Mergers&Acquisitions

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Q & A

Spotlight on **R&W Insurance**

BY DAVID F. BIRKE
AND CRAIG P. WARNKE

The following is a Q&A interview with Akerman's David Birke, co-chair of the firm's M&A and private equity practice, and Craig Warnke, a managing director in Marsh's transactional risk practice.

The interview outlines the surge in interest in and utilization of representations & warranties insurance over the past few years, factors in deciding which of the burgeoning number of insurers to select, and the increased breadth of coverage available. Also discussed are other considerations of which prospective insureds should be aware before purchasing these increasingly important policies for their transactions.

David Birke (Akerman): Less than 10 years ago, some buyers offered representation & warranty policies to try to gain a competitive advantage in an auction process—or sellers might purchase a sell-side policy. Now it seems as though every seller expects the buyer to purchase a buy-side R&W policy. What percentage of middle-market deals use a buy-side R&W policy as the primary source of indemnity?

Craig Warnke (Marsh): While it's difficult to put a precise percentage on the deals using R&W insurance, we can affirmatively state that it is simply market standard for middle-market M&A deals to feature a buyer-side R&W policy. The increase in usage of the product over the past two to three years in North America is tremendous and shows no signs of abating. For example, see the chart below that shows the number of transactions using R&W insurance via Marsh in North America. Given our market share and the continuation of current trends, we would estimate that in 2018, well over 1,200 middle-market M&A transactions will utilize R&W insurance.

> The expansion of the underwriter base in the R&W insurance marketplace has been **nothing short of remarkable.**

David: Early on, there were only a handful of insurers writing R&W policies. How much has the insurer base expanded and are the newcomers traditional underwriters or alternative providers?

Craig: The expansion of the underwriter base in the R&W insurance marketplace has been nothing short of remarkable. Just a few years ago, we could find that our clients had only one (or even no) option for a difficult to place risk, given the limited number of players in the market. That same risk today would likely attract multiple and attractive quotes from insurers. In 2018, there are approximately 20 credible underwriters capable of providing primary R&W insurance terms on middle-market M&A transactions, with many others willing to participate on excess layers. Given the sheer number of market participants, there is well over $1 billion of R&W insurance capacity that can be deployed on a single transaction should the need arise, which was recently validated on a transaction where Marsh placed aggregate policy limits in excess of $1 billion on a recent transaction.

The expansion of underwriting capacity has come from both traditional insurance companies as well as from managing general underwriters (MGU). For insurance companies, the R&W sector represents an attractive source of premium growth that covers risks generally uncorrelated with their overall book of business. This also made it relatively easy for experienced and entrepreneurial underwriters to start their own MGU and find insurance company partners.

David: Are buyers choosing insurers strictly based on price and exclusions or are other factors significant to the decision?

Craig: Pricing is certainly a significant factor for our clients when it comes to choosing an underwriter. In light of the prior discussion, the increase in the number of R&W insurance underwriters has led to dramatically increased competition in this sector, resulting in lower premiums across the board. We estimate that premiums for primary R&W insurance are approximately 10 percent lower than 2017 premiums (and this follows on the heels of a 9 percent pricing decrease in 2017 from 2016).

While clients are enjoying the benefits of lower pricing, our advice to them is that pricing is just one facet to consider and should not be the determining factor in selecting an insurer. We believe that the "right" insurer for a particular transaction is a function of the coverage being provided (with an emphasis on any deal-specific exclusions), ability to execute, claims-paying history, relationship(s) with the client or counsel, along with the premium.

David: Have you seen insurers getting more comfortable with risks that they seem to have previously been excluding (e.g., government reimbursement and FLSA matters)?

Craig: In short, yes. Underwriters have expanded their underwriting » Page 12

DAVID F. BIRKE *is co-chair of the M&A and private equity practice at Akerman.* CRAIG P. WARNKE *is managing director at Marsh.*

Cases Indicate There Is **Leeway for Controllers** When Determining **'MFW'-Compliance**

BY GAIL WEINSTEIN,
ROBERT C. SCHWENKEL
AND BRIAN T. MANGINO

Delaware law has long embraced the concept of expansive judicial deference to the decisions of corporate directors. The seminal *MFW* decision, in 2014, ushered in an era of even further expanded deference.

MFW provides a pathway for early dismissal of challenges to M&A transactions under the business judgment rule standard of review *even* in the context of a transaction between a corporation and its controlling shareholder. Prior to *MFW*, the more stringent entire fairness standard of review has been applicable in this context.

MFW is applicable to a controller transaction *if* the transaction was subjected ab initio (i.e., from the "outset of negotiations") to the unwaivable conditions that the transaction be approved by both (1) an independent special committee and (2) a majority of the minority stockholders (the so-called "ab initio requirement"). In addition, the committee must have been fully authorized (including to definitively "say no" to the transaction) and must have met its duty of care in negotiating the deal price; and the stockholder vote must have been fully-informed and uncoerced. The underlying premise of *MFW* is that these procedural protections, if followed, will circumscribe the controller's influence over the transaction from the outset and thus will replicate the process that would pertain to an arm's-length third party transaction (thus eliminating the need for a higher standard of review).

Whether a controller will determine to structure a transaction to be *MFW*-compliant depends on the specific facts and circumstances. In our survey of public company controller mergers (over $50 million in value) since *MFW*, roughly half appeared to be intended to be *MFW*-compliant (all involved a special committee and about half included in the merger agreement a condition that the transaction be approved by the minority stockholders). While private company merger agreements are not publicly available, in our experience, *MFW* compliance is somewhat less frequent in that context.

Typically, the primary reason for a controller determining to forgo the protections of *MFW* is to avoid subjecting the transaction to the uncertainty of the result of a minority stockholder vote. Another reason is » Page 12

GAIL WEINSTEIN *is senior counsel and* ROBERT C. SCHWENKEL *and* BRIAN T. MANGINO *are partners in the corporate department of Fried, Frank, Harris, Shriver & Jacobson.*

Political Intervention in **Global M&A**

The Development of Foreign Investment Regimes And Its Impact on Cross-Border M&A

BY JOSEPH FALCONE,
JAMES ROBINSON
AND VERONICA ROBERTS

Against a background of protectionist rhetoric, public interest and foreign direct investment (FDI) scrutiny in the M&A process is on the increase in traditionally open Western economies. From enhanced review by the Committee on Foreign Investment in the United States (CFIUS), to the expansion of the German FDI regime (with similar proposals at the EU and EU-country level), as well as with longstanding FDI restrictions in many parts of Asia, the current regulatory climate globally presents uncertainties for cross-border M&A.

