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M&A and Corporate Governance Newsletter

The Need for a Holistic Approach to Global Cyber Issues

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As the issue sets in cyber become more complex and global, companies have to take a cross-cutting, holistic approach to understanding and dealing with the cyber issue. From a legal perspective, there are four broad categories of issues that leaders in companies need to think through and address: public policy, litigation, corporate governance and transactions. Often the issues are interconnected, and an action in one affects the other. In this piece, “cyber” refers to security and privacy issues that affect enterprise and network operations, information and treatment of information, and have an impact on governments, partners, customers and consumers, globally. This is a big and complex set of issues, and the intent here is not to delve deeply into each one, but to share a lexicon for thinking through these cross-cutting issues around policy, litigation, governance and transactions.

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Public Policy

Governments around the world are all trying to figure out what to do about the cyber issue. All at about the same time. In the US, the Director of National Intelligence has called cyber the number one national security threat. President Obama has talked about it as both a national security and economic security issue. With over 85 percent of the critical infrastructure (communications, IT, financial services, electricity, energy, transport, health care, etc.) of the country owned by the private sector, the government needs to, and is, working through the quintessential public policy question—what is the proper role of government vis-a-vis the private sector in cyber? How do we achieve national and economic security—and innovation?

More fundamentally, companies have to have a vision, a view, a policy, a true North for cyber that works globally.

But it's not just the US working through this issue set. At the same time, the European Union has legislation pending in the European Parliament (based on a European Commission proposal that would regulate all critical infrastructure for cyber); India has regulations pending on service provider networks and is working through other critical infrastructures; China has enacted its Multi-Level Protection Scheme of regulation for broad sectors of the economy; Korea is looking at cloud regulation, as is Brazil; and the whole issue of Internet governance and who should "own" or "control" the Internet into the future (essentially ICANN or the ITU) is one of the hottest and most important issues this year. And, of course, the developing Pacific and European trade agreements are looking at cross-border data flows and regulatory conformance.

All of this is happening with the backdrop of the reporting based on leaks related to Mr. Snowden, and significant government-to-government and industry-to-government discussions on the issues of security, privacy and trust—and what the global rules of the road look like going forward. Suffice it to say, a lot going on in cyber.

For companies, the solutions and their advocacy must be, by definition, global. The Internet, enterprise networks, business models, markets, technology, and the underlying standards and protocols (IETF, IEEE, ICANN, ISO, Common Criteria) are global. If, as Tom Friedman says about the broader economy, 'The World is Flat," and regardless about what lumpiness you might otherwise believe—the policy world really is flat. A proposal made in DC in the afternoon is noted and compared in Beijing in the morning. More fundamentally, companies have to have a vision, a view, a policy, a true North for cyber that works globally. You cannot advocate one thing in one capital and another a millisecond away in another. Nor should you.

If the issue is continuing to have the ability to drive innovation into your product sets and the network, or securing your global infrastructure or intellectual property, or providing secure services based on cloud and virtualization and big data, you need to advocate for and obtain global rules that allow you to do all these things, while at the same time understanding the security and privacy concerns of the governments globally. It is possible.

Perhaps not simple, but certainly achievable and critical to the future of global information technology and communications into the future.

The rules are being written now, and when written will likely have long-term effects. Leaders in companies would benefit from engaging in discussions about cyber, understanding what's core to them and their shareholders, employees and partners, and charting a strategic path and action plan to help ensure a global, interoperable, secure and innovation-driven future.

Litigation and Investigations

In addition to the policy issues corporate leaders need to think through, cyber has created a whole set of litigation issues as parties and governments set out to assign obligation and liability when things go wrong in cyberspace. The issues range from criminal (what was done to you, what can you do), to regulatory (FTC, FCC, DoJ, DoD, ITAR, Exports, HIPPA, SEC—and then to global and State equivalents), to US Constitutional (search and seizure, privacy, speech, association), and, of course, civil (tort, contract and loss of intellectual property). Some of these duties and obligations are being assigned in the ongoing global policy discussions. And some are the stuff of current headlines, like "data breaches" at retail chains, universities and hospitals, and governmental organizations ,that cause consumers to wonder about the security and privacy of their information on line. Given the wide-scale effects of data breaches and treatment of data, many of these cases are class actions, and we are starting to see shareholder derivative lawsuits against directors and officers.

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In each of these categories of litigation, understanding technically what happened, the global and technical implications for the company for taking a particular legal position, the priorities and care-abouts of governmental actors, and what's the right application of new cyber facts to underlying laws and principles—are all quite important as many of the issues can be cases of first impression. In the cyber area, as in others, the use of internal investigations to understand what really happened, and how to redress and address issues can be helpful, particularly where the company's relations with governments, core customers and brand are involved. Action that indicates how seriously the company takes security and privacy is, in fact, meaningful. And, like in other areas, communication is key. When appropriate, like in publicly reported data breaches, explaining to the public, government leaders, employees and partners what happened and what the company's response and recovery plans are can be crucial to retain the value of the company's brand and confidence in its leaders. Deciding what to bring, how to defend and the interdependencies of the players and technologies is not simple, and requires a holistic understanding of the cyber playing field.

Corporate Governance and Compliance

Cyber is now recognized as a board-level issue. In part that's because of the intense governmental national and economic security issue globally. But it's more than that. At its core, cyber is about maintaining and driving competitive advantage. Given the integration of IT into core business processes, and the productivity gains, and transition of business models to IT-enabled services, the actual ability to deliver core services is also about IT and cyber risk. Further, for technology and many other types of companies, a company's competitive advantage is tied to innovation—and innovation is tied to its intellectual property, and the theft of intellectual property and innovation is a real, ongoing activity, and a top-level concern of companies, shareholders and governments. And, of course for technology companies making hardware and software products and services, cyber and security and trust in their products is core to the future of the business.

So what to do? First, companies clearly have to manage the cyber risk. Put in place best practices to secure systems, intellectual property, customer data and product assurance. Create and follow internal security and privacy and IPR polices, assign owners and leaders, and train employees. Ensure security-incident response, recovery, communications and escalation plans are in place and exercised. Understand who your partners, suppliers and distributors are. Put in place cyber threat information-sharing arrangements with others in your industry. Make sure the CIOs and CISOs have the resources they need, and frequent interactions with leadership. Understand the litigation risk (both as to loss of information, failure of service and theft of intellectual property), take steps and build compliance to demonstrate risks have been addressed. Insure against corporate, officer and director risk.

But in addition, and more than that, companies have to go through the hard work of identifying which assets and processes are core to its competitive advantage—are most valuable (intellectual property, customer data, ability to provide x service, brand) and prioritize those assets of highest value, and build out real security, mitigation, and response and recovery around those prioritized assets. You may not be able to secure everything, but you can prioritize, figure out what's of greatest value, and continually do your best to protect that core.

As in other cyber issues, given the complex global technology, legal, policy and geopolitical issues, an interdisciplinary approach with deep experts is key.

Transactions

There are five primary sets of cyber issues in transactions. First, governments and companies may care about the existence, treatment and security of hardware or software in cross-border deals, whether reportable or not under the rules for Committee on Foreign Investment in the United States, or Department of Commerce export controls and Department of State ITAR. Second, data today is a thing of value, and in any transaction—cloud, third-party vendor, mobile application, outsourcing—the security and privacy of data today and in the future should be understood, negotiated and agreed upon. Third, in any contract for essential services—communications, electricity, financial services, data center, supply chain, distribution—the security of the service provider needs to be understood and agreed upon. Fourth, in any merger or acquisition, the security posture, state of systems, contingent liabilities, culture, third-party agreements, governance and compliance need to be part of due diligence and undertaken by experts. And fifth, most cyber experts say, it's not "if" you've had a cyber issue, but "when" you've had it and if you "know" it. So, in transactions and agreements, it's important to agree on a process for dealing with the issue in case something happens, and then when and if something happens, the parties have a path forward for resolving or moving through the issues together.

