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Legal Update

Asia Investment in the United States – Preparation Brings Opportunities

Introduction

Despite recent economic, public health and geopolitical challenges, Asia companies with a long-term global vision can benefit from US expansion through organic growth and collaboration with US parties. The United States remains an attractive market for Asia companies to develop new partners, markets, products, and innovation. In addition, certain US parties are seeking Asia partners to grow their businesses and would welcome an Asia company's investment and collaboration. This is especially true to the extent the initiative would help grow the US business in the US market and, through cooperative efforts with the Asia partner, enable a US company to expand its products and services in Asia markets.

While there are certainly many hurdles in an Asia company successfully completing a cross-border project in the United States or with US parties, Asia companies that are prepared to address US regulatory and other legal issues head-on have a greater chance of finding the right opportunity to grow their business while still managing deal execution risk.

US Regulatory Challenges

One of the key challenges for Asia companies in acquiring or investing in US businesses and certain technologies is complying with US national security rules and regulations. The Committee on Foreign Investment in the United States (CFIUS), the committee authorized to review certain transactions involving foreign persons, has seen its authority expanded with the enactment of the Foreign Investment Risk Review Modernization Act (FIRMMA"). FIRMMA was signed into law in 2018, and the final rules and regulations to implement FIRMMA became effective February 13, 2020. CFIUS, traditionally authorized to review transactions "by or with any foreign person which could result in foreign control" of a US business (now called a "covered control transaction," now has expanded jurisdiction over (a) real estate transactions situated near specified ports and sensitive government and military installations and (b) non-controlling investments by foreign persons (who gain certain rights) in US businesses involving critical technologies, critical infrastructure or sensitive personal data (the "TID US Businesses"), called "covered investments."

For most covered control transactions and covered investments (collectively called covered transactions), whether to file is a voluntary question for parties to a transaction. However, receiving approval from CFIUS is the only way to legally guarantee that CFIUS or the President

will not subsequently review a transaction post-closing and impose changes on the transaction to mitigate any risk to US national security, or force a divestment.

CFIUS filings are now no longer voluntary but mandatory for (1) investments in US businesses that deal in "critical technologies," and (2) the acquisition of a "substantial interest" (i.e., a voting interest of 25% or more) in a TID US business by a non-US person in which a foreign government has a "substantial interest" (i.e., a voting interest of 49%).[i] CFIUS also now permits a short-form filing called a Declaration, in addition to the longer-form Notice, and recently imposed a filing fee for Notices that is based on the dollar size of the transaction (See CFIUS Institutes Filing Fees for Notices, Effective May 1, 2020.)

In addition to FIRMMA, trade agreements between China and the US further restrict technology transfer transactions. Specifically, China agreed that it would not support or direct US investments with the objective of acquiring foreign technology to reach its industrial policies, pursuant to the US-China Economic and Trade Agreement, effective by February 14, 2020.[ii] Similar to the rules under FIRMMA, trade restrictions and guidelines continue to be in development. (See, e.g., US Department of Commerce Announces Rules to Restrict Exports to China and Other Countries of Concern.)

CFIUS and US technology transfer restriction rules are key threshold issues in evaluating a US expansion opportunity. However, if addressed early on, these issues can oftentimes be managed or, at a minimum, identified early in the deal process prior to significant costs being incurred or the existence of a possible transaction being publicly disclosed. Many US investment and expansion opportunities do not pose US national security concerns or can be managed by proactively taking steps to address the concerns of US governmental and private parties. In these cases, expanding operations in the United States and investing in US companies can be welcomed by US parties and local governments, especially where the project will lead to more US jobs and economic growth and/or create opportunities for US companies to expand in Asia.

Key Considerations for Potential Investments in US Companies

From the perspective of a US company or stakeholder, one of the primary reasons to work with an international party over a US domestic party on a transaction is the potential for greater value creation. Oftentimes, this means that the international party is willing to pay a higher price than a US party. However, beyond the purchase price, a US party that is continuing to be part of the business going forward may also be considering other value creation drivers such as entering into a strategic alliance whereby new businesses and markets are jointly developed or risks shared. In light of the various business challenges arising from volatile geopolitical, economic and public health issues, US and Asia parties collaborating on alliances – whether they be in the form of strategic (but non-controlling) investments, partnership arrangements or joint ventures – may become more prevalent.