The historical "level playing field" frustration when it comes to FDI restrictions has turned. Asian countries, and in particular China and India, have progressively opened parts of their economies to FDI and have streamlined their screening processes. At the same time, there is a reverse trend with more restrictive FDI regimes and more active enforcement in the United States, Europe and Australia.

Political interventions in deals in Western economies have traditionally focused on national security, defense and critical infrastructure, as well as regulated industries (though generally on "fit and proper owner" tests, irrespective of nationality). The scope of many Western FDI regimes is now being extended to cover the acquisition of sensitive data, high tech industries and critical technologies by foreign entities.

This article focuses on the increasing government FDI intervention in Western economies and compares that to Asian governments' differing approach as they look to encourage FDI in their emerging economies.

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CFIUS

CFIUS is certainly the most interventionist Western regime at present and, following President Trump signing the Foreign Investment Risk Review Modernization Act (FIRRMA) in August 2018, can be expected to continue to be so.

Recent CFIUS impacted deals include: Broadcom's proposed acquisition of Qualcomm (March 2018); Ant Financial's proposed acquisition of MoneyGram (January 2018); and Canyon Bridge Capital's proposed acquisition of Lattice Semiconductor (September 2017—via Presidential order).

While FIRRMA was a less restrictive response than some had anticipated given the protectionist political rhetoric, it will bring a renewed level of scrutiny to foreign investments into the United States (and foreign investments into non-U.S. target companies which have U.S. business operations).

Most notably, FIRRMA expands CFIUS "covered transaction" jurisdiction over control investments to include: (1) real estate purchases near sensitive national security facilities (codifying current CFIUS practice); (2) transactions in connection with bankruptcy; (3) transactions designed to "evade or circumvent" CFIUS review; plus, importantly, (4) non-controlling investments in U.S. businesses holding critical technology and infrastructure or personal data of U.S. citizens, from countries that pose a particular national security concern. In addition, the legislation revamps the CFIUS process, including adding: (1) a permissive declaration route to expedite clearance of transactions with less significant national security concerns; and (2) a mandatory declaration where the acquirer is state-owned and the acquisition would give a non-U.S. government a "substantial interest" in U.S. critical infrastructure or technology, or in U.S. citizens' personal data.

Questions about how CFIUS will implement FIRRMA remain. While certain provisions took effect immediately or will within 18 months, many of the details must await the issuance of new regulations by CFIUS, a process that can take months, if not years, to complete.

That said, FIRRMA has clearly codified into law the recent heightened CFIUS scrutiny of transactions by non-U.S. deal parties, particularly in the technology, telecom and infrastructure sectors.

EU-Wide Regime

With pressure from France and Germany to take action in this area, the EU Com- » Page 10

JOSEPH FALCONE *is a disputes partner,* JAMES ROBINSON *is a corporate partner and* VERONICA ROBERTS *is a competition regulation and trade partner at Herbert Smith Freehills.*

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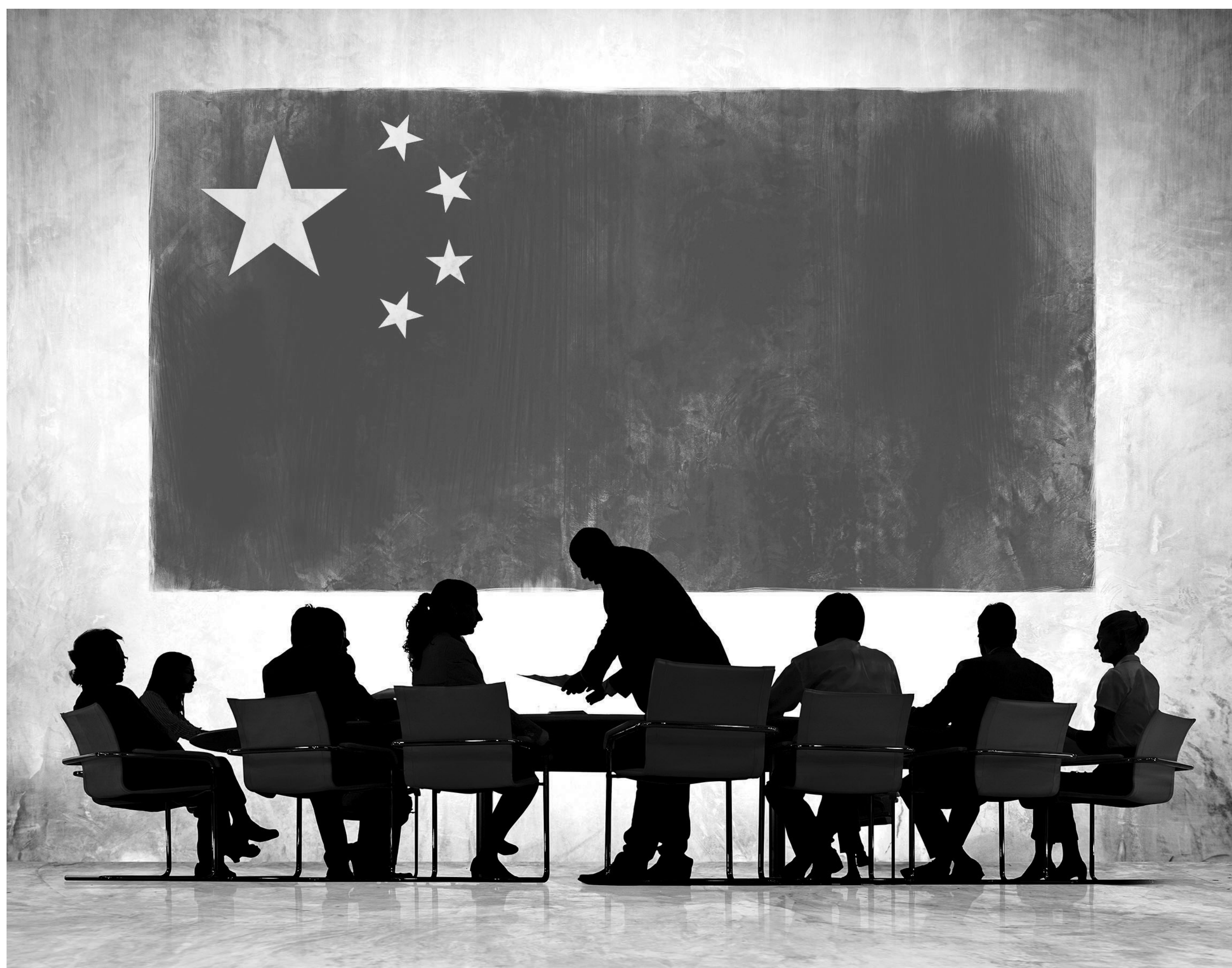
MERGERS & ACQUISITIONS: Angela Turturro, Sections Editor | Monika Kozak, Design