Conclusion

Leaders in companies are faced with a wide range of interrelated cyber issues today. Given the global nature of networks, and the intense and important attention of government leaders and customers and consumers globally, leaders must view the issues holistically and understand that often seemingly disparate issues are interconnected and can take on a life of their own. This is a classic area where an interdisciplinary approach is called for. Often, policy merges into governance that can merge into litigation or a transaction. Seemingly disparate issues merge, where often there is a separate corporate owner. Leaders who think about these issues in holistic and interrelated ways will be able to understand them, seek proper counsel and move through the tough issues with a clear sense of direction and effect.

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Delaware Chancery: "Poison Pill" Affords Only a Limited Defense to Activist Attacks

Boards Must Demonstrate a Reasonable, Proportionate Response to a Legally Cognizable Threat

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In a recent Chancery Court decision, Vice Chancellor Parsons upheld the use of a rights plan, or "poison pill," as a defense to activists seeking to acquire a controlling interest in Sotheby's without paying a premium.[1] His decision also makes clear, however, the limits of this defensive measure, and points out the facts that are key to a determination that the adoption or refusal to waive the provisions of a rights plan are an appropriate exercise of a board's fiduciary duties in the context of a potential proxy contest.

Further, although the Sotheby's board's adoption and refusal to waive the provisions of the rights plan were upheld, and the activists were not granted an injunction to delay the Sotheby's annual meeting, the parties nevertheless settled the proxy contest before the annual meeting. Preliminary vote totals prior to the meeting showed that Sotheby's was badly trailing the activist Third Point in shareholder voting on the director slate. Sotheby's agreed to appoint the three Third Point nominees, expanding the board to 15 members, terminated the rights plan as of the annual meeting, and allowed Third Point to increase its stake to no more than 15 percent.

Background

Stockholder activism is on the rise across the United States. Many boards of directors are confronting activists who acquire "toehold" investments in the company's stock and agitate for a variety of changes to the policies, capital structure or management of that company. These demands are often accompanied by a demand for board seats and the threat of a proxy contest to seat those directors or a withhold campaign against the incumbent directors. Sotheby's faced this situation in 2013. From May through July 2013, three activists—Third Point, Trian and Marcato—revealed that they had taken positions in Sotheby's stock, and Third Point and Marcato increased their positions over the following months. Sotheby's management kept its board informed and met with Third Point and Marcato.

By August 31, 2013, the three activists had accumulated approximately 15 percent of the company's outstanding shares, and Third Point had derivative positions that, if exercised, would increase that total ownership to over 20 percent. The activists indicated intentions to pursue "potential changes of strategy and leadership," and "an extraordinary corporate transaction, such as a merger, reorganization or liquidation." The board knew that a proxy contest was likely and considered the return of capital to its

1 *Third Point LLC v. Ruprecht, et. al.*, C.A. No. 9497-VCP (May 2, 20014).

stockholders as a response to the activists. Third Point increased its position to 9.2 percent on October 2, 2013, and criticized Sotheby's "chronically weak operating margins and deteriorating competitive position relative to Christie's [Sotheby's key competitor]," as well as management's lack of alignment with shareholders," "a sleepy board and overpaid executive team" and "lack of expense discipline."

On October 4, 2013, the board adopted a shareholder rights plan, which expired in one year unless approved by a shareholder vote. Nothing in the rights plan would prevent the board from readopting the plan in whole or part after it expired. The rights plan included a qualifying offer exception so that the rights plan would not apply to an "any or all" offer that cashes out all of the Sotheby's shareholders and gives them at least 100 days to consider the offer.

Another feature of the rights plan key to the case at hand was the plan's two-tiered structure. Persons who reported their ownership under Schedule 13G were permitted to acquire up to a 20 percent interest in Sotheby's. A person is permitted to report ownership under Schedule 13G only if the person has not "acquired the securities with any purpose, or with the effect, of changing or influencing the control of the issuer, or in connection with or as a participant in any transaction having that purpose or effect" and they own less than 20 percent of the issuer's securities. All other stockholders, including persons who reported their ownership under Schedule 13D, were limited to a 10 percent stake in Sotheby's.

On January 29, 2014, Sotheby's announced a special dividend of $300 million and a $150 million share-repurchase program. Third Point and Sotheby's then attempted to negotiate a resolution to avoid a proxy contest, but failed to come to an agreement. On February 27, 2013, Third Point announced its intention to run a slate of three directors at the upcoming Sotheby's annual meeting, and that it had increased its stake to 9.53 percent. Third Point continued to increase its position in Sotheby's, reaching 9.62 percent as reported on March 13, 2014, and then requested a waiver to permit it to acquire up to a 20 percent stake in Sotheby's. The board rejected the request for a waiver and notified Third Point on March 21, 2014. On March 25, 2014, Third Point sued in Delaware Chancery Court seeking a preliminary injunction to delay the Sotheby's May 6, 2014 annual meeting. Vice Chancellor Parsons held that Third Point had not demonstrated a reasonable probability of success on the merits. In so doing, the Vice Chancellor also provided further guidance for boards who are confronting similar situations.

Standard of Review

The Vice Chancellor considered both the adoption of the rights plan and the Sotheby's board's denial of Third Point's request for a waiver. He held that the standard for review of both decisions was the familiar *Unocal* standard.[2] Under *Unocal,* there are two prongs that must be satisfied. The first prong is that "the board of directors had reasonable grounds for believing that a danger to corporate policy and effectiveness existed," or in other words, "a board must articulate a legally cognizable threat." For this prong, directors must demonstrate "good faith and reasonable investigation," and "actually articulate some legitimate threat to corporate policy and effectiveness." The second prong is a "proportionality" test,

2 *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

under which the board must demonstrate that the defensive response was "reasonable in relation to the threat posed." The Delaware courts first consider if the defensive action is "draconian, by being either preclusive or coercive." If not, the courts determine if the response falls "within a range of reasonable responses to the threat" posed. The defendant board bears the burden of proving the reasonableness of its actions under *Unocal*.

Chancery Court Found the Adoption of the Rights Plan Was a Reasonable Response to a Threat Reasonably Perceived

Vice Chancellor Parsons noted that "the presence of a majority of outside directors, coupled with a showing of reliance on advice by legal and financial advisors, 'constitute[s] a *prima facie* showing of good faith and reasonable investigation.'"[3] He then concluded that there was sufficient support for the board's assertion that its good faith investigation led it to determine that Third Point posed a legally cognizable threat "of forming a control block for Sotheby's with other hedge funds without paying a control premium."

He also concluded on this record that the primary purpose of the adoption of the rights plan was not to interfere with the stockholder franchise, but found rather that the board was motivated to adopt the rights plan in response to the control threat posed by Third Point, and any effect on electoral rights was incident to that end. In making this determination, the Vice Chancellor expressly considered whether there were any facts supporting an inference of entrenchment and concluded there were none. Thus, he noted that the board was not staggered, turned over at an above-average rate and was dominated by outside, independent directors. There was no showing that serving on the board was material, financially or otherwise, to those independent directors, such that they would have a disabling personal incentive to quash a proxy contest.

Vice Chancellor Parsons also reviewed the record and determined that none of the directors, other than the CEO (who had been personally attacked and risked losing his employment), felt an animus toward Third Point or its president, Daniel Loeb, that would impede their judgment or motivate their actions with respect to Third Point. One important fact to the Vice Chancellor was that the parties had been negotiating a settlement pursuant to which Mr. Loeb would have received a seat on the board. He thus concluded that there was no reasonable probability of plaintiffs establishing that the board's dislike of Loeb or Third Point was the driving force behind any board decisions.

