MERGERS & ACQUISITIONS

MERGERS AND ACQUISITIONS PRACTICE HAS BEEN THROUGH A FEW REVOLUTIONS as the U.S. and world economies have struggled the past five or six years. Now, though, California practitioners are seeing a general stabilization and several bright spots, even with volume continuing to fall in purely domestic deals. Acquisitions originating abroad are rising fast as industries develop and mature around the world, but particularly in China; tech M&A is continuing strong; and clients are more interested than ever in legal advice about the strategic aspects of deals, rather than just the technical. *California Lawyer* checked in for an update on the field with Joseph M. Doloboff of Blank Rome; Jaclyn Liu of Morrison & Foerster; E. Thom (Todd) Rumberger of Foley & Lardner; and Thomas M. Shoesmith of Pillsbury Winthrop Shaw Pittman. The roundtable was moderated by *California Lawyer* and reported by Donna Blum of Barkley Court Reporters.

EXECUTIVE SUMMARY

MODERATOR: There's been a pretty significant drop in M&A this year, even though there were signs in 2011 and 2012 that the volume would be higher, and that seems to be among the most significant continuing issues. What are the biggest new developments in your practice in the last year or so?

JACLYN LIU: You're right; M&A volume was down in the U.S. about 4 percent in 2012 as compared to 2011. Everyone is predicting an uncertain U.S. M&A market with shrinkage in 2013 at the same levels as 2012. And a number of bankers are saying, from their firsthand experience, that the dip is expected to be more significant. There is, however, an uptick in outbound M&A activities from China during the first half of 2013, which has continued for a couple of years. In the past, a majority of my M&A work involved domestic or European companies. However, all but one M&A matter that I worked on during the past year involved an Asian or European party either as the seller or the acquirer. And, previously, inbound M&A involved mostly foreign companies acquiring divisions of U.S. public companies or private U.S. companies; more recently foreign companies are buying U.S. public companies outright, which adds complexity and deal challenges.

MODERATOR: What kinds of companies? What kinds of industries?

LIU: Across the board; I helped a French co-op acquire apple orchard productions in the U.S., SoftBank in its acquisition of Sprint, and a Chinese medical device company in its acquisition of a division of a U.S. public company. But my M&A work is predominantly in the technology space.

MODERATOR: Todd [Rumberger], what big trends are you seeing in your practice in Silicon Valley?

TODD RUMBERGER: The trend personally for me was a very active M&A plate last year, leading down to the wire and into the holidays, in large part people trying to beat the 12/31 deadline, the fiscal cliff. It was everybody's expectation that, because of the general acceptance that taxes would be going up, sellers were going to get a lot better net result if the deal closed by year-end. This work included both typical Silicon Valley M&A involving big tech acquisitions of early-stage and venture-backed companies, but also a number of deals in the private equity arena, which has its own style for the way the deals are structured and negotiated, not dissimilar to the more pragmatic way venture financings on the West Coast are negotiated, with some well known deal points up for grabs and many others simply not pushed too hard; deal certainty and getting to the closing are paramount once the decision is made to buy (or sell).

MODERATOR: So you're not seeing a drop except to the extent people are sort of catching their breath?

RUMBERGER: Yes, though it seems like some deals which were jumping on my radar early this year have been stalled, not dead, but not making nearly the progress deals were making last year at this time; I don't think many people expected a slow-down in the first half of the year, but we experienced one.

LIU: Yes, money is still relatively cheap.

JOSEPH DOLOBOFF: I've seen three major trends. First, some large, public high-tech companies that did a lot of acquisitions and are now in the integration stage. Where I've seen the largest drop-off is in the number of leveraged recapitalizations—taking advantage of a good debt market—where private-equity firms came in, took majority ownership of a company, and allowed founders who had grown the company to take a bunch of chips off the table yet retain a significant minority ownership interest. Those deals have fallen off quite a bit now that we've got the increase in capital gains tax rates; that 5 percent made a big difference.

The third trend that I see, and maybe because I'm focused on the tax side, is more companies with large net operating losses that are looking at acquisitions of companies that are heavy taxpayers, which they can acquire at a higher price because they have the advantage of the operating loss tax shelter. The public company deals, which for me are mostly on the high-tech side, I expect to pick back up at the end of the summer.