China Targeted M&A Re-Emerges in SPAC World

BY JIE XIU
AND BRIAN C. DAUGHNEY



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Recently there has been an uptick in China targeted mergers and acquisitions using the formerly and again popular reverse-merger concept through special purpose acquisition companies (SPACs).

For purposes of this discussion, "China targeted" includes businesses that may be located in China or based in the United States which cater to the domestic China community. In this article, we will examine some of the legal and regulatory issues, the structural characteristics of these transactions, and the relevant factors driving this recent trend.

Background of Market for China Targeted SPACs

The use of a SPAC vehicle to complete mergers and acquisitions with China targeted companies is not new. This activity reached a high point in May 2008, when the SPAC entity Nuverra Environmental Solutions completed its $400 million public offering. Later that year, Nuverra acquired a Chinese company engaged in the bottled water business in China, China Water and Drinks, in a reverse acquisition. Soon after the closing of this transaction, M&A activity in the United States for China targeted companies decreased significantly due to several factors, including the discovery by the U.S. Securities and Exchange Commission of fraudulent activities centered on the accounting standards of Chinese companies in reverse mergers in 2008 and 2009, and the global economic crisis during and following those years.

The last two years have seen renewed interest in M&A activity for China targeted companies, particularly through the use of SPACs. In June 2018, Thunder Bridge Acquisition (TBRGU) completed its IPO and listed on NASDAQ, raising $225 million. Its acquisition targets will be in the financial services and financial technology industries. Also, in June 2018, New Frontier completed its listing on the NYSE, having raised $200 million to acquire a health care, technology or education business in China. In August 2018, Tottenham Acquisition I Limited, raised $46 million to acquire a target business focused on operating businesses in the technology, media, telecom, education, e-commerce, health-care and consumer goods industries with primary operations in Asia (with an emphasis in China).

The surge in activity has continued in recent months. August 2018 saw the closing of two additional China targeted acquisition SPACs, TKK Symphony Acquisition Corporation and Longevity Acquisition Corporation, which collectively raised $260 million. Underlining the breadth and scope of China-targeted activity, TKK intends to seek an acquisition opportunity of "consumer/lifestyle assets that may have particular application for the PRC market" while Longevity Acquisition seeks to acquire a China based entity in order to "add value to these [China] businesses primarily by providing them with access to the U.S. capital markets."

Recently in August 2018, Atlantic Acquisition, a SPAC created to merge with a target company in the Chinese food industry, announced that it successfully completed its business combination with HF Group Holding Corporation, a predominantly Chinese-managed food logistics company based in the United States. The business combination had a total transaction value of approximately $300 million and the company is now known as HF Foods Group and trades under the symbol HFFG on NASDAQ. (Becker & Poliakoff and Ms. Xiu, Mr. Daughney and Ms. Klein served as counsel to HF Foods Group.)

Legal Issues Related to SPACs

A SPAC is a shell company formed for the express purpose of raising funds in an underwritten public offering under the Securities Act of 1933, and which has no business operations. The business purpose is to locate one or more suitable target businesses to acquire and merge into the SPAC. Under SEC Rule 419, SPACs are not treated as "blank check" companies because they raise and hold funds in excess of $5,000,000. This exemption allows the securities of the SPAC to publicly trade until the acquisition is complete. Additionally, treatment of SPACs is less onerous in the fully registered IPO process for NASDAQ or NYSE listed companies under state "Blue sky" laws than smaller Rule 419 offerings. Generally, however, SPAC offerings follow many of the traditional Rule 419 standards, including:

- funds from the IPO are held in trust for the benefit of investors if an acquisition is not consummated,
- any acquisition must represent 80 percent of more of the proceeds held in trust;
- the acquisition must occur within a specified time frame (generally 18 to 24 months following the IPO); and
- stockholders of the SPAC must have the right, following full disclosure under the SEC's proxy rules, to approve or disapprove the proposed acquisition, and convert no votes into their pro rata portion of the IPO funds held in escrow—essentially to get cashed out.

Although there are many variations on the theme, to be attractive to underwriters and investors, several considerations must be addressed by the SPAC sponsors. SPACs generally need to be led by an experienced management team with specific industry sector expertise or significant M&A experience. SPACs need to qualify for either NASDAQ or NYSE listing. SPAC offerings are comprised of units of securities, with shares of common stock combined with either warrants or rights to acquire additional shares. The SPAC unit initial offering price is almost always $10.00 and following the IPO, the units become separable and the public trading market includes the units, common stock and warrants (or rights). The funds held in trust must equal and often exceed the funds raised in the IPO. These excess funds come from insider purchases completed prior to or simultaneously with the IPO. SPAC sponsors may need to agree to additional purchases of equity (usually by exercising warrants) and a post-acquisition trading lock-up of shares.

> The last two years have seen **renewed interest in M&A activity** for China targeted companies, particularly through the use of SPACs.

From the practitioner's viewpoint, counsel to the SPAC and any target companies will need to be familiar with and ensure compliance with the public offering process under the Securities Act of 1933; how to negotiate terms with underwriters for the IPO; the SEC's disclosure requirements for registered companies under the Securities Exchange Act of 1934; the SEC's proxy statement requirements in the mergers and acquisition context; and NYSE or NASDAQ listing requirements. Counsel will also need to focus on various voting structures or control or blocking agreements within the SPACs corporate governance documents to facilitate successful completion of the acquisition vote.

Why Are SPACs Attractive For the China M&A Market?