Vice Chancellor Parsons also found that the rights plan was not coercive or preclusive. Thus, there were no features that would force a stockholder to vote in favor of the board or any consequences on stockholders for voting their shares as they wish. The proxy contest was said to be "winnable by either side." Even with a 10 percent cap on the shares Third Point could acquire, success was deemed reasonably attainable. The court therefore found the adoption of the rights plan was a reasonable response to a legally cognizable threat.

3 *Selectica, Inc. v. Versata Enters., Inc.*, 2010 WL 703062 at *12 (Del. Ch. Feb. 26, 2010).

The Two-Tier Structure Upheld on These Facts

Third Point also attacked the two-tier structure of the rights plan, and the discrimination against shareholders filing Schedules 13D as unreasonable. In response, the court noted that when the plan was adopted there was an objectively reasonable possibility that Third Point was working with one or more hedge funds to create a control block through conscious parallelism. Vice Chancellor Parsons noted the discriminatory feature, but expressly found the rights plan was a "closer fit" to addressing the perceived threat. Having held that the 10 percent threshold was reasonable and proportionate, here the question was whether the rights plan was unreasonable because it allows Schedule 13G filers, more likely to vote in favor of management, to go up to a 20 percent stake. Vice Chancellor Parsons noted that this was an important question, but not relevant at the preliminary injunction stage since Third Point was the largest stockholder at 9.6 percent. Thus, no stockholder was actually treated differently by the different threshold.

Refusal to Waive Rights Plan Threshold Subject to Separate Review; Negative Control Was a Legally Cognizable Threat

The Vice Chancellor had more trouble finding that the refusal to waive the rights plan threshold closer to the annual meeting was reasonable. He again separately analyzed whether there was an objectively reasonable and legally cognizable threat at the time the board rejected the waiver. He noted that Third Point didn't seek a waiver of the rights plan in its entirety, but only a waiver to permit Third Point to increase its stake to 20 percent, which was the threshold permitted for Schedule 13G filers.

A 20 percent stake in the hands of Third Point might allow it "to exercise disproportionate control and influence over major corporate decisions, even if they do not have an explicit veto power."

The Vice Chancellor was skeptical of whether the board could objectively determine in March 2014 that Third Point continued to pose a "creeping control" risk either individually or as part of a "wolf pack." The Vice Chancellor was, however, persuaded that Third Point still posed a risk of "negative control," where a person obtains a veto right through a level of share ownership or board representation at a level that does not amount to majority control, but is sufficient to block certain actions that may require supermajority votes. He explained that a 20 percent stake in the hands of Third Point might allow it "to exercise disproportionate control and influence over major corporate decisions, even if they do not have an explicit veto power." He considered the facts surrounding Third Point's interactions with Sotheby's in determining whether Third Point might be able to exercise "effective negative control," noting Mr. Loeb's domineering manner and his actions toward Sotheby's demonstrated his likely use of such effective negative control. He noted that while there might be a level of ownership above 10 percent and below 20 percent where the threat of effective negative control was not a real threat, he observed that all that was required was that the 10 percent cap be reasonable, not perfect. On these facts he held that the rejection of the waiver request did not violate the *Unocal* standard.

Irreparable Harm Found

Vice Chancellor Parsons did find, however, that Third Point had demonstrated the likelihood of irreparable harm, because the odds of winning the proxy contest were reduced. Nothing prevented Third Point from making its case to stockholders, and it was not certain that the relief requested would affect the outcome of the vote, since it would only matter if the margin of victory was 10 percent or less and only if Third Point actually acquired the stock. However, the likelihood of success was demonstrably greater with more shares, particularly where the parties described the proxy contest as a "dead heat." He also found the harm "irreparable," because the alternative remedy of holding a second meeting was not sufficient due to the "insurmountable obstacle of confusion and antipathy."

Importantly, the Vice Chancellor also expressed some sympathy to the arguments of the other stockholder plaintiffs who argued that a discriminatory rights plan would chill socially valuable activist stockholder activity, that stockholders should be treated equally and that purely passive stockholders are likely to favor management than activists. He noted that these were not imminent threats, and thus not compelling for the injunction, but might argue against the validity of the two-tiered pill in the long term.

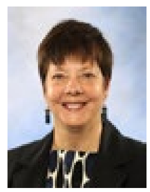
Lessons Learned

This case provides some noteworthy lessons for boards considering the adoption of a rights plan in defense against an activist acquiring stock or considering a request from an activist for a waiver. Here are some key takeaways:

- First, keep in mind that email lives forever, is discoverable and can easily be taken out of context. The decision is replete with emails from the CEO and other board members and could be used to show inappropriate motivation, or to provide a window into the board's view of the activist's positions.
- The minutes of the board meetings considering the adoption of a defensive measure should reflect the board's reasons for its decision, and particularly the threat perceived by the board.
- The two-tier structure employed in the rights plan at issue here, with a lower percentage for Schedule 13D filers is subject to continuing challenge by activists and although it was upheld in this case it should not be viewed as *per se* reasonable. It seems clear that if there were large stockholders exempted, or some facts demonstrating that shareholders more likely to vote in favor of the management slate were able to increase their stakes, while stockholders opposing directors slate could not, might permit a finding that the primary purpose of that structure was impermissibly to affect the exercise of the franchise.

- The threat of "creeping control" is a legally cognizable threat, but it may not be a threat as to the same stockholder over time depending on the behavior and motivations of the stockholder in question.
- "Effective negative control" is a legally cognizable threat, even if the stockholder does not have an explicit veto, and a 20 percent stake may be enough in some cases to give a stockholder such a negative veto, providing disproportionate control and influences, particularly when that stockholder is the largest single stockholder.
- Whether there is "effective negative control" will depend on the facts and circumstances, including the person's own actions—and inferences that could be drawn from those actions—as well as the landscape in which the purported threat must be exercised.
- In a close proxy contest, the court is likely to find irreparable harm in the limitation on the ability of the activist to acquire additional stock.
- The long term validity of a two-tiered rights plan is subject to some question, given the court's sympathetic consideration of plaintiff assertions that stockholders should be treated equally, and that activist stockholders are less likely to favor management than passive investors.

The Delaware courts will carefully consider the board's actions in adopting or maintaining a defensive measure, particularly in cases where the defensive measure is alleged to interfere with the stockholder franchise. The record created by the board will be the key to the board's determination of the appropriateness of the defensive measure.



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Recent SEC Guidance on Social Media Use: Implications for Activist Campaigns

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The SEC has recently issued guidance for using social media in connection with public offerings, business combinations, proxy contests and tender offers.[1] In these contexts, SEC legending requirements have precluded the use of social media platforms, like Twitter, that limit the number of characters that can be included in a communication. In its recent guidance, however, the SEC stated that its staff will not object to the use of a hyperlink to satisfy the legending requirements under the following circumstances:

- The communication is distributed through a platform that has technological limits on the number of characters or amount of text;
- Including the required legends would cause the communication to exceed these limits; and
- The communication contains an active hyperlink to the legends and prominently conveys, through introductory language or otherwise, that important or required information is provided through the hyperlink.

The SEC did not specify wording for the hyperlink, but issuers will presumably settle on hyperlinked statements such as "important information" or "required disclosure."[2]

Companies that do not currently use Twitter as part of their communications strategy should consider starting to use it, both to assist in ordinary-course messaging and to avoid ceding a battlefront before an activist engages.