Below are some considerations for an Asia company or investor in evaluating and successfully implementing a US expansion initiative.

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[i] See "CFIUS Proposes Rule to Refine Mandatory Filing Requirements and Tie the Critical Technologies Requirement Solely to Export Control Authorizations" (Mayer Brown, May 22, 2020); "Regulations Expanding Review of Foreign Investment in the US Are Now Effective" (Mayer Brown, February 14, 2020); "CFIUS Annual Report Further Demonstrates Scrutiny of Foreign Investments Is on the Rise" (Mayer Brown, December 3, 2019) *and* "Technology, Investment and Security: The Modernization of CFIUS - What Does it Mean for the Global Investor?" (Mayer Brown, November 7, 2018).

[ii] See "US-China Phase One Trade Deal—Key Provisions" (Mayer Brown, January 16, 2020).

I. PLANNING STAGE CONSIDERATIONS

The following factors may help an Asia investor decide whether it wants to acquire a new US business or build an existing business organically (the so-called "Buy vs. Build" decision).

- **Regulatory matters**. Determine how likely and how costly it would be to obtain required regulatory approvals for the proposed transaction (in the United States and other relevant jurisdictions), especially in light of the recent changes in foreign direct investment regulations in the United States and Asia. In addition to conducting a preliminary US national security screening analysis, a particular transaction may need to obtain approvals for antitrust and other regulatory approvals specific to an industry or a location.
- **Operational challenges**. Evaluate any operational challenges from business integration and different expectations of US customers and workers, as well as how best to deal with the local social, economic and political environment.
- **Employee considerations**. Identify the appropriate US or foreign employees that are important to the business early, to better assess employment-related costs and compliance with employment laws in the United States, such as wages and hours, workplace safety, workers' compensation and anti-discrimination laws, to name a few. Employment relationships are generally governed by the laws of the state in which the employee works, and under most state laws, the default is "at-will" employment, meaning the employee or employer can terminate the employment relationship at either party's option at any time. Some states may accept non-competition or other restrictions imposed by employers on employees while other states do not.
- **Tax matters**. Analyze US and international tax matters to determine the optimal tax structure for the transaction and the entities that enter into such transaction (e.g., determine what type of US entity should be formed in what state). Potential Asia investors should also understand any tax laws and regulations that impact the combined business, such as US transfer pricing regulations, which generally require intercompany transactions with non-US related parties to be priced at arm's length based on fair market value. Note that there may be federal, state and local tax incentives available for Asia investors depending on locations, industry-type and the number of potential new jobs to be created.

II. DUE DILIGENCE CONSIDERATIONS

If an Asia investor decides to buy or invest in a US business, conducting due diligence on the target business is important to confirm valuation and identify any deal issues. While there are many different due diligence approaches, prioritizing and focusing on the evaluation of key value drivers and deal risks during the early stage of the transaction can lead to more efficient and cost-effective results. In addition to the planning-stage considerations discussed above, below are some key legal due diligence matters to consider for a US transaction:

- Analyze the target company's organizational documents, agreements with investors (equity and debt) and employees to determine whether there are any required consents or any special payouts or other contingencies that would become payable due to the transaction.
- Identify and review the target company's material contracts with customers, suppliers, service providers and other business partners to determine, among other things, any unusual terms or the existence of any conditions that could restrict or otherwise impact the continuation of such contracts after the closing of the transaction.
- Assess COVID-19 impacts on the target business, including:
  - Target's remote working capabilities, information technology systems, data privacy compliance and cybersecurity risk.

- Target's material contracts (e.g., any risk of non-performance by any party), risk of litigation and target's business continuity planning.
- Ability of the target company to receive US federal or state financial assistance due to COVID-19 impacts.
- Labor compliance matters and employee benefits offered (or required to be offered) by the target company.
- Evaluation of updated financial information and forecasts. For financial due diligence, it is important to obtain updated financials and short-term liquidity and cash flow forecasts, as historical financial information from the last two years may not sufficiently indicate the extent of the impact on a target's business due to recent pandemic-related events, such as stock market volatility, supplier disruptions and changing consumer needs/preferences.

