with the IPO process and periodic disclosures
- ✗ Dilution of current ownership and potential loss of control
- ✗ Registration process can be lengthy, and |
- ✗ Price volatility



# About Winston & Strawn

# Global Reach

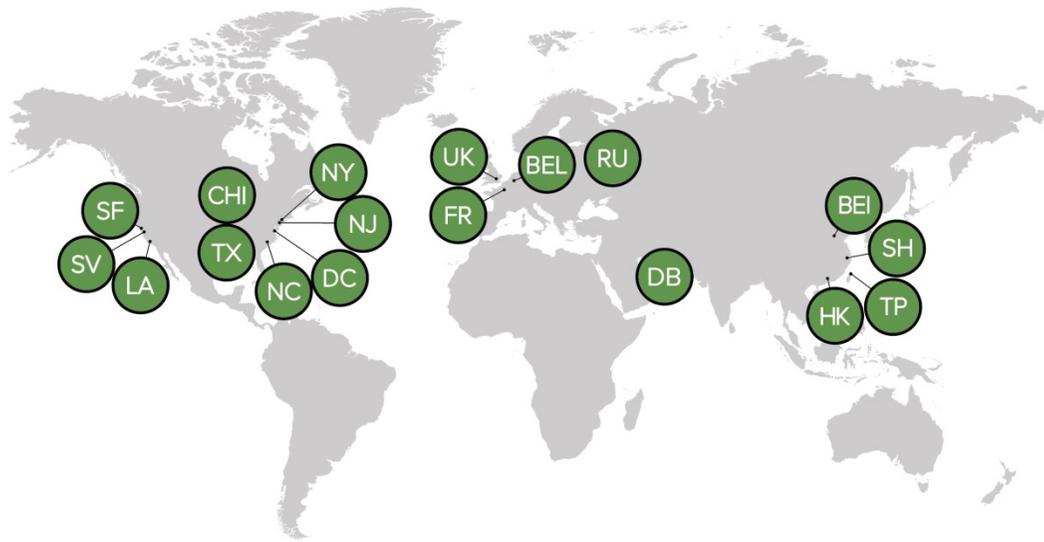
**850+**

Attorneys worldwide

**18**

Offices

Beijing, Brussels, Charlotte, Chicago, Dubai, Hong Kong, Houston, London, Los Angeles, Moscow, New York, Newark, Paris, San Francisco, Shanghai, Silicon Valley, Taipei, and Washington, D.C.



**160+**

Years of Experience

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- Energy
- Environmental Law
- Financial Services Litigation
- Government Relations and Regulatory
- Health Care
- Intellectual Property
- International Arbitration
- Labor and Employment Relations
- Mergers and Acquisitions
- Private Equity
- Product Liability
- Public Finance
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[Winston] attorneys **keep the objectives of the client in sharp focus.**

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## Simon Luk

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### **Practice**

Antitrust / Competition  
Class Actions  
Compliance & Counseling  
Corporate Governance  
Corporate and Transactional  
Merger & Acquisitions  
Private Equity Transactions  
Project Finance  
Securities and Capital Markets  
Transactions - Asia

### **Education**

Columbia University, JD, 1978

### **Bar Admissions**

New York  
District of Columbia  
Hong Kong

Simon Luk is the chairman of Winston & Strawn's Asia practice and a partner in the firm's Hong Kong office. His practice focuses on private equity, international corporate securities and cross border M&As.

Mr. Luk represents multinational corporations in cross-border mergers and acquisitions, U.S. capital market fund raising, private equity investments, compliance with regulation of the Securities and Exchange Commission policies, and the acquisition of assets and brand names.

Mr. Luk serves as honorary legal adviser to the Hong Kong Electronics Association, the Toy Manufacturers Association of Hong Kong, the Hong Kong Electrical Appliances Manufacturers Association, the Hong Kong Young Industrialists Council, the Monte Jade Science and Technology Association of Hong Kong, the Hong Kong Brands Protection Alliance, and the Hong Kong Shandong Business Association.