The guidance is likely to result in an increased use of Twitter and other social media platforms that restrict character use in connection with the type of transactions to which the guidance applies. In particular, shareholder activists have already embraced social media. Carl Icahn has publicly declared his intention to use Twitter to promote his activist agendas[3] and has used Twitter in campaigns against several companies, including Apple and Dell. The SEC's recent guidance is likely to lead to greater use of Twitter in activist campaigns. Companies that do not currently use Twitter as part of their communications strategy should consider starting to use it, both to assist in ordinary-course messaging and to avoid ceding a battlefront before an activist engages.

The SEC's recent guidance also addressed an area of concern for issuers involved in securities offerings who use social media platforms to distribute messages intended to comply with Securities Act safe harbors. Some social

1 See *Compliance and Disclosure Interpretations Questions* 110.01, 110.02, 164.02, 232.15 and 232.16.

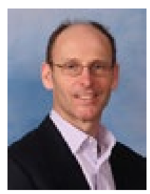
2 The guidance applies in the context of legends required pursuant to Rules 134(b), 134(d), 165(c) and 433(c)(2)(i) under the Securities Act of 1933, and Rules 14a-12, 13e-4(c), 14d-2(b) and 14d-9(a) under the Securities Exchange Act of 1934.

3 See David Benoit, "Carl Icahn Wants to Create Twitter Movement," *The Wall Street Journal* (Sept. 9, 2013).

media platforms facilitate the re-transmission of messages by third parties under circumstances that may not comply with the safe harbors. According to the SEC, if the third party is neither an offering participant nor acting on behalf of the issuer or an offering participant, and the issuer has no involvement in the re-transmission, the re-transmission would not be attributable to the issuer.[4]

This guidance is consistent with the SEC's long-standing position that issuers are generally not responsible for electronic communications of third parties unless they have taken steps to associate themselves with the communications, for example through having "adopted" them or through "entanglement" in their preparation.[5]

Note that the SEC's recent guidance does not supersede the SEC's 2008[6] and 2013 guidances[7] regarding the use of electronic media in compliance with Regulation FD. Issuers should continue to use social media to communicate material nonpublic information only if they have provided appropriate notice of the specific social media channels they use to disseminate such information or simultaneously transmit the information through recognized Regulation FD compliant channels.



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4 The guidance applies in the context of retransmission of electronic communications made in compliance with Rules 134 or 433 under the Securities Act of 1933.

5 See *Use of Electronic Media*, Release No. 33-7856 (Apr. 28, 2000).

6 See *Commission Guidance on the Use of Company Websites*, Release No. 34-58288 (Aug. 1, 2008), regarding when information posted on a company web site is deemed "public" for purposes of Regulation FD.

7 See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934; Netflix, Inc., and Reed Hastings, Release No. 69279 (Apr. 2, 2013), regarding extension of the SEC's approach to social media generally.

DOJ Unwinds an Anticompetitive Consummated Technology Acquisition Under Terms Requiring More Than Standard Asset Divestiture

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The US Department of Justice has signaled that it may insist on exceptional remedies—requiring more than mere divestiture of acquired assets—when confronted with consummated transactions that it deems anticompetitive.

On April 24, 2014, the Antitrust Division of the US Department of Justice (DOJ) and Bazaarvoice announced an agreement that the company would divest all of the assets it acquired when it bought PowerReviews in mid-2012. Bazaarvoice also agreed to a number of additional terms designed to restore competition in the market for ratings and review (R&R) platform software. Judge William H. Orrick of the US District Court for the Northern District of California had previously found, after a three-week bench trial, that Bazaarvoice had violated the federal antitrust laws when it acquired "its only real commercial competitor" in that market. *United States v. Bazaarvoice, Inc.*, 2014 U.S. District WL 203966, *2 (N.D. Cal., Jan. 8, 2014). The parties were preparing to contest the remedy when they reached the settlement, which is subject to court approval. At a hearing a day after the settlement was announced, Judge Orrick indicated that he would likely approve it.

The case demonstrates the government's willingness to challenge relatively small transactions, even after they have been consummated, to enforce the antitrust laws. It underscores that the best practice when considering a transaction is to seek antitrust advice at an early stage. Such counsel enables the parties to incorporate a realistic assessment of potential antitrust risk into their negotiations. It also helps them avoid entanglement in costly and drawn-out government challenges, or at least effectively anticipate and prepare for them.

Background

Bazaarvoice sells its R&R platform to manufacturers and online retailers. They incorporate it into their websites to collect and display consumer-generated product ratings and reviews. R&R platforms help drive online sales by providing shoppers with other consumers' product evaluations. The software has become increasingly sophisticated. One important feature enables a manufacturer to syndicate its reviews to the retailers that sell its products; retailers also can share their reviews with manufacturers. Thus, syndication allows retailers and manufacturers to display more, and the most current, reviews to their customers. It also provides them with a larger data set to which they can apply market analytics. Syndication gives rise to network effects because as more retailers and manufacturers adopt the software platform, they both have more opportunities to share more reviews for a given product with each other. These network effects create a significant barrier to entry into the R&R platform market.

Reportedly valued at $168 million, the acquisition of PowerReviews was not reportable under the Hart-Scott-Rodino Act, even though it met the Act's "size of transaction" test of $75.9 million, because it did not also meet the Act's "size of person" test. Under the latter requirement, a transaction involving the acquisition of a software company is reportable if the acquirer has at least $151.7 million in annual net sales or total assets, and the acquired company has at least $15.2 million in total assets. Like many start-up companies, PowerReviews' assets in the year before it was acquired were less than the $15.2 million threshold. Because the parties did not have to obtain prior governmental approval, they consummated the acquisition before the Antitrust Division opened its investigation. Therefore, because the transaction had already closed, the Antitrust Division sought a remedy that would unwind the deal. Bazaarvoice has agreed to sell all assets acquired from PowerReviews to Viewpoints LLC, a provider of a consumer-reviews platform, for an undisclosed amount.

Government Imposes Exceptional Remedies to Restore Competition

Importantly, in addition to the asset divestiture, the settlement contains additional requirements designed to place the divestiture buyer in the competitive position that PowerReviews would likely have achieved today had it not been acquired nearly two years ago. According to the Antitrust Division, while PowerReviews had a track record of adding features to its platform, Bazaarvoice shelved the PowerReviews software after acquiring it. To compensate for development lost since the acquisition, the buyer will receive perpetual licenses to Bazaarvoice's patents. Bazaarvoice also agreed to allow the buyer to obtain and use its R&R platform trade secrets, know-how and other proprietary information. The Antitrust Division took the position that these provisions would reverse the deterioration of PowerReviews' business caused by Bazaarvoice's failure to invest in research and development for the PowerReviews platform. However, the transfer encompasses virtually all of Bazaarvoice's intellectual property portfolio rather than being limited to additions made to that portfolio since the acquisition.

In remarks before the Institute for Consumer Antitrust Studies in Chicago on April 25, 2014, Leslie Overton, Deputy Assistant Attorney General for Civil Enforcement at the Antitrust Division, indicated that it was the Antitrust Division's historical practice and current policy in addressing consummated transactions to require divestiture of additional assets beyond those acquired in the transaction when the acquired assets had been rendered obsolete or insufficient by the passage of time.

Bazaarvoice also agreed to grant the buyer a four-year license to sell Bazaarvoice's syndication services to the buyer's R&R platform customers. The DOJ required that Bazaarvoice provide those services on nondiscriminatory terms. These services are intended to make the buyer's R&R platform more competitive as it seeks to attract a critical mass of manufacturers and online retailers. They also compensate for Bazaarvoice's migration of PowerReviews customers to its own R&R platform. This concession is an important one from a competitive perspective because it lowers the barriers to entry that syndication represents. Indeed, Bazaarvoice had long resisted its own customers' requests to offer a syndication interface to the PowerReviews platform. A court-appointed trustee will monitor Bazaarvoice's compliance with the settlement.

