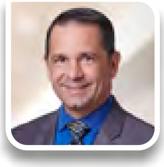
AMID REGULATORY HEADACHES FOR M&A – UNDERSTANDING THE CURRENT ENFORCEMENT LANDSCAPE IS KEY TO GETTING DEALS DONE

BY JOHN R. INGRASSIA[1]



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Mergers and acquisitions are facing dual changing regulatory landscapes with respect to antitrust review and enforcement, and foreign investment into U.S. businesses under CFIUS. Both sets of changes represent aggressive tightening, make is more challenging to gain approval, and add costs and time to deals that ultimately do win clearance. New theories of harm being advanced under both regulatory regimes means having to evaluate new risks, and procedural changes under both regimes means navigating new waters. In this article we address what's happening at both agencies, how it is impacting M&A, what it means for getting deals done, and how to navigate the new norms.

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I. ANTITRUST/HSR

We have seen a number of noteworthy developments with respect to Hart-Scott-Rodino ("HSR") reporting and merger review more generally under the new administration and under new agency leadership. With the surge in M&A activity reportedly "straining" the Federal Trade Commission's resources, several new tactics have come into play that impact not only merger review and clearance, but the way mergers are getting negotiated. While the heavy attention that all things antitrust is currently getting from Congress and the agencies will likely result in landscape shifts in enforcement policy and priorities for years to come, some of what's already been implemented and is already underway is having immediate impact. The general approach has been a doubling down on enforcement, stripping away of exemptions and interpretations that make review more streamlined, and investigations that are more intrusive and lengthy. Some highlights include:

- Elimination of HSR early termination grants – requiring observance of the full 30-day HSR waiting period in all filed transactions;
- Issuance of "Warning Letters" at the close of HSR waiting periods;
- Withdrawal of long-standing informal interpretations relating to HSR reporting, and public admonitions to the premerger office for issuance of so called "loophole" interpretations;
- Curtailing of parties' ability to exclude the value of outstanding debt from transaction value for HSR reporting obligation assessments;
- Withdrawal of long-standing informal interpretations relating to exclusion of copyright acquisitions from HSR reporting requirements;
- Withdrawal of the Vertical Merger Guidelines just only recently issued in 2020;
- Merger investigations that delve into historically off-limits areas, such as employee compensation, and issuance of "Second Requests" that are more broad reaching and invasive; and
- Consent decree provisions that are more onerous and restrictive;

Under the HSR Act, transactions that meet certain annually adjusted thresholds (currently a $101 million transaction size) are subject to notification and waiting period requirements. The FTC announced the new thresholds for 2022 effective February 23 – which increased from $92 million to $101million. The HSR Act enables antitrust regulators to review transactions, investigate and address potential competitive concerns prior to completion, and carries monetary penalties for failure to comply — also adjusted for 2022, to $46,517 per day.

Most transactions that meet the reporting requirements do not raise substantive antitrust concerns and are never investigated (typically around 90 percent), and the agency has historically terminated the statutory 30-day waiting period for most of those transactions in less than 30 days. Beginning in February of 2021, the FTC suspended the longstanding practice of granting parties 'early termination' of the 30-waiting period for transactions it does not intend to investigate.

More recently, the agency has begun issuing letters to parties in certain transactions the agency may intend to investigate even after expiration of the HSR waiting period.[2] Jurisdiction to conduct antitrust review of mergers and acquisition is independent of the HSR reporting requirements. This means the enforcement agencies can investigate any transaction before or after closing, whether subject to HSR reporting or not, and whether the HSR waiting period has expired or not. There are historical examples of the agencies using that authority to review non-reportable transactions, and even to open investigations of reportable transactions after expiration of the HSR waiting period – though these have been rare. The new practice of issuing waring letters to parties that an investigation may remain ongoing even post-HSR clearance has several important implications around certainty or finality of investigation practices, and around obligations under parties' merger agreements with respect to closing potentially over a pending or ongoing investigation.

While the letters being issued do not assert any new authority not already existing under law, they are not being issued in every transaction. This means that the transaction for which the letters are issued are selected as ones that potentially raise more significant antitrust issues, and ones that the agency is more likely to investigate post-HSR waiting period and even post-closing – effectively putting merger parties on notice that the acquisition may face meaningful risk of agency action post-closing.

This, in turn, raises potential questions as to whether closing conditions are sufficiently satisfied to require the parties to close. A skittish buyer trying to assert that they are not required to close over the (arguably) pending investigation may face an uphill battle depending on how the conditions to closing were drafted in the merger agreement – which typically point to the expiration of applicable waiting periods and not the absence of potential ongoing investigations. The FTC's new practice is already ushering a change in the way certain provisions are drafted, with careful buyers seeking provisions that no investigations are open or pending and that no such warnings or warning letters have been issued.

2 See https://www.ftc.gov/system/files/attachments/blog_posts/Adjusting%20merger%20review%20to%20deal%20with%20the%20surge%20in%20merger%20filings/sample_pre-consummation_warning_letter.pdf?utm_source=govdelivery.