THOMAS SHOESMITH: Our overall M&A activity is probably down by more or less the same percentages that Jackie [Liu] was mentioning. But, by sector, it's actually pretty strong and in many cases up, which is also consistent with her experience. Our Silicon Valley office, which is heavily concentrated on technology companies, is very active in M&A right now. There are market fundamentals at work, of course, as well as industry trends. Many large tech companies, for example, particularly in life sciences, have become expert at outsourcing innovation and then buying the winners. The oil and gas and energy sectors are also very strong. And then of course China has been an area where we've seen a lot of changes and a lot of activity. The switch from outbound investment from the U.S., to inbound investment from China, has been dramatic. We all thought it was going to happen—

LIU: A long time ago.

SHOESMITH: That's right. It's been "about to happen" for at least five years, but now it's happening. That's exciting and different. Investment from the U.S. into China also is changing. Ten years ago it was primarily aimed at manufacturing for export. Now the attraction is the huge market in China and more broadly in Asia.

LIU: And that trend changes the due diligence requirements of an acquirer. It's much easier to conduct physical due diligence on a factory than if the value driver for the acquisition is the Chinese target's distribution or marketing channels. The old adage was: Retain the target's general manager, who will know the ins and outs of the business, and you are golden. But not anymore. As the value drivers for inbound M&A move beyond brick and mortar to leverage Chinese manufacturing efficiencies, the due diligence process for such deals will become more "U.S. style."

A certain amount of patience on the part of foreign acquirers is needed as many Chinese targets are not prepared for such intense legal and financial scrutiny of their businesses.

SHOESMITH: The big change that's happened in my practice is that U.S. clients looking at China don't just see a lot of people who

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work cheap; they're now seeing a tremendous market. For example, China is now the biggest market in the world for smart phones.

MODERATOR: But another key change you're seeing this year is more investment from China.

SHOESMITH: That's true. And inbound investment from China has been driven by the big players. The wave of smaller buyers is just starting. The last time we had a wave of inbound foreign investment like this was the Japanese in the 1980s and '90s. Of course, there, you were dealing with large corporations but not state-owned enterprises, and that makes Chinese investment more policy-driven than was the case with the Japanese. And the Chinese are buying strategic properties as well as less glamorous but often highly productive businesses like—

RUMBERGER: Chicken producers.

SHOESMITH: That's right—chicken, pork.

LIU: Beyond state-owned enterprises (SOEs), a few factors that have fueled outbound M&A activities from China are the volumes of Chinese companies on the Hong Kong Stock Exchange and the PRC domestic exchanges, the Shanghai Stock Exchange and the Shenzhen Stock Exchange. Listing there has provided private Chinese companies, not just the SOEs, with the capital necessary to invest and acquire abroad. Also, in connection with the listing process, those Chinese companies would set up a Caymans or BVI holding company with some capital residing offshore. This is significant because in my prior experience Chinese acquirers rarely were the successful bidders in a bidding war for a U.S. target. Part of the problem was the lack of sophistication in deal-making but a large part was the inaccessibility of the money. If the money was located in the PRC, savvy sellers would immediately know the process would take no less than four to six months, and that was often a deal-breaker.

DOLOBOFF: I think globalization comes in all shapes and sizes. In deals I do for domestic high-tech companies, they may be buying another domestic company, but the chances are nearly 99 percent that the target has operations in other countries. So almost every deal has some global aspects to it, and you have to bring in advisers from outside of the U.S. with skills in other jurisdictions to get almost any deal done.

SHOESMITH: I agree. Twenty years ago, when I said "I'm an international lawyer," most people said, "What's that?" Now, if I said the same thing, they'd say, "So am I." China is still a special case, though. I think it is by far the most surprising place for Westerners to do business—and I've done transactions in Korea, Japan, the Middle East, Latin America and a number of other countries. I always say China confronts Westerners with two levels of surprises. Of course you expect to be surprised in a deal, but in China it's in a way and for a reason that is surprising. The intricacy of the web of inter-relationships in China that affects every deal is pervasive and mostly opaque to an outsider, even to a Westerner who has lived there for many years. And, if the counter-party doesn't have a Western-trained person, then one side is negotiating holistically and the other linearly.

DOLOBOFF: Even setting negotiations aside, due diligence can be frustrating. I was quite surprised at how difficult it is to obtain from a China-based company certain information that we take for granted in domestic deals.

