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FOREIGN DIRECT INVESTMENT - PRACTICAL CONSIDERATIONS FOR BUYERS AND SELLERS

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The UK prime minister recently declared the end of the so-called “golden era” of relations with China, adding that the closer economic ties of the previous decade had been “naive”. That assessment followed the UK government’s decision to reverse the takeover by a Chinese-owned company of Newport Wafer Fab, Britain’s largest microchip plant.

Such developments are not unique to the UK. Across the world, there has been growing recognition that acquisitions in sensitive industries or of sensitive technologies have a direct impact on national security and geopolitical stability. The result is increased global regulation of foreign direct investment, or FDI.

As FDI regimes evolve in response to world politics and government policy, it has been necessary to keep apace of developments and their impact on M&A and transaction certainty. While the degree of regulation varies significantly across different jurisdictions, there are certain key, recurring issues for buyers and sellers. These are briefly summarised in the following sections.

INITIAL CONSIDERATIONS

It is crucial, when planning a transaction, to examine the implications of any proposed structure. FDI constraints will need to be identified and addressed, as well as other customary investment barriers. These include merger control and regulated sectors for which specific licenses may be required, such as defence, insurance, infrastructure, and energy.

While FDI restrictions vary across jurisdictions, there are broad themes common to most regimes. Initial considerations in any M&A transaction often involve establishing:

1. the identity of the buyer;

2. the identity of the target and the nature of its business; and

3. the level of control to be acquired.

The identity of the buyer is often a function of nationality or the country of incorporation. Under some FDI regimes, establishing the buyer's identity can be a protracted process requiring checks on source of funds, connections to politically exposed or sanctioned persons, tax residence, regulatory status, the countries in which the buyer operates or has branches or establishments, and whether it supplies or contracts with entities in specified territories.

Similarly, while the identity of the target is often a function of the location of its business and assets, the analysis is more complex in acquisitions with several connected micro-transactions and an expansive group structure. The application of the legislation to each such transaction and each member of the group should be examined. Even if, for example, an acquisition in itself does not trigger FDI scrutiny, the related transitional services or licensing arrangements may do. Similarly, an entity that is ostensibly out-of-scope may be caught by FDI restrictions by virtue of its contractual relationships with other in-scope entities or because an incidental part of its wider operations is in-scope. Where the target's business nominally falls within a proscribed list of industries that are subject to FDI regulations, consideration should be given to whether the turnover or profit thresholds provide an exception.

When determining the level of control to be acquired, regulators often review the degree of influence exercised by a buyer over the target and its business. This means that acquisitions of minority interests may still attract FDI scrutiny. Asset acquisitions are also typically regulated, depending on the nature of the assets within the transaction perimeter.

Certain FDI regimes, including in the UK, have extra-territorial application. These may be relevant even if there would appear to be only tenuous links or triggers that could result in restrictions applying. To respond meaningfully to any FDI scrutiny, it is therefore critical for the buyer and seller to anticipate potential regulatory challenges and pre-empt or address them during the structuring phase of a transaction. Robust deal structures often incorporate elements of the following:

1. being transparent and initiating early engagement with regulators as to the buyer's identity, source of funds and links with third parties;

2. drawing the transaction perimeter at the right level so as not to inadvertently encompass in-scope target entities or businesses; and

3. setting an acceptable level of control or influence a buyer may have over the target, including by way of governance rights, reserved matters, board seats, and monitoring or management arrangements.

BUYER PERSPECTIVE

Notification

Generally, the burden of compliance with FDI restrictions tends to fall on the buyer. Broadly, this means it is normally for the buyer to notify in-scope transactions to the relevant regulator and to obtain the necessary approvals before an acquisition can proceed. In practice, given that sanctions for non-compliance include unwinding transactions, the buyer and seller will work closely together to identify any FDI requirements.

Even if the relevant criteria are not met and a notification is not strictly required, voluntary notification should be considered as a prudent and cost-effective way of reducing the risk of a transaction being subsequently called in for review. In jurisdictions where there is no prescribed process for making a voluntary notification, it is often possible to seek informal advice and guidance from regulators. Views expressed in such circumstances will typically be non-binding and subject to caveats. However, informal confirmation that a regulator is likely or unlikely to be interested in a transaction could offer a buyer a substantial degree of comfort or, alternatively, give the buyer the impetus it needs to walk away from a transaction.