The surge of China-targeted SPACs is driven mostly by target side dynamics. Entrepreneurs involved with China targeted companies are typically interested in merging with a U.S. SPAC to increase visibility, obtain enhanced prestige of becoming a U.S. listed public company, and enable them to obtain liquidity out of China. On a macro level, the size and breadth of the China-targeted market, not just in China but throughout Asia and in the United States, provides large scale opportunities for continued growth.

Further, Chinese entrepreneurs who own or control operating companies are seeking to tap into the China based investor class as a base for their holdings, using the attraction of a U.S. listed post acquisition SPAC company. As China continues its economic expansion through the private sector, technological innovation, structural and economic reforms and demographic changes, the need to enter the U.S. equity markets to fund this growth will increase.

Chinese entrepreneurs are also attempting to diversify their holdings in China by expanding globally, and using the stock of a U.S. public company will assist them in making acquisitions in the United States. In contrast to the steep political hurdles for listing in China, SPAC IPOs completed in the United States are more efficient. Further, U.S. equity listings facilitate foreign exchange for RMB-funded PRC companies.

Challenges Facing Chinese SPACs

Going public in the United States is a major undertaking and not without challenges. The political sparring between China and the United States on tariffs and the U.S. government's increased scrutiny over Chinese deals may cause hiccups in the M&A market, including valuation issues.

The fallout caused by the reverse merger accounting issues from several years ago still affects investors' opinion of Chinese companies and questions are still raised on the reliability of their financials. These issues are compounded by the corporate governance challenge of board oversight and general compliance and regulatory concerns that must be addressed since the principals of many China-based entities are unfamiliar with U.S. corporate law concepts such as fiduciary duty and conflicts of interest.

Conclusion

Opportunities for Chinese companies or businesses targeting the China community to access U.S. capital markets have recently increased dramatically through a variety of business combination vehicles that avoid the uncertainty of a traditional IPO. China-target SPACs are providing a new wave of public listings and business combinations in the United States. These Chinese and U.S. combined post acquisition entities provide investment opportunities to both U.S. and Chinese investors but require legal and business oversight by experienced practitioners and corporate directors.

JIE XIU *and* BRIAN C. DAUGHNEY *are shareholders in the New York office of Becker & Poliakoff. Shareholders* STEVEN GLAUBERMAN *and* MICHAEL GOLDSTEIN, *and attorney* SARAH KLEIN, *assisted in the preparation of this article.*

Intervention

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mission tabled draft legislation in relation to FDI screening on public security grounds in September 2017. Amended and approved by the European Parliament in June 2018, the Commission, Council and the Parliament's Committee on International Trade (the "trilogue") have prioritized reaching an agreement before the May 2019 European elections.

The draft does not propose a power for the Commission itself to screen and block foreign investments—very difficult politically—instead, it proposes: (1) a set of minimum requirements for such controls if EU-countries choose to put them in place, e.g., on grounds of security or public order, and as to transparency, timing and judicial review; and (2) coordination mechanisms between EU-countries and the Commission, including a power for the Commission to review investments in projects of wider EU interest and issue a non-binding, but nonetheless influential, opinion (e.g., if not followed, an explanation of "why not" must be provided to the Commission).

For grounds of security or public order, the draft proposes limiting the review to considerations of the potential effects on: (1) critical infrastructure (including energy, transport, communications, data storage, space and financial infrastructure, as well as sensitive facilities); (2) critical technologies (including AI, robotics, semiconductors, technologies with potential dual-use applications, cybersecurity, space and nuclear technology); (3) security of supply and critical inputs; and (4) access to sensitive information and the ability to control sensitive information.

The inclusion of critical technologies is seen by many as a reaction to mainly Chinese attempts to buy key European IP assets, e.g., Midea's 2016 takeover of KUKA.

It remains to be seen whether, and in what form, the legislation will be adopted, in particular given potential opposition from some EU-countries, such as Greece and Portugal, who see open FDI as vital. However, at the EU-country level, many have already taken steps or issued draft legislation.

German AMV Foreign Investment Restrictions

Germany revised its own 2009 FDI regime, the *Außenwirtschaftsverordnung* (AWV), administered by the Federal Ministry for Economic Affairs (BMWi) in July 2017.

Recent AWV impacted deals include: Yantai Taihai's attempted acquisition of aerospace/nuclear component manufacturer Leifeld Metal Spinning (BMWi prohibited in August 2018); State Grid of China's attempted acquisition of a 20 percent stake in transmission-operator 50Hertz (failed after the German government-owned bank KfW invested instead in August 2018).

The AWV allows the German government to block the acquisition of 25 percent or more of the voting rights of a target business if: (1) the investor is located outside the EU/EFTA; and (2) the acquisition is in the military sector or otherwise poses an "actual and sufficiently serious threat to a fundamental interest of society" such that it "endangers public order or security."

Whilst the 2017 reforms do not expand these basic grounds, they: (1) set out a non-exhaustive list of businesses where the government considers an acquisition could pose a particular threat to public order or security; and (2) provide that the signing of a purchase agreement for such businesses must be notified to BMWi.

The list of example businesses is helpful clarification, though it is a lot wider than many would have expected. It covers operators of "critical infrastructures," developers of software used by such critical infrastructures and providers of cloud computing services. "Critical infrastructures" are defined in detail by reference to particular sectors (and thresholds), including energy, water, food, information technology, telecommunication, health, financial services and transport.

In light of this relatively broad range of businesses, a considerably larger number of acquisitions are expected to be notified.

BMWi has three months from obtaining knowledge of a signed deal to decide whether it wishes to examine a transaction and, if so, has a further four months from obtaining complete acquisition documentation to impose restrictions. If a buyer chooses to notify voluntarily and apply for a clearance certificate (which may, within appropriate limits, be applied before signing), the BMWi has two months to decide whether a closer examination is required, failing which clearance is deemed to be granted. If a buyer fails to notify a transaction and the BMWi does not otherwise obtain knowledge of it, the BMWi can intervene up to five years after deal signing.

While the amendments do evidence an enhanced desire to monitor FDI and its effects on critical business areas, the basic grounds on which the government may intervene have not changed. In particular, the amendments did not introduce any powers to restrict FDI into critical technologies (such as AI, robotics, semiconductors or cybersecurity, except where expressly listed as a military application) or for reasons of industrial policies or lack of reciprocity.

A More Interventionist UK?

The UK has traditionally been one of the most open of the European economies to foreign investment. Indeed, the UK government currently has national security powers to intervene only in those transactions that meet the jurisdictional thresholds of the UK (or EU) antitrust merger control regime (subject to limited exceptions).