The Antitrust Division made one apparent concession in the settlement negotiations. It had previously sought a provision that the asset divestiture would be deemed adequate only if the PowerReviews R&R platform generated, at the time of divestiture, at least 80 percent of the revenue that it had been generating at the time PowerReviews was acquired. If not, Bazaarvoice would have to license its own proprietary R&R platform to the divestiture buyer. That provision was not included in the settlement.

The settlement demonstrates that the potential competitive harms arising from consummation of a transaction without governmental approval may prompt the government to seek exceptional remedies.

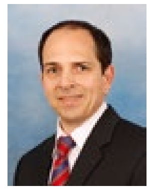
The Antitrust Division had argued in its briefs that this condition would insure that the buyer would be placed in the competitive position that PowerReviews would have occupied today absent the transaction. For practical purposes, this condition would have insured that Bazaarvoice would meet the benchmark (by shifting enough of its customers to the PowerReviews platform prior to divestiture), given the prospect of having to license its "crown jewels." Nevertheless, this condition would have been the least likely to receive court approval in the context of a contested remedy. A license to the "crown jewels" would put the buyer in a superior competitive position compared to the one PowerReviews had enjoyed when it was acquired. Not only did PowerReviews have a significantly lower market share, its R&R platform lacked important features offered by Bazaarvoice.

The Significant Cost of Noncompliance

The settlement demonstrates that the potential competitive harms arising from consummation of a transaction without governmental approval may prompt the government to seek exceptional remedies. Such remedies can inflict continuing compliance costs and burdens on the company. In addition, because divestiture sales are ordinarily completed under significant pressure, they often cannot be expected to bring full value. Besides the cost of counsel and economics experts, the time and resources a company spends dealing with an investigation, a lawsuit, and the attendant negative publicity could also lead to lost business opportunities. Management distraction, declining employee morale, and uncertainty in customer and supplier relationships often become issues. Sometimes all of these costs can exceed the value of the transaction itself.

Moreover, post-closing government investigation and litigation can subject the company to a prolonged period of uncertainty. Unlike with premerger notifications, the DOJ and FTC have no regulatory deadlines within which to complete a post-closing investigation. Courts likewise have no deadlines within which to resolve a lawsuit challenging a consummated deal. Defendants also have a greater incentive to litigate longer and harder after a deal is closed and an acquired company has been integrated. And the company may be required to unwind a deal years after it has closed.

The prospect of significant expenses and delay of a post-closing investigation and litigation should be weighed against the relatively small investment in time and money of an early antitrust analysis of a nonreportable deal. Premerger antitrust analysis need not necessarily be lengthy or costly, particularly for a deal small enough that the DOJ and FTC need not be notified, nor should the analysis cause delay if it is begun while the parties are conducting due diligence. Such an analysis could be conducted in a matter of days or a week or two, depending on the availability of company documents and key business people. In sum, a company should take a conservative approach regarding small, nonreportable deals by assessing possible antitrust risks early rather than rolling the dice on post-consummation governmental review.



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EU Antitrust: Parent's Liability for Antitrust Violations of Portfolio Companies and Joint Ventures

Dr. Sebastian Jungermann Partner and **Dr. Jens Steger** Associate

The European Commission's recent decision to impose a €301.7 million fine on a cartel of high-voltage-power-cable producers highlights its determined efforts to hold investment firms and parent companies liable for the antitrust conduct of their portfolio companies and joint ventures.

On April 2, 2014, the European Commission (EC) fined a group of underground and submarine high-power-cable producers a total of €301.7 million (US $416 million). According to the EC, the group of six European, three Japanese and two Korean manufacturers operated as a cartel from 1999 until 2009, when the EC conducted unannounced raids of their businesses. Underground and submarine high-voltage-power cables are typically used to connect generation capacity to the electricity grid, to interconnect different power grids or to connect renewable energy projects such as offshore wind farms.

The EC was informed about the group's activities by Swiss ABB, which blew the whistle on the operation and received full immunity, avoiding a fine of €33 million for its own participation in the cartel. Two of the world's biggest cable producers, Prysmian and Nexans, were among the European manufacturers fined, with Prysmian receiving the highest fine of any cartel member—€104.6 million.

With this decision, the EC fired a warning shot at private equity firms, hedge funds and other firms that purely invest but also "control" businesses. Besides these cable companies and some of their current and former shareholders, the EC also sanctioned Goldman Sachs for €37.3 million (US $51 million) because its private equity fund Goldman Sachs Capital Partners bought Prysmian in 2005, held all the voting rights in the portfolio company for about two years and was involved in making strategic decisions for the company until 2010, at which time it began to sell down its shares.

Before Goldman acquired Prysmian, the company was part of Pirelli, which was also sanctioned. The EC saw Pirelli and Goldman Sachs as being jointly liable for Prysmian's fines, first calculating an amount based on Prysmian's own conduct and then apportioning the resulting €104.6 million fine between the two former parents based on their respective periods of their control of Prysmian. As a result, Pirelli was found to be jointly and severally liable with Prysmian for two-thirds of the fine (€67.3 million), while Goldman Sachs was found responsible for the remaining third of the fine (€37.3 million).

It does not even matter whether such decisive influence was actually exercised; what matters is the possibility of exercising that influence.

One of the key issues under European competition law is the question of which company in a group is liable for an infringement of competition law. Under EU competition law, liability is imposed on "undertakings." In accordance with the EC and the European courts, an "undertaking" is an entity or group of entities which effectively function as a "single economic unit." And a holding or parent and its subsidiaries form such a unit when the holder is in a position to exercise control over the conduct of such subsidiary. Control simply means "decisive influence." Usually it does not even matter whether such decisive influence was actually exercised; what matters is the possibility of exercising that influence. Decisive influence can be established where an affiliate, despite having its own and separate legal personality, does not decide independently its own market conduct and behavior and is considered to operate in accordance with the will of its parent company. Additionally, a parent does not need to have "sole control" to assess parental liability, "joint control" may also lead to liability and significant fines.

The fining decision regarding Goldman's investment and its "decisive influence" over its former portfolio company is not the first wakeup call from the European antitrust watchdog. In 2007, the EC imposed fines of €243 million on six companies, including E I DuPont and Dow, for participating in an illegal price-fixing and market-sharing cartel in relation to chloroprene rubber. Both Dow and DuPont were held to be jointly and severally liable for the conduct of their 50-50 joint venture, Dupont Dow Elastomers LLC (DDE). The EC concluded that both parents exercised "decisive influence" on the commercial conduct and policies of DDE, and therefore could be held jointly liable for DDE's anticompetitive conduct. In September 2013, the Court of Justice of the European Union issued two judgments confirming both the fining decision and the finding that a parent company can be held liable and fined by the EC for the antitrust infringements of its 50-50 joint venture in the EU.

Companies have to consider this growing risk associated with being hit by heavy antitrust fines in the EU, along with the increased possibility of private enforcement actions in the courts of the EU member states.

These decisions endorse the EC's current hardened approach of attributing antitrust liability, wherever possible, to parent companies. Under EU competition rules, parents can be held liable for infringements committed by joint ventures over which they exercise decisive influence. Such influence may exist even if the holding or parent company did not participate in the breach, did not have any knowledge about it, and could only veto, but not determine, strategic business decisions of the joint venture. Most importantly, this approach maximizes antitrust fines by enabling the EC to avail itself of a higher maximum fine limit based not just on the turnover of the portfolio company or subsidiary itself, but of the entire corporate group of the parent, regardless of whether the parent is active in the same industry or not.