Due Diligence

Buy-side due diligence will be essential in determining whether a notification is made. In particular, whether the target and its operations fall within the scope of the relevant FDI restrictions is something that should be considered. This will involve a detailed review of the target's activities, the countries in which it operates, its contractual relationships, the location of its assets and the equivalent analysis in respect of each other entity within the transaction perimeter. In certain jurisdictions, proscribed lists of targets and jurisdictions are reviewed and refreshed on a continuous basis and so it should be verified that the latest versions of these lists are in use.

It is also necessary to assess whether the target, or any member of its group, was party to any historic transaction that ought to have been subject to FDI restrictions and, if so, whether the relevant approvals were obtained. This mitigates the risk of acquiring an asset that is subsequently subject to review or other penalties.

Conditions to Completion

A key question for the seller and buyer is whether the acquisition should be conditional on FDI clearance before completion of the transaction. The position is straightforward if it is clear the transaction requires regulatory approval. If, however, there is no such requirement, buyers may still seek a condition that entitles the buyer to obtain informal clearance or comfort, whether under a voluntary notification process or otherwise, before the transaction proceeds to completion.

Where a condition is included in the sale and purchase agreement, the buyer will often expect to control the application process and dictate timing. If so, provisions should be negotiated for the seller to provide its full cooperation, including by undertaking to provide information and access to management. The buyer should also consider whether it is prepared to comply with all of the potential remedies and conditions that a regulator may attach to its approval. If not, the

documentation should either specify the type and scope of remedies and conditions that would be acceptable or, alternatively, provide for the ability to withdraw from the transaction at that stage, perhaps in exchange for an agreed termination fee.

SELLER PERSPECTIVE

Choosing the Right Buyer

While it is typically for the buyer to ensure compliance, a seller should satisfy itself as to the likely application of any FDI restrictions. Having a completed transaction unwound, and the potential reputational and financial fallout, would be an unfortunate outcome for both parties. In auction sales, a seller should consider whether the FDI analysis changes if the identity of the buyer changes so that, for example, selecting a different buyer means that FDI restrictions no longer apply or apply to a lesser extent. Even in a bilateral sale, it may be possible to address FDI challenges by using different investment and investor structures.

Certain FDI regimes apply even if the acquiring entity is not a foreign entity. However, depending on the regulator, we expect some buyers to attract greater scrutiny than others. When potential buyers are evaluated, a buyer's connection to certain jurisdictions may have an impact on the way a regulator views the transaction and, therefore, the level of execution risk.

Conditions to Completion

If there is a mandatory filing requirement, and completion cannot occur until the relevant approvals have been obtained, it is not uncommon for the seller to request "hell or high water" provisions. These require the buyer to comply with whatever orders or measures the relevant regulator may impose as a condition of granting approval. Such measures or orders include ensuring that certain operations are conducted only within specified jurisdictions, divesting part of the target business, the employment or retention of local staff or management, and limiting access to sensitive premises or confidential information. Requesting break fees and other undertakings from the buyer should also be considered if the deal terminates as a result of approval being withheld.

Even if there is no mandatory filing requirement, the buyer may insist on a condition that entitles it to make a voluntary notification in the interests of certainty. The key question for the seller is whether it would accept such a condition, given the potential impact on the timetable. The seller may choose to trade away such a condition in return for fewer restrictions on how the business is conducted between signing and completion, or for an option to withdraw from the transaction if such notification results in the commitment of additional time, expense and management resources above a certain threshold. All of these will have to be weighed against the perceived likelihood of the transaction being called in for review after completion and what the parties agree is an appropriate allocation of risk as between the buyer and seller.

CONCLUSION

The rapidly developing legal and regulatory FDI landscape means the rules, and the manner in which regulators interpret such rules, are continuously changing. It is often the case that FDI legislation is drafted broadly so as to afford regulators maximum flexibility in applying the relevant rules to any transaction. The challenge is in understanding and navigating these areas of discretion, engaging in open dialogue with regulators, assembling an organised transaction team with the right reach and expertise in the relevant jurisdictions, and being alive to the role of the transaction documents in allocating risk.

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