Recent examples under the new policy include the *3D Systems Corporation/Oqton, In*c. transaction, where the parties' agreement provided the if the FTC or DOJ issues a warning letter that an investigation in pending beyond the expiration of the HSR waiting period expired, the investigation would be treated as closed only 30 days after receipt of such letter – if an active investigation is not pending. In the *Universal Corporation/Shank's Extracts, Inc.* transaction, the parties' agreement likewise provided for an extension of the closing date by 30 days where the buyer receives a warning letter before closing.

Section 8 of the Clayton Act prohibits certain overlaps in officers or directors between competing companies to guard against anti-competitive coordination and information exchanges that can arise from simultaneous board membership. Thus, as a general rule a person cannot serve on the boards of two competing companies, which can arise where installing board members of potentially competing portfolio companies. Under the statute, no person, or representative of the same person or entity, is permitted to serve simultaneously as a director or officer of competing companies, but there are carve-outs and exceptions. The prohibitions of Section 8 are limited to cases in which each of the companies has, under the revised thresholds for 2022, capital, surplus, and undivided profits of more than $41,034,000. Even where the threshold is met, however, the restrictions do not apply where the competitive sales of *either* company represents less than 2 percent of its total sales, or are less than $4,103,400; or where the competitive sales of *each* company represent less than 4 percent of its total sales.

With antitrust enforcement of the technology sector making news daily, and lawmakers, enforcers and regulators all finding new ways to attack an industry that arguably is responsible for one of the greatest eras of advancement in history, knowing where the pitfalls are is the order of the day. To protect against buying the next antitrust headline, new areas of inquiry are required – beyond assessment of the combination's market shares. In addition to debt ratios, cap tables and pending litigation, good diligence now includes a clear assessment of the parties' business, their offerings and the markets implicated. This is necessary to evaluate whether either or both are in areas currently subject to enhanced antitrust scrutiny. Such areas can include diverse businesses such as platforms, ecommerce, internet infrastructure, social media, search, online advertising, streaming content, and fintech.

Also consider whether the transaction would combine businesses that are in a vertical or vendor/vendee relationship. These can include, for instance, combinations of content producers or suppliers with content distributors. Transactions in this space can hit two areas that are presently the focus of what may be an undue level of agency attention – technology and vertical transactions. Vertical transactions can and do take place in all industries whenever two levels of a supply chain combine, such as manufacturer/distributor or distributor/retailer. While antitrust enforcement of *exceptional* vertical mergers that would lead to market foreclosure of inputs or distribution/sales channels has a long history, the trend now is to examine vertical mergers more closely as a matter of course. Add to this the Federal Trade Commission's withdrawal in September 2021 of the Vertical Merger Guidelines, issued and updated only recently in 2020 and criticized by the new Commission majority as based on "unsound economic theories that are unsupported by the law or market realities."

Historically, the FTC Premerger Notification Office has taken the view that the retirement of debt is not included in the calculation of whether a stock transaction meets the reporting threshold and is thus subject to the reporting and waiting period requirements of the HSR Act. That position was reversed in August 2021, reportedly on the basis that "as a result of developments in deal structures and financing, sometimes the retirement of debt is part of the consideration for a transaction in that it benefits the selling shareholder(s)." Accordingly, in "any instance where selling shareholder(s) benefit from the retirement" of debt, the debt is considered part of the transaction consideration for purposes of assessing the parties HSR reporting obligations. This is having immediate impact as we see reporting of transactions that historically would have not been subject to HSR filing requirements.

A number of changes have also been announced and implemented with respect to the FTC's merger investigation, or Second Request, process, including examination of how a proposed merger may impact labor markets, and "how the involvement of investment firms may affect market incentives to compete." Finally, in cases where merger parties settle with the agency on a challenge to the transaction rather than facing the agency in court, the consent decree process sets out the parties' obligations on a going forward basis. Historically, such consent decrees, among other things, required parties to notify the agency prior to certain future acquisitions implicating areas that are the subject of antitrust concern under the settlement.

Beginning in October, 2021, however, FTC consent decrees in such cases (beginning with its consent decree in the *DaVita Inc./Total Renal Care, Inc.* transaction) now requires <u>prior approval</u>. This is a significant policy change for the FTC and has the potential to chill, not only settlements, but also M&A transactions at the outset, where such provisions are commercially untenable.