This development demonstrates the limits of "limited liability" in relation to investments made by financial investors, private equity funds, hedge funds or any other parent company in a business. Companies have to consider this growing risk associated with being hit by heavy antitrust fines in the EU, along with the increased possibility of private enforcement actions in the courts of the EU member states. Before investing in a business, a potential parent company should ensure it conducts a thorough antitrust and competition due diligence. Equally as important, it should also have an effective compliance program in place, which is implemented throughout both the corporate group and the lifetime of the investment, including its exposure through all portfolio companies, joint ventures and even certain minority shareholdings.

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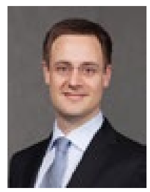

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Antitrust Merger Control: New Rules for Simplified Treatment of Less-Sensitive Cases in China and the European Union

Dr. Sebastian Jungermann Partner and **Steven R. Wright** Partner

In the last six months, authorities in both the People's Republic of China and the European Union have issued new regulations concerning less-sensitive merger control cases. In the EU, transactions that were unlikely to raise antitrust concerns were already eligible for simplified treatment, but new rules have further streamlined this process. Meanwhile, the PRC has now introduced rules that, for the first time, could allow for the expedited review of concentrations less likely to be of concern to regulators. In fact, the new PRC rules have some similarities with the EU rules, including with respect to defining which concentrations may qualify for simplified treatment. However, the PRC rules appear to be somewhat less developed and less permissive than the EU rules, which is likely due to a desire on the part of PRC regulators to exercise caution as they begin developing a "fast track" for merger control review. Below, we discuss the new regulations applicable to the simplified treatment of certain cases in China and the EU.

China

If certain revenue thresholds are met, M&A transactions may be subject to a mandatory merger control filing with the Anti-Monopoly Bureau (AMB) of the Ministry of Commerce (MOFCOM) of the PRC. From the time when the Chinese Anti-Monopoly Law took effect on August 1, 2008, through the end of 2013, MOFCOM received 866 merger review filings, and the number of merger control filings being made in China has been increasing rapidly. In 2013 alone, MOFCOM received 224 merger filings, eight percent more than in 2012. Among all cases, approximately 97 percent (717) were unconditionally cleared, while only approximately three percent were conditionally approved (22) or prohibited (1).

If a merger filing is required in China, the filing parties generally have the burden of collecting data and providing a Western-style economic analysis of the anticompetitive impact of the proposed transaction. Even though a Phase I merger control decision in China should be issued within 30 days, antitrust merger control investigations usually involve several rounds of back and forth with the AMB. In practice, investigations often take three to four months to complete, and some can take up to nine months or more, with transaction completion being subject to satisfactory AMB antitrust approval. This can create substantial transactional uncertainty and risks.

New Regulations Concerning "Simple Cases"

To streamline the review process for transactions that are not likely to raise significant antitrust concerns in China, MOFCOM has recently released regulations that may allow for the expedited treatment of so-called "simple cases." On February 11, 2014, MOFCOM issued the "Interim Provisions on Standards Applicable to Simple Cases of Concentrations of Undertakings" (the Provisions); which were interim regulations relating to the treatment of concentrations deemed to be "simple cases."

Under these new rules, transactions qualifying as "simple cases" will be allowed to submit simplified merger filings and will likely be subject to expedited review.

Then, on April 18, 2014, MOFCOM issued the "Guidance on Notifications for Simplified Cases of Concentrations of Undertakings (Trial Version)" (the Guidance). The Guidance provides further clarification regarding, and instructions for implementing, the Provisions issued in February.

Under these new rules, transactions qualifying as "simple cases" will be allowed to submit simplified merger filings and will likely be subject to expedited review. However, there is no specific shorter timeline spelled out in the interim regulations or implementing rules, so there is no real assurance that qualifying transactions would actually receive faster review.

MOFCOM will provide public notice of transactions submitted as "simple cases" on the AMB website, giving third parties a fixed timeframe (10 days) to comment on such transactions.

One interesting feature of the new protocol is that MOFCOM will provide public notice of transactions submitted as "simple cases" on the AMB website, giving third parties a fixed timeframe (10 days) to comment on such transactions. This public notice period and comment system may help to avoid the need for the AMB to engage in protracted consultations with affected third parties. However, it could also potentially invite unwanted attention, which may discourage some parties from seeking "simple case" treatment, as standard merger filings in the PRC are still not subject to public disclosure.

Indeed, effective as of May 1, 2014, MOFCOM has announced that it will publish the names of parties being investigated in connection with "gun jumping" (or closing a transaction before receiving required MOFCOM antitrust clearance), indicating the potentially punitive function of MOFCOM's public disclosure.

Criteria for "Simple Case" Treatment

The following types of transactions may be treated as "simple cases":

- "Horizontal" transactions with an aggregated market share of less than 15 percent;
- "Vertical" transactions with individual market shares in each segment of less than 25 percent;
- Combinations that are neither "horizontal" nor "vertical" (e.g., involving conglomerates) with individual market shares in relevant businesses of less than 25 percent;
- The establishment of joint ventures operating entirely outside of China (but meeting relevant revenue thresholds);
- Acquisitions of foreign assets or securities of companies operating entirely outside of China (but meeting relevant revenue thresholds); or
- Reductions of the number of controlling shareholders in joint ventures (i.e., through buyout by existing shareholders).

However, MOFCOM has discretion not to apply this designation, even if one or more of the above conditions apply. For instance, it may refrain from granting a simple case qualification if:

- It is hard to define the relevant market(s);
- High barriers exist to enter the relevant market(s);
- Technological improvements may be adversely affected;
- The transaction may harm customers, other market participants, or China's national "economic development";
- MOFCOM receives third-party complaints; or
- It obtains evidence concerning adverse effects on competition, etc.

Voluntary Consultation to Seek Simple Case Treatment

Under the new rules, parties to a transaction may now choose to submit a written application to MOFCOM to arrange for a discussion with the AMB (officially called a Consultation) regarding whether a potential transaction is likely to meet the standards for "simple case" treatment. However, the requirements for the written application are not specified, and it appears that any feedback given by the AMB would be informal and nonbinding, so the practical significance of these Consultations is not clear.

If the parties decide to try to file a concentration as a "simple case" (whether or not they have previously elected for a Consultation), they must submit the following application documentation: a notification letter, an analysis of the effects on competition in the relevant markets, the relevant transaction agreements, audited financial reports, and other documents and materials which MOFCOM may request during the procedure. Compared to a standard merger filing, these documentation requirements should be somewhat less burdensome. Furthermore, MOFCOM requires the parties to submit an electronic notification form describing certain information regarding the proposed transaction. This digital information would then be published on the AMB website to inform, and invite comments from, third parties.

Outlook

It remains to be seen to what extent these new rules will lessen the burden of document preparation by the parties to a transaction, and to what extent they will speed up the antitrust merger review process in China. Even though these rules provide no assurances to qualifying transactions, and apparently allow MOFCOM to withdraw the "simple case" qualification at any time, even a few days before the end of Phase I review, they do show MOFCOM's intention to develop a more transparent and more effective antitrust merger review process. This is a good starting point in the development of an expedited review process for less sensitive transactions, and it is expected that future official promulgations will help clarify what this "fast-track" may entail in terms of timing.

European Union

In December 2013, the European Commission (EC) adopted legislation to simplify the procedure for review of transactions under the EU Merger Regulation (EUMR). This reform package, which came into effect on January 1, 2014, extends simplified treatment to more merger "notifications" submitted to the EC, reduces the information that parties have to submit and streamlines the pre-notification process. The reform package is comprised of a revised Merger Implementing Regulation, a Notice on Simplified Procedures and revised notification forms (i.e., Form CO, Short Form CO and Form RS).

Expansion of Simplified Procedure

The most important element of this new package is a broadened scope of non-problematic transactions that qualify for simplified treatment under the EUMR. Under the simplified procedure, companies may provide significantly less information in their merger filing than under the ordinary procedure, and the EC can clear a transaction without conducting a market investigation on the anticompetitive effects of the transaction. It is expected that approximately 60–70 percent of all transactions subject to merger filing in the EU will be treated under the new simplified procedure (approximately 10 percent more than under the former rules).