(See Novel Coronavirus (COVID-19): Considerations in M&A Due Diligence.)

III. NEGOTIATION CONSIDERATIONS

We have highlighted below certain provisions in primary US transaction documents that are particularly relevant to an Asia investor, with a particular focus on issues relating to impacts of COVID-19 and recent regulatory changes regarding foreign direct investment in the United States.

- **Contingent payment structures**. If the target company has suffered from short-term disruptions of its business due to COVID-19, but there is uncertainty of these impacts to long-term value, instead of lowering the valuation of the target company, parties may opt to pay a portion of the purchase price at the closing with future payments (commonly known as "earn-outs") being contingent on the target business meeting certain business or financial milestones.[iii]
- **Reverse break-up fee and/or security deposits**. In light of regulatory uncertainty involving Asia buyers, especially acquirers from China, US sellers may argue for the Asia buyer to pay a breakup fee and/or make a security deposit to shift the risk of not being able to close the transaction due to US national security review or other regulatory matters to the Asia buyer. The inclusion and amount of such fee or deposit are typically highly negotiated and vary depending on the analysis of the regulatory risk and parties' negotiation leverage.
- **Best efforts regulatory approval covenant**. Otherwise known as a "hell or high water" provision, this covenant commonly refers to a buyer's agreement to do whatever is necessary to obtain US and other jurisdictions' regulatory approvals, including agreeing to accept any regulatory conditions that may be imposed by a regulatory authority. This covenant is separate from the reverse break-up fee mechanism because a failure to comply with this covenant could result in the buyer paying damages even if the failure to obtain a regulatory approval would not trigger the payment of a reverse break-up fee. With increasing regulatory uncertainties, it is very important for Asia parties to analyze the likelihood of obtaining governmental approvals, potential regulatory burdensome conditions that would not be acceptable and customize the covenant accordingly.
- **Passive investor provisions and CFIUS cooperation covenant**. In order to obtain CFIUS approval, parties can stipulate standards and manners of cooperation or include covenants to

[iii] For additional information on non-cash considerations in an M&A deal, see "Bridging the Gap in the Post-COVID-19 World: Use of Contingent, Deferred and Non-Cash Consideration in M&A Transactions—A Practical Checklist" (Mayer Brown, May 6, 2020) or *listen to* our Podcast accessible at "Bridging the Gap: Non-Cash Consideration in Post COVID-19 M&A" (Mayer Brown, May 4, 2020).

help the buyer maintain passive investor status or otherwise increase the probability of obtaining CFIUS approval, as applicable.

- **Material adverse change closing condition**. Also known as a material adverse effect ("MAE") closing condition, the substantial deterioration of a target company's business prior to the closing could potentially permit the buyer to walk away from the deal without breaching the purchase contract in those situations where the closing occurs after a purchase contract is signed. Sellers would typically negotiate excluding from the definition of MAE a number of events that could impact the target's business such as a pandemic like COVID-19. To prevent such a broad carve-out from forcing a buyer to close a deal where the target no longer has the expected value or other benefits, the buyer could insist on retaining the right to walk away for any significant event that disproportionally affects the target business compared to the impact on other comparable companies. Determining whether an MAE has occurred or has disproportionately impacted a target company is often difficult, and US courts have not made it easier for a buyer to use an MAE provision as a walk-away right. Accordingly, the buyer may also negotiate for specific closing conditions customized to a target's valuation and business to provide a walk-away right with more certainty for specific risks.

Conclusion

While the first quarter of 2020 has seen reduced levels of M&A/investment activities in the United States due in large part to the COVID-19 outbreak and, to a lesser extent, the continuation of regulatory restrictions on foreign investment in the United States, there are still opportunities for Asia companies to partner with US parties as businesses adjust their strategies for the post-COVID-19 period. Asia is starting to recover from the global pandemic and has already adopted new strategies in dealing with COVID-19 that could be transferable to the US market through a strategic investment or alliance with a US company or developing a new US business by hiring US-based employees. Although geopolitical, economic and regulatory developments are expected to continue to evolve in this unique period, careful planning and preparation on how to address US transaction issues as outlined in this article can help to increase the success of completing a US expansion project and reduce deal risk.

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