Following public disquiet over the investment by China General Nuclear Power in the new Hinkley Point nuclear project, in October 2017 the UK government published a consultation paper proposing to extend its powers of national security review.

In June 2018, the UK government reduced the jurisdictional thresholds for certain transactions in specified sectors: military, quantum technology and computer hardware (with one governmental intervention under these rules to date – the acquisition by Chinese-controlled Gardner Aerospace of Northern Aerospace, cleared in July 2018).

Then, in July 2018, the UK government published a White Paper setting out its proposals for a more significant overhaul, enabling the government to review transactions for national security risks on an economy-wide basis, with sectors most likely to give rise to national security concerns to include national infrastructure, advanced technologies, direct suppliers to government/emergency services and dual-use technologies.

The proposed national security review will be a distinct regime with no turnover/market share requirements, so with the potential to capture smaller transactions. The triggers would be share acquisitions of 25 percent or more, or the acquisition of significant influence over an entity or asset. It would be a voluntary notification system, with the right to intervene where parties choose not to notify, and a six month call-in period post-completion.

The UK government has stressed that the UK remains open for investment (particularly important post-Brexit) and emphasizes in the White Paper the narrow national security grounds for review. However, Prime Minister May has previously declared the need for a "proper industrial strategy" to protect strategic interests (citing Pfizer's attempted 2014 acquisition of AstraZeneca). The UK government expects to introduce a new regime from around May 2019.

Asia-Pacific

Whilst Western states demonstrate an increased tendency to enact protectionist FDI-related policy, the reverse has been true in the Asia-Pacific region. In 2016, the Asia-Pacific saw the adoption of 52 FDI-related policies, 43 of which were facilitative of foreign investment. Between January 2017 and June 2018, 47 of the 74 FDI-related policies adopted in the region were characterized by the UN Economic and Social Commission as "liberalising" (with the remainder falling into the bracket of either "neutral" or "restrictive").

During this latter period, it was China, India and Vietnam that were most active in this field with their policy-making activities weighted heavily towards measures that would liberalize their respective FDI regimes. Such efforts are reflected in the numbers, with 2018 seeing China attract a record $136 billion in investment, making it the second highest recipient of foreign capital worldwide.

This trend does not, however, hold true for every state in the Asia-Pacific region. In recent times, the region's fourth most active policy-maker in this sphere has been Australia. However, despite being well-known for its strong and well-established FDI regime, over 70 percent of its recent policy amendments have either been regulatory or restrictive of FDI.

Australia has displayed a particularly protectionist approach to FDI from China. There has been recent political debate as to whether Australia's Foreign Investment Review Board should allow a A$13 billion bid from a Chinese entity to buy APA Group and this tendency is likely to continue following the recent appointment of Scott Morrison as Prime Minister. During his time as federal Treasurer, Mr. Morrison gained somewhat of a reputation for blocking Chinese investments. Examples include blocked bids for electricity distributor, Ausgrid and for Australia's largest private landowner, S. Kidman and Co. Limited.

Conclusion

In summary, the key impacts of foreign investment regimes on cross-border M&A are: (1) possible FDI approvals will need to be considered early, i.e., alongside antitrust merger filings; (2) FDI regimes are more unpredictable than antitrust reviews, with broader discretionary governmental powers and less transparency of decision-precedents, so early engagement with the relevant authorities is likely to be advisable; (3) given many regimes are suspensory, timing of deals may be significantly impacted; and (4) competing bid or, where hostile, defensive scenarios will be more complex.

Balancing Minority Equityholder Rights and Acquirer's Ability to Consolidate Under **U.S. Accounting Rules**

BY LLOYD L. ROTHENBERG AND MEGAN STOMBOCK

The consolidated financial statements for the results of operations and financial position of a group of companies are required to be presented as if all of the companies were a single company in accordance with FASB's Accounting Standards Codification (ASC) 810-10-10-1.

There is a presumption that consolidated financial statements are more meaningful than separate financial statements and that they are usually necessary for a fair presentation when one of the entities in the consolidated group directly or indirectly has a controlling financial interest in the other entities. In general, a parent company is required to consolidate the financial information of another company if it has a "controlling financial interest" in the other company.

When a company acquires at least 50 percent but less than 100 percent of the equity interests of a private target company (a Minority Interest Acquisition), it can be difficult to ascertain whether the acquirer has obtained a controlling financial interest for purposes of the financial accounting rules. Minority equityholders will typically retain very limited control over the target company in a Minority Interest Acquisition and often negotiate certain rights over significant actions of the company to protect their interests. Such rights and protections may include the right to receive certain information about the target company or review books and records of the target company, preemptive rights, the ability to require the target company or the other equityholders to purchase their equity at a certain time or under certain circumstances (i.e., a "put right") or "tag along" rights, or the right to designate a member of the target company's board of directors (or managers) or have board observer rights. Minority equityholders often insist on having certain consent rights or require unanimous board approval (if minority equityholders have a board seat) before the target's management (which is typically controlled by the acquirer) can make certain decisions or take certain actions that could have an adverse impact on the minority equityholders. These rights include the company's ability to (1) change the target's business or enter into a new line of business; (2) dissolve or liquidate the target; (3) amend or terminate any organizational or governing document; (4) sell the target or issue any equity interests of the target; (5) acquire or dispose of assets or equity interests outside the ordinary course of business; (6) incur certain indebtedness or encumber assets; (7) make certain distributions or redemptions; (8) enter into, terminate or amend material contracts; (9) approve or materially change the budget; (10) enter into any affiliate transaction; or (11) hire or fire certain employees or substantially change their compensation.

LLOYD L. ROTHENBERG *is a partner and deputy chair of Loeb & Loeb's capital markets and corporate practice.* MEGAN STOMBOCK *is a senior associate in the practice.*

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If an acquirer in a Minority Interest Acquisition desires to consolidate for financial accounting purposes, tension can arise between the acquirer obtaining an adequate controlling financial interest in the target for financial statement accounting purposes and minority equityholders retaining adequate rights and protections—especially where an earnout or other contingent consideration is involved and/or the minority equityholders' remaining equity interests will be sold to the acquirer pursuant to puts and calls in subsequent years.