The new rules also broaden the scope of transactions that may qualify for the simplified procedure by increasing qualifying market share thresholds. The types of cases qualifying for simplified procedures under the new rules are as follows:

- "Horizontal" transactions with an aggregated market share of less than 20 percent (raised from 15 percent);
- "Vertical" transactions with individual market shares in each segment of less than 30 percent (raised from 25 percent);
- Transactions in which combined market shares are between 20 percent and 50 percent, but the increase in market share after the combination would be negligible and would not meet certain market concentration thresholds.

The "Super-Simplified Notification"

Further, the new EU rules introduce a "super-simplified notification" for joint ventures that are active entirely outside the European Economic Area (EEA). In such cases, parties only need to describe the transaction, their business activities and provide the sales figures that the EC needs in order to establish jurisdiction.

Fewer "Pre-Notification Discussions"

The new rules for simplified notifications also reduce the burden to engage in discussion with the EC prior to notification. Notifying parties usually have to discuss their draft filings with the EC before submitting a formal notification. Such pre-notification process often is useful for identifying the information that the EC's case team will need to run an efficient investigation. Certainly, the time required for the pre-notification process is often linked to the quality of the submissions that the case team receives. However, the EC has committed to keeping the pre-notification process as short as possible and, for certain simple cases, a pre-notification contact will not be necessary anymore.

More Internal Business Documents Required

Although the new rules generally reduce the amount of information that needs to be submitted for qualifying transactions, the amount of internal business documents, such as board presentations, that need to be submitted is actually increased. The new Short Form CO (the notification template) introduces an obligation for companies to submit presentations prepared for or received by members of the board management, board of directors, supervisory board and/or the shareholders meeting analyzing the relevant transaction if the transaction gives rise to horizontal overlap or vertical links. Under the former simplified procedure (old Short Form CO) no internal business documents needed to be submitted. Also, the new Form CO expands on the current Form CO's requirements for the submission of internal business documents, and covers the following additional documents: (1) minutes of meetings of the board management, board of directors, supervisory board and/or shareholders meeting discussing the transaction; (2) documents that analyze the proposed transaction in relation to alternative transaction scenarios; and (3) documents dating up to two years back that discuss the affected markets, even if such documents are not specific to the transaction. For documents falling under the second and third categories, however, the new Form CO offers the possibility of making a waiver request.

Even though the standard waiting period of 25 working days—including for even the most straightforward cases—will not be affected, the new rules regarding simplified review show the intention of the EC to reduce business costs and resource expenditure for all filings.

Outlook

The fact that the EC has widened the scope of its simplified merger review procedure is a positive development for dealmakers. This procedure allows companies to use a shorter notification form for transactions that are unlikely to raise competition problems in the EEA. Companies need to provide significantly less information, and the EC may clear qualifying transactions without investigating possible effects amongst customers, competitors and other parties. However, the new rules actually require the submission of substantially more internal business documents than were previously required, which is not a fact that has been emphasized by the EC. These changes may require companies to submit even more internal business documents than are required under, for example, items 4(c) and 4(d) of the US HSR form in relation to documents that are not specific to the transaction, but discuss the competitive conditions in affected markets. Even though the standard waiting period of 25 working days—including for even the most straightforward cases—will not be affected, the new rules regarding simplified review show the intention of the EC to reduce business costs and resource expenditure for all filings. Nevertheless, the practical effect of these rules will certainly depend on how receptive the case teams at the EC will be to various types of waiver requests in practice.

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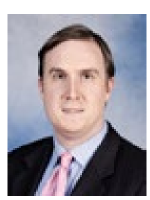

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Unleashing the Dragon: The PRC Governmental Approvals and Filings Needed to Close Deals With Chinese Companies

Yingxi Fu-Tomlinson Partner and **Steven R. Wright** Partner

Introduction

As China's economy has expanded to become the world's second largest, Chinese companies have become increasingly interested in investing abroad. Over the past few years, China has emerged as one of the most active players in the global M&A market. Though many Chinese companies have the financial capability to make significant overseas acquisitions, deal makers at potential targets are often somewhat wary of their overtures, particularly when a competitive and time-sensitive bidding process is underway. There are many reasons for this wariness, some more justified than others. However, a very real practical concern is whether a potential Chinese buyer would be able to consummate an overseas transaction in a timely manner.

PRC authorities seem to be gradually easing restrictions on outbound investment in order to assist Chinese companies in developing international presences.

Chinese companies looking to invest or make acquisitions abroad are generally subject to certain PRC governmental approval and filing requirements, which can cause delay and add uncertainty in the acquisition context. PRC authorities are mindful of these challenges and seem to be gradually easing restrictions on outbound investment in order to assist Chinese companies in developing international presences.

To provide US and international dealmakers with an understanding of what their Chinese counterparts face, and how this may practically affect deal process and execution, this article outlines key PRC governmental approval and filing requirements applicable to Chinese companies wishing to invest or engage in M&A deals abroad, including discussion of recent regulatory developments. It also provides a brief discussion of the types of internal corporate approvals typically required by Chinese companies entering into major transactions.

Unleashing the Dragon

If one thinks of Chinese companies with international ambition as dragons, they are dragons on a leash. Multiple leashes, actually. Three key authorities—the National Development and Reform Commission (NDRC), the Ministry of Commerce (MOFCOM) and the State Administration of Foreign Exchange (SAFE)—each hold a leash. If a Chinese entity is a state-owned enterprise (SOE), there may be an additional leash held by the State-owned Assets Supervision and Administration Commission (SASAC) to provide further oversight and safeguarding of state assets. These authorities use approval and filing processes to control and monitor Chinese companies' investments abroad and cross-border flows of capital.

NDRC Approval/Filing

The NDRC is charged with regulating outbound investments by Chinese companies. Its primary focus is on significant projects involving resources development or the use of large amounts of foreign exchange.

Current NDRC regulation in this area is largely based on the newly issued "*Administrative Measures for Verification and Registration of Overseas Investment Projects,*" which became effective on May 8, 2014 (NDRC Measures). Previously, almost all outbound investments were subject to formal approval from the NDRC or its local counterpart, but the NDRC Measures have significantly streamlined the review and registration process. Under the new rules, only two types of investment projects require formal approval from the NDRC, while other investments are subject to a simpler and less time-consuming filing requirement.

Projects requiring approval from the state level NDRC are now limited to: (i) projects for which a Chinese party's aggregate investment amount equals or exceeds US $1 billion; and (ii) projects involving "sensitive states and regions" (e.g., countries without diplomatic relations with China or under international sanctions) or "sensitive industries" (e.g., telecommunications operations, certain natural resources and news media). A project not falling into the above categories, for which a Chinese company's investment amount would range from US $300 million to US $1 billion, or which is a centrally administered SOE, would be subject to a filing with (but not official approval from) the state level NDRC. Additionally, any investment over US $300 million deemed an "acquisition deal" would be subject to an additional "project information reporting" requirement. Significantly, this reporting would need to be accepted by the NDRC, in its discretion, prior to the Chinese party executing binding agreements or taking other significant actions.

Projects requiring state level NDRC approval can be expected to be approved or disapproved within 20 business days after submission of an application, though the NDRC has discretion to extend this timeline. For projects only requiring filing with the NDRC, the process is expected to be completed within seven business days after submission of filing documents. Any required project information reporting should also be accepted by the authorities within about seven business days, as evidenced by a confirmation letter from the NDRC, and such reporting could potentially be filed simultaneously with the relevant approval or registration.