II. CFIUS

The CFIUS landscape is likewise very different from how things looked only a short time ago, and CFIUS continues to be an important issue and consideration for investors both inside the U.S. and abroad. With the enactment of FIRMA's updates to CFIUS in 2018, and the 2020 implementation of the new rules, 2021 was the first full year under the new regime. Some of the newer features of CFIUS now include:

· mandatory filings for certain transactions (limited to certain transactions implicating critical technology, critical infrastructure, and sensitive personal data)
· short form Declaration filings (now available for all transactions following a limited Pilot Program availability)
· CFIUS filing fees ($750 to $300,000 depending on transaction value);
· electronic filings;
· coverage of certain real estate investments and acquisitions involving proximity to sensitive government facilities and installations;
· expanded scope of critical infrastructure coverage;
· coverage with respect to sensitive personal data;
· expanded coverage of emerging and foundational technologies (i.e. geospatial imagery software);
· expanded CFIUS identification and review of non-notified transactions
· "White List" exempted investors for certain investors from UK, Canada, Australia, and, as of January 5, 2022, New Zealand and;
· Country-specific application of certain rules related to critical technology.

For U.S. based fund investors, CFIUS is often implicated by the presence of non-U.S. partners – co-investors, joint managers, or, to a lesser extent, in the LP base. The extent and scope of CFIUS coverage and jurisdiction turns on the type of rights granted to non-U.S. person or non-U.S. controlled entities, such as investment management discretion; GP removal rights; LPAC representation, board or observer rights; and certain information rights such as rights to Material Non-Public Technical Information. Non-U.S. investors are more directly implicated in CFIUS coverage, though nationality matters to CFIUS and risk assessment is highly country-specific.

CFIUS's appetite for clearing investments originating in certain parts of the world continues to wane. The ensuing chill in the investment climate has led to a sharp downward trend in filings specifically relating to investment originating in China (sometimes by way of the Cayman Islands) – down approximately 90 percent from just several years ago. Notably, many of the filings that relate to inbound investment from China focus on critical technology, one of the more sensitive areas of CFIUS review and a particular focus for the U.S. national security establishment. Though we also continue to see Chinese investment in U.S. critical infrastructure and in industries implicating sensitive personal. CFIUS does not evaluate issues relating to other foreign access to U.S. critical technologies, such as licensing, contracting, or other arrangements that are not M&A related.

As the CFIUS and foreign investment review climate has not improved in the Biden administration from the prior administration, we expect to see continued lighter showing with respect to Chinese investment and continued chilly reception from the Committee. Consider the Biden administration's review of ByteDance's non-notified acquisition of Musical.ly (TikTok) initiated under the Trump administration. In October 2021, CFIUS also opened an investigation into China based Tencent's planned acquisition of Sumo Group, a UK based producer of video games, as announced by the parties. CFIUS dos not publicly announce investigations or enforcement actions. CFIUS likewise investigated China based Wise Road Capital's proposed acquisition of Magnachip Semiconductor – by way of a Cayman affiliate. The parties did not initially file with CFIUS, and according to the company, on May 26, 2021, "the CFIUS Staff Chairperson, acting on the recommendation of CFIUS, requested that the parties file a notice concerning the Merger and thereby undergo formal CFIUS review of the Merger." The review led to the parties abandoning the transaction in December 2021.

Though there is not public reporting with respect to specific transactions, filings or investigations, CFIUS identified 117 non-notified transactions the last reporting year for consideration (an all-time high), with 17 leading to formal filing and review. Such investigations can be costly and distracting for completed transactions, and at the margins can lead to undoing of completed deals. Thus, the better counselling under the current CFIUS climate is to file on a voluntary basis for transactions that are arguably likely to garner CFIUS's interest or attention. CFIUS also puts a high level of scrutiny on investors from Russia (even aside from current sanctions) and certain middle-eastern countries. Though, largely a function of investment flow, most of the filings still come from lower risk countries – Canada, UK, Japan, South Korea and Germany.

We continue to see sharp increases in short form Declaration filings, especially with respect to fund investors, as investors and practitioners become more comfortable with the newer process. The short form Declaration filings afford the added benefit of a shorter 30-day waiting and review period (versus 45 for the traditional Joint Voluntary notice long form filing), though is not always advisable for transactions likely to result in more in-depth investigations. This, plus an overall increase in the number of CFIUS filings more generally given the expanded scope of coverage areas, has led also to a smaller percentage of transactions that ultimately are subjected to remedies (or mitigation measures in CFIUS parlance) – hovering at around 10 percent of all filed transactions.

In the last available public reporting year, CFIUS implemented mitigation measures in approximately 20 transactions. Such mitigation measures typically include one or more of: restrictions on certain intellectual property, trade secret, or technical knowledge transfers; limiting access to information related to certain technology to only U.S. persons; assurances of continuity of supply to the U.S. Government; exclusion of certain sensitive assets from the transaction; prior notification and approval of future increases in ownership or additional rights; or ultimately, divestiture of all or part of the U.S. business. CFIUS's expanded mission, and staffing, also means that today we see at least some level of investigation on almost half of all submissions, which remain largely voluntary submission with less than 20 percent of all filings falling into the mandatory filing requirement category.

The primary sectors subject to review continue to include utilities (such as power generation and infrastructure), computer system design (critical technology), software (especially encryption related software), financial services, transportation, aerospace, and industry (such as chemical manufacturing). Real estate investments remain a small minority of reported and reviewed transactions.