In this article we will first explain the financial statement consolidation rules generally in connection with Minority Interest Acquisitions and propose potential solutions to balance minority equityholders rights and protections and an acquirer's ability to consolidate under the financial statement consolidation rules.

Financial Accounting Consolidation Rules Applicable to Minority Interest Acquisitions. ASC 810 provides two financial accounting consolidation models under U.S. GAAP—the variable interest model and the voting interest model. The starting point in considering whether an entity is eligible for consolidation is to determine whether such entity is a variable interest entity (VIE). If it is determined that the entity is not a VIE or a scope exception from the VIE model applies (e.g., the subsidiary entity is a non-profit, employee benefit plan, governmental entity, or investment company), you then analyze the relationship of the entities under the voting interest model. The special rules under ASC 810 applicable to limited partnerships and the rules under the International Financial Reporting Standards (IFRS) are beyond the scope of this article.

> Minority equityholders will typically retain **very limited control over the target company** in a Minority Interest Acquisition and often negotiate certain rights over significant actions of the company to protect their interests.

Variable Interest Model. Under the VIE model, the reporting entity must have a variable interest in a legal entity. A variable interest is generally an economic relationship with a legal entity that absorbs risk or is entitled to the rewards of the entity. A legal entity is generally any legal structure used to conduct activities or to hold assets.

If a reporting entity has a variable interest in a legal entity, then it must determine whether the legal entity is a VIE. If any one of the following 3 criteria is satisfied, the company is a VIE.

(1) The entity lacks sufficient equity at risk, e.g., the company is not sufficiently capitalized or highly leveraged.

(2) The equity investors at risk as a group lack the characteristics of a "controlling financial interest", i.e.:

- The power to direct the most significant activities of the legal entity.
- The obligation to absorb the expected losses of the legal entity.
- The right to receive the expected residual returns of the legal entity.

(3) The legal entity is structured with disproportionate voting rights, and substantially all of the activities involve or are conducted on behalf of an investor with disproportionately few voting rights.

If the legal entity is a VIE, you next determine whether the reporting entity has a "controlling financial interest" in the legal entity, and thus, is the VIE's primary beneficiary. A reporting entity will be deemed to have a "controlling financial interest" in a VIE if it has both the power to direct the activities of the VIE that most significantly impact the VIE's economic performance (the "power criterion") and the obligation to absorb losses or the right to receive residual returns of the VIE that could potentially be significant to the VIE.

Part of the power criterion analysis is determining the party that makes the significant decisions or controls the activity or activities that most significantly affect the VIE's economic performance, including whether there is another party that has to consent to important decisions or that can force the reporting entity to take certain actions. Protective rights, e.g., approval or veto rights that do not affect the activities that most significantly impact the entity's economic performance, are permissible. In contrast, a single reporting entity that has the unilateral ability to exercise substantive rights to block or participate in *all* of the activities that most significantly affect the VIE's economic performance, would preclude a reporting entity's ability to consolidate for financial reporting purposes.

Voting Interest Model. If an entity being considered for consolidation is not a VIE, you then move to the voting interest model to determine whether control exists. Under the voting interest model, a reporting entity is presumed to control another entity if it owns, directly or indirectly, more than 50 percent of the outstanding voting shares of the entity. However, that presumption may be overcome if a noncontrolling equityholder has substantive participating rights in decisions that allow it to effectively participate in certain significant financial and operating decisions that are in the ordinary course of business.

Some rights of a noncontrolling equityholder are considered merely protective rights or not significant and do not overcome the presumption of consolidation by the majority owner. In contrast, substantive participating rights give noncontrolling equityholders the ability to participate in key recurring business decisions of the company may overcome the presumption of consolidation by the majority owner. ASC 810-10-25-13 and ASC 810-10-55-1 provide factors and examples to help reporting entities determine whether noncontrolling rights represent protective rights or substantive participating rights, including:

- Amendments to articles of incorporation or partnership agreements of the investee (protective)

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Leeway

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that the "ab initio requirement" (i.e., the requirement that the committee and minority stockholder vote conditions be imposed "from the outset of negotiations") means that the determination whether to structure a deal to be *MFW*-compliant must be made at the very earliest stage of the process, when the controller has the least sense of how things are likely to proceed.

The *MFW* decision itself emphasizes the need for "strict compliance" with the prescribed procedures (including the ab initio requirement) in order to obtain business judgment review of a controller transaction. Importantly, however, two 2018 decisions—*Olenik v. Lodzinski* (July 2018) and *In re Synutra* (February 2018)—indicate that, notwithstanding the ab initio requirement, depending on the facts and circumstances, there appears to be some leeway for controllers in terms of their timing in determining whether or not to structure a transaction to be *MFW*-compliant—at least when the substantive *MFW* prerequisites (approval by a special committee with independent directors who met their duty of care and minority stockholder approval in a fully-informed and uncoerced vote) clearly are satisfied.

In *Olenik*, Vice Chancellor Joseph Slights ruled that *MFW* applied to the challenged controller squeeze-out merger even though there had been "extensive preliminary discussions" before the *MFW*-required conditions were imposed by the buyer. The court emphasized that the ten months of discussions had been "exploratory in nature" and that "negotiations" did not begin until the buyer submitted a "definitive proposal" (in the form of a formal offer letter). We note that there were not meaningful price discussions between the parties until after the offer letter was submitted and that two months of price negotiations ensued after submission of the offer letter. In *Synutra*, Vice Chancellor J. Travis Laster ruled that *MFW* applied even though the buyer did not impose the *MFW*-required conditions until after it had already submitted a proposal to the target company (with a specified price) and the target board had met and formed a special committee. The court pointed out that the *MFW*-required conditions were imposed "promptly" (two weeks) after the initial proposal (in a "follow-up letter" reaffirming the initial proposal) and that "negotiations" did not begin until after the conditions were imposed.

Key Points

• **In 'Olenik', the Court of Chancery found that the ab initio requirement was fulfilled (and 'MFW' therefore applied) even though there had been "extensive preliminary discussions" before the buyer imposed the 'MFW'-required conditions.** The court held that, notwithstanding ten months of discussions between the controller and the company about the possible squeeze-out merger, for *MFW* purposes, "negotiations" between the parties did not begin until the buyer submitted a "definitive proposal" (in the form of a formal offer letter). The court distinguished (a) "exploratory discussions" (even if "extensive") to determine *whether a proposal would be made* from (b) "negotiations" to reach a definitive agreement *after a proposal has been made.* We note that the factual context included (1) no evidence of significant price discussions having occurred during the ten months of discussions preceding the offer letter; (2) two months of back-and-forth negotiation over pricing following submission of the offer letter; and (3) a special committee that the court viewed as having been independent and having functioned effectively.