Projects with investment amounts of less than US $300 million, and not otherwise subject to approval or filing with the state NDRC, would generally be subject to registration with the provincial level NDRC. Though not clearly specified in the NDRC Measures, the timing for such registration should also be around seven business days.

MOFCOM Approval/Filing

Current MOFCOM Process

For any outbound investment, the MOFCOM process is the next step after the NDRC process described above. MOFCOM's focus is on monitoring Chinese companies' overall investment and M&A activities abroad.

Under the currently effective "*Measures for Administration of Overseas Investments*" (MOFCOM Measures), almost all outbound investments (excluding investments involving financial institutions and insurance companies, which are subject to a different regulatory regime) are subject to review and approval by MOFCOM and/or its local counterpart. As with the NDRC process, different levels of official review would apply depending on the type of transaction involved.

Under current regulations, state level MOFCOM approval would apply to: (i) investments in certain specially designated areas (the current list is not public, but the 2010 list included only Afghanistan, Iraq and Taiwan) or countries without diplomatic relations with China; (ii) transactions where the Chinese party's investment amount exceeds US $100 million; (iii) investments where third-party country (i.e., not China or the country of investment) interests are involved; and (iv) investments into offshore special purpose vehicles.

As a procedural matter, applications requiring approval by MOFCOM at the state level must first be submitted to the provincial level counterpart of MOFCOM for initial review, which should take approximately 10 business days. The application will then be internally handed over to the state level MOFCOM, whose official response should be issued within approximately 20 business days thereafter (excluding any time necessary for MOFCOM to consult with other relevant authorities).

The following investments (to the extent they do not fall into categories requiring state level MOFCOM approval) are currently subject to approval by the provincial level MOFCOM: (i) transactions where the Chinese party's investment amount exceeds US $10 million but is less than US $100 million; (ii) investments in the energy or mining industry not subject to state level approval; and (iii) investments where "solicitation of business in China" would be required. The provincial level approval process should be completed within approximately 20 business days (excluding any time necessary for the provincial level MOFCOM to consult with other relevant authorities).

For investments below US $10 million that do not fall into any of the categories described above, a "simplified and expedited process" is generally now applicable. Under this process, investors are only required to submit an application form to the provincial level MOFCOM, who will then review such documentation. If the matter does not raise concerns with the reviewing officials, an approval certificate should be issued within three business days after submission.

Draft Amendment to MOFCOM Measures

In conjunction with the recent overhaul of the NDRC process, MOFCOM promulgated draft Amended MOFCOM Measures on April 16, 2014. According to the draft measures, the MOFCOM process will also be modified from the current "approval"-based approach to a "registration"-based one. If adopted, only investments involving "sensitive states and regions" or "sensitive industries" (similar to designations in the new NDRC process) would be subject to state level MOFCOM review and approval. For other investments, investors would only need to submit a registration form to, and register with, the competent MOFCOM, which would be quite similar to the current "simplified and expedited process" for smaller investments in terms of process and timing. It is likely (though not certain), that the draft will be followed by legally effective measures (likely to be substantially similar) before the end of the year.

The SAFE Process

Now comes the "show me the money" process. Since exchange of foreign currencies is still restricted by the Chinese government, wiring investment capital offshore from China requires registration with the State Administration of Foreign Exchange (SAFE). SAFE is the gatekeeper of the flow of foreign exchange into and out of China.

The *Rules on Foreign Exchange Administration of Overseas Direct Investment by Entities in China* (SAFE Rules) set forth the basic SAFE process for outbound investments. To proceed with the SAFE process for remitting purchase price offshore, a would-be Chinese investor needs to first complete related formalities with the competent NDRC and MOFCOM authorities, as discussed above, and then present proof of completion to the relevant local counterpart of SAFE. The timing for obtaining registration is unclear under the applicable rules and may vary depending on location. In practice, the registration period may typically take from two to three weeks.

Once the registration certificate is issued, the investor may arrange for bank account opening and capital remittance. The total amount of foreign exchange remitted offshore in this way may not exceed the amount filed and registered with SAFE.

Additional SASAC Approval/Reporting Potentially Applicable to SOEs

When SOEs or their affiliates (almost two-thirds of China's 500 largest domestic companies have some state ownership) make an outbound investment, such investments may require approval by or reporting to SASAC, either at the state or local level, which would typically occur after any required project information reporting with the NDRC, but prior to formal NDRC approval/filing. If necessary, this approval process may take approximately 20 business days to complete.

Shanghai Free Trade Zone: A Game Changer?

It is worth mentioning that the PRC government has recently launched a series of pilot programs to loosen regulatory controls over investment and trading activities in the Shanghai Free Trade Zone (FTZ). For outbound investments by companies registered within the FTZ, the approval/filing requirements and processes are quite different from those applicable elsewhere in China. According to the currently effective rules, if a project does not deal with "sensitive states and regions" or "sensitive industries" and doesn't involve certain complicated investments, then the project can be filed directly with the Administration Committee of the FTZ in two successive filings, which would essentially replace the NDRC and MOFCOM processes described above and which could each be completed within five business days. Currently, it appears that normal SAFE procedures would apply for outbound investments originating from the FTZ. However, it is possible that the authorities will streamline this process for the FTZ as well, and it is expected that the pilot programs within the FTZ may serve as a model for nationwide reforms in the future.

Other Approvals

Internal Corporate Approvals

Of course, the above-referenced PRC governmental approvals/filings are in addition to Chinese companies' internal corporate approvals. For privately held companies, this generally involves board and/or shareholder resolutions, which may not be different from international norms. For SOEs, this may involve multiple levels of internal/parent entity approvals, which can delay transactions by weeks or months depending on the availability of required individuals. Additionally, it is worth noting that outbound investment by a PRC listed company may trigger certain disclosure and reporting obligations under relevant listing rules.

Interaction with Non-PRC Approvals

Separately, of course, the jurisdiction in which the target company is located is likely to have regulatory approvals that may be applicable to acquisitions by foreign buyers, e.g., HSR antitrust and/or CFIUS national security filings in the US. These processes could potentially be undertaken simultaneously with required PRC processes (but after any required NDRC "project information reporting" confirmation).

PRC governmental approvals/filings are in addition to Chinese companies' internal corporate approvals.

Dealmakers need to consider the time required for the various PRC approvals/filings and how this will affect the overall timing and stages of a potential transaction.

What Do All the Approval/Filing Requirements Mean to a Deal?

First, US and international dealmakers should be aware that their Chinese counterparts need to go through various regulatory processes in order to legally make an investment or acquire a business abroad and to remit related funds offshore. This is an important due diligence item and a critical condition to closing.

Secondly, dealmakers need to consider the time required for the various PRC approvals/filings and how this will affect the overall timing and stages of a potential transaction. The approvals/filings required for a Chinese company's outbound investment can be expected to take anywhere from around six weeks for less-sensitive smaller transactions involving private Chinese companies, to six months or more for larger acquisitions involving SOE acquirers. To address the risks arising from PRC governmental approvals/filings (and, when applicable, other regulatory approvals such as the CFIUS process), sometimes targets would request, and Chinese companies may agree, to have a non-refundable deposit placed in escrow, which would be released to the target if the transaction falls through due to such regulatory issues.

Finally, dealmakers should bear in mind that economic dynamics and political undercurrents in China can change quickly. For now, recent changes in NDRC requirements and planned revisions to relevant MOFCOM rules point to a trend of more streamlined domestic regulatory processes that will likely continue in the near future, and the Shanghai FTZ pilot programs could be a game changer if similar reforms are rolled out nationwide. If so, the dragon of China's foreign investment potential may finally be unleashed.

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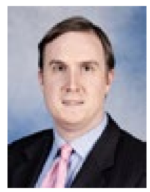

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