• **'Olenik' appears to indicate that the court is not likely to find 'MFW' inapplicable based on the ab initio requirement when the other 'MFW' requirements have been clearly satisfied.** The court's discussion of the distinction between "discussions" and "negotiations," while providing helpful guidance, does not establish a clear dividing line between the two. However, we believe that the decision underscores that, in general, the court will tend to disfavor a finding that *MFW* is inapplicable based on the ab initio requirement, at least where (1) the minority stockholders approve the transaction (which, in this case, they did overwhelmingly), (2) the special committee functions effectively in overseeing the process and does not just "rubber-stamp a fully-baked deal," and (3) the initial discussions do not appear to involve a tradeoff where the controller agreed to accept the *MFW* approval conditions in exchange for a lower price.

• **Notably, in 'Olenik', the court did not find it problematic that the lead negotiator for the buyer had significant ties to the controller.** The factual context included a nine-person board, seven of whom had been appointed by the controller and five of whom were senior executives of the company and/or were serving on boards of or membership unit holders in the controller or its affiliates. The lead negotiator for the company throughout the process was "L," who was the CEO and a director of the company and had a financial interest in and significant connections with the controller. The court stated that, given L's track record and expertise in the industry, it was unsurprising that he would be selected as the lead negotiator (notwithstanding his conflicts of interest based on his ties to the controller). We note that the court (in our view, importantly) considered the special committee to have functioned effectively in actively overseeing the process and considered the two directors who comprised the committee to have been independent and disinterested.

• **'Synutra' provides another example of the Court of Chancery granting some leeway with respect to the ab initio requirement.** In *Synutra*, the court ruled that the ab initio requirement was satisfied (and therefore *MFW* applied) even though the buyer did not impose the *MFW*-required conditions until after the buyer had already submitted a proposal (with a specified price) to the target company. Further, after the proposal was submitted and before the *MFW* conditions were imposed, the target board had met and had formed a special committee. The court pointed out that the *MFW*-required conditions were imposed in a "follow-up letter" that reaffirmed the initial proposal, which was delivered "promptly" (two weeks) after the initial proposal. The court ruled that actual "negotiations" with respect to the proposal did not begin until *after* the conditions had been imposed. The court emphasized that nothing "substantive" had occurred between the time the buyer first approached the target and when the MFW conditions were imposed. Specifically, the court noted, before the follow-up letter was submitted, there was no evaluation of the submitted proposal by the board; although the special committee had been formed, it had not met; and, "the prompt sending of the Follow-up Letter prevented the [Buyer] form using the [*MFW*] conditions as bargaining chips" in the negotiation process.

The 'MFW' approach has been adopted in New York. The **New York Court of Appeals adopted the MFW approach** in 'Kenneth Cole' (2016).

• **As in 'Olenik', the factual context in 'Synutra' was not "optimal."** In *Synutra*, after the company waived the conflict of interest, the company's regular counsel "switched" to representing the buyer—and even after the switch advised the company's directors about their fiduciary duties and the formation of a special committee. Also, the special committee's banker presented the committee with a valuation of the company that provided an unusually wide range of values (from $1.70 to $20.03). The court concluded that these facts, while not "optimal," did not establish that the committee had been grossly negligent. The court observed that the committee met 15 times over 10 months; retained "undeniably independent" advisors; conducted a market check that included contacting 13 potential strategic buyers and 12 potential financial buyers; negotiated a price increase (that represented only a 2 percent increase over the buyer's initial offer, but represented a 58 percent premium to the company's unaffected stock price and a 31 percent and 20 percent premium, respectively, to the 30-day and 60-day averages); and negotiated certain revised deal terms, including a reduced termination fee and the inclusion of a go-shop provision.

These decisions appear to indicate that, depending on the facts and circumstances, there is some leeway for controllers in terms of their timing in determining whether or not to structure a transaction to be *MFW*-compliant. At the same time, however, as noted above, in most cases the critical factor for a controller in determining whether to structure a transaction to be *MFW*-compliant is not related to the strictures of the ab initio requirement but to the uncertainty for the transaction created by the minority stockholder approval condition.

Practice Points

• **A controller who is considering structuring a transaction to be 'MFW'-compliant should seek to ensure that the "preliminary discussions" do not constitute "negotiations."** In *Olenik*, the court reasoned that "negotiations" began following the buyer's submission of a "definitive proposal" (in the form of a formal offer letter). With respect to the court's view of the period preceding submission of the buyer's offer letter as "preliminary discussions," (1) it appears that significant back-and-forth price-related discussions did not occur during this period (although the court did not specifically articulate this as a basis for its finding); (2) meaningful back-and-forth pricing negotiations did occur for two months after submission of the offer letter; (3) there was no indication of a tradeoff between imposition of the *MFW* approval conditions and pricing; and (4) in the court's view, after the special committee was formed toward the end of the preliminary discussions, the committee functioned well to oversee the process through the signing of the merger agreement. In *Synutra*, the court viewed "negotiations" as not having commenced even after a formal offer letter was submitted because nothing "substantive" occurred before the *MFW*-required conditions were "promptly" added in a follow-up letter.

• **Earlier rather than later imposition of the 'MFW'-required conditions is still the safest course.** As discussed, these decisions appear to indicate that the court is likely to view a well-functioning special committee and fully-informed approval by the minority stockholders as outweighing potential foot-faults relating to the ab initio Nonetheless, a buyer seeking to structure a transaction to be *MFW*-compliant should consider that the dividing line between "preliminary discussions" and "negotiations" for *MFW* purposes is still less than certain and, therefore, the *earliest* possible imposition of the required conditions is still the safest course for ensuring *MFW* compliance.

• **The application of 'MFW' has been extended beyond mergers to controller transactions generally.** While the *MFW* case itself and both *Olenik* and *Synutra* involved controller squeeze-out mergers, the Court of Chancery has applied *MFW* also to consulting arrangements between a controller and the controlled company (*EZCORP*, 2016); to allegedly disparate consideration received by a controller in connection with a merger of the controlled company with an unrelated third party (*Martha Stewart Omnimedia*, 2017); and to an arguably pro rata share reclassification which the court viewed as a conflicted transaction (because it created a class of stock for use for capital raises while preserving the controller's control position) (*Crane*, 2017). In *Crane*, Chancellor Bouchard wrote that there is "no principled basis on which to conclude that the … protections in the *MFW* framework should apply to squeeze-out mergers but not to other forms of controller transactions."

• **The 'MFW' approach has been adopted in New York.** The New York Court of Appeals adopted the *MFW* approach in *Kenneth Cole* (2016).

Accounting

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• Pricing of transactions between the owner of a majority voting interest through voting interests and the investee and related self-dealing transactions (protective)

• Liquidation of the investee or a decision to cause the investee to enter bankruptcy or other receivership (protective)

• Acquisitions and dispositions of assets that are not expected to be undertaken in the ordinary course of business (protective)

• Issuance or repurchase of equity interests (protective)

• Incur additional indebtedness to finance an acquisition that is outside the ordinary course of business (protective);

• Location of the investee's headquarters (non-substantive participating)

• Name of the investee (non-substantive participating)

• Selection of auditors (non-substantive participating)

• Selection of accounting principles for purposes of separate reporting of the investee's operations (non-substantive participating)

• Acquisitions and dispositions of assets that are expected to be undertaken in the ordinary course of business (may be substantive participating rights)

• Right to agree, approve or veto annual financial budget of the company (substantive participating)

• Right to agree and approve selection, appointment, compensation of the CEO of the company (substantive participating)

• If reasonably possible or probable that the investee will need to incur the level of borrowings that requires noncontrolling equityholder approval in its ordinary course of business (substantive participating)

• Rights relating to dividends or other distributions may be protective or participating and should be assessed in light of the available facts and circumstances, e.g., rights to block customary or expected dividends or other distributions (may be substantive participating) and rights to block extraordinary distributions (protective)

• Rights relating to an investee's specific action in an existing business may be protective or participating depending on facts and circumstances, e.g., if investee had the ability to purchase, rather than lease, the property without requiring approval of the noncontrolling equityholder, then the right to block the investee from entering into a lease would not be substantive

• Provisions that govern what will occur if the noncontrolling equityholder blocks the action of an owner of a majority voting interest need to be considered to determine whether the right of the noncontrolling equityholder to block the action has substance, e.g., if blocking approval of an operating budget, simply defaults to last year's budget adjusted for inflation, and if the investee is a mature business for which year-to-year operating budgets would not be expected to vary significantly, then the rights are not substantive

• Rights relating to the initiation or resolution of a lawsuit may be considered protective or participating depending on facts and circumstances, e.g., if lawsuits are a part of the entity's ordinary course of business, then the rights may be considered substantive participating.

Potential Solutions to Provide Adequate Rights and Protections for Minority Equityholders in Minority Interest Acquisitions. From an acquirer's perspective, a minority equityholder's substantive participation rights under the applicable financial consolidation accounting model in connection with a Minority Interest Acquisition could preclude the acquirer from consolidating the target. From the minority equityholders' perspective, the financial accounting consolidation rules can operate to severely limit their continuing rights and protections regarding Minority Interest Acquisitions.

The parties may wish to engage an accountant with **detailed knowledge of these rules** to determine the extent of the rights and protections that are available to minority equityholders while still preserving an acquirer's ability to consolidate the target.

To mitigate such limitations and to protect minority equityholder interests, at a minimum you can provide that minority equityholders have all of the rights deemed to be protective rights under the consolidation rules. You can also provide minority equityholders with review and comment and/or meaningful consultation rights in lieu of consent rights with respect to the items that constitute or are reasonably likely to constitute participating rights or substantive participating rights under the applicable facts and circumstances. If the majority equityholder, board or manager takes or causes the company to take or fail to take specified actions regarding operations or business decisions that could adversely impact a minority equityholder's interest the minority equityholder may require the majority equityholder to purchase the minority equityholders' interests at a premium or if the minority equityholder is also an employee of the entity, an employment agreement can allow the minority equityholder to terminate the employment relationship for good reason and require the acquirer to pay substantial severance.

Balancing these rights can be difficult and the consolidation analysis turns on the facts and circumstances of the entities and the business as a whole. The parties may wish to engage an accountant with detailed knowledge of these rules to determine the extent of the rights and protections that are available to minority equityholders while still preserving an acquirer's ability to consolidate the target.

Insurance

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appetite in response to the competitive landscape plus a favorable loss history across the industry. Issues that may have been categorically excluded a few years ago, including government payor reimbursement risk and FLSA matters (just to name two examples), are now eligible to be covered under an R&W policy subject, of course, to satisfactory underwriting results. Though insurers have liberalized their underwriting appetite, they have not relaxed their underwriting standards as coverage is still predicated on the buyer having done robust and comprehensive due diligence.

David: What trends are you seeing in claims being asserted under R&W policies and how are the insurers responding? How long does it typically take for claims to be paid?

Craig: We are simply seeing more claims being made under these policies—but this is purely a function of more policies being written. We have not observed a meaningful increase in the percentage of our policies that have claims, which remains in the range of 10 percent to 15 percent, depending on policy year. The biggest driver of claims across our portfolio is breaches in the financial statements representations—with taxes, employee benefits and compliance with laws claims not far behind.

Insurers have taken the increase in claims in stride and have taken (in our estimation) a very reasoned approach in claims settlements and negotiations. In just the past year, we've secured payments in the tens of millions of dollars for our clients under these policies.

As to the timing of claims payments, it's very fact-specific and depends on the nature of the underlying claim and whether it's tied to underlying litigation, etc. I've had claims settle in as quickly as 60-90 days while others have gone on for a number of years.

David: What are some of the more material issues of which a buyer needs to be aware in selecting a policy?

Craig: When utilizing R&W insurance on a transaction, buyers need to be thoughtful about their due diligence process, ensuring that they don't view the procurement of the policy as a substitute for due diligence. As stated earlier, the insurers are expecting buyers to do thorough and robust due diligence on every transaction. That said, insurers do recognize that a "one size fits all" approach doesn't work in today's marketplace, and they are willing to accommodate each buyer's approach—as long as the work gets done.

Buyers should also focus on working with seasoned advisors in the R&W insurance process, as executing on aggressive deal timelines is critical to the success of the transaction.

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