SHOESMITH: In part this is a function of business cultures. It isn't necessarily advantageous to be transparent in China. And you're right, it makes diligence really hard. I think transparency is an attribute of large, diversified and mostly impersonal economies, which China has not been until recently. A hundred years ago in this country, for example, all the great capitalists knew each other. You could put them all in one room. In fact, J. P. Morgan often did. They exchanged information among themselves, but transparency to the world at large was essentially unknown. China is developing very, very fast and I think we'll see more transparency as it does. A world-class economy can't exist for long without it.

> ***"Most Chinese companies don't start a business with an exit strategy in mind. Most … are focused on maintaining a nice, stable business."*** —JACLYN LIU

LIU: From my experience, most Chinese companies don't start a business with an exit strategy in mind. Most Chinese entrepreneurs are focused on maintaining a nice, stable business that they can hand off to their family. Such a mindset impacts how the business is structured and the attention to legal formalities. Of course, business dynamics are changing in China now.

SHOESMITH: One of the interesting things about China is that it's passing from one system to another, so you see this sort of mixing of the waters. Chinese companies are becoming more international, and the number of internationally educated entrepreneurs and managers is increasing dramatically. I imagine it won't be long before Chinese clients use lawyers throughout the course of a deal —and less often bring me a signed purchase agreement and ask me to take a look at it.

MODERATOR: That's what's called a done deal. Moving to increasing regulation in both the U.S. and China, are tax concerns causing competitive problems? Is the American regulatory pic-

ture at this point an impediment compared to what you're facing in other countries, or is that challenge overblown?

DOLOBOFF: The provision of our tax code that taxes companies on profits they earn overseas when they don't even bring the money back to the U.S. paves a difficult road for U.S. companies when they're making acquisitions abroad. Also, tax law changes that would encourage companies to bring cash back to the U.S. where it could be deployed to help build more jobs just can't be a bad thing.

I have a question for the Chinese experts. You mentioned Japan and the purchase of real estate that we saw by the Japanese in the late '70s or early '80s. Those purchases led to a tax code provision for foreign investment in real property that generally imposed a 10 percent withholding tax on sales by foreigners of U.S. real estate. Do you anticipate that, if we see a flood of Chinese investment into the U.S., there will be some comparable fear regarding high tech or some other market, and there will be a similar tax code reaction?

SHOESMITH: Yes.

LIU: I'm sure that would be the case.

SHOESMITH: It's partly a political question and partly a cultural question. We're always afraid somebody is taking us over. We're more than twice as large as the next largest economy in the world—which is China—and we're still worried about someone taking us over. Particularly with regard to information technology, infrastructure, and the like.

RUMBERGER: Regarding the U.S. regulatory landscape, potential Foreign Corrupt Practices Act violations always seem to be an area of concern. Not too long ago, I was representing a private-equity buyer who was acquiring a small, publicly traded software company with most of its sales in Latin America; a year or two earlier, the target company had entered into a consent decree with the U.S. Justice Department, and it had a number of penalty payments due for an FCPA violation; after reviewing the decree and conducting further due diligence, our buyer ultimately decided the risks were too great.

Going back to an observation I made earlier, I would say, even where there may not be a formal overseas subsidiary or foreign operations/sales for a target company, that target company may be using—or have used—an offshore engineering team for some aspect of software development. So foreign legal questions lurk in the background in a lot of tech deals, even early-stage, and particularly those that are software-based, sometimes only concerning whether the target's IP was properly documented and assigned. And that can often be a question of foreign, not just U.S. law.

LIU: In the age of globalization, we need to be mindful of many laws in other jurisdictions, including the U.K.'s anti-bribery legislation [The Bribery Act of 2010]. If you think the FCPA is difficult, the anti-bribery legislation is even more challenging because certain provisions are completely untested and businesses have no idea how to implement certain provisions which negatively impacts acquirers' ability to do due diligence compliance properly.

MODERATOR: Let's shift away from the global picture. What are the very early-stage concerns that we hear much less about? Where are things headed in terms of deal structures or the kinds of companies that are coming up?

RUMBERGER: I started seeing early-stage exits really pick up back in 2009, when a lot of the big tech companies had a mountain of cash on their balance sheets, which they were under some pressure to deploy or dividend back, and I don't think it has slowed down since. Most startups and even venture-backed companies in Silicon Valley are aware that if they do have an exit, it's likely to be by an acquisition, not sale into the public markets. Many founders, particularly in 2009 and '10, liked the idea of getting any exit, any return on their efforts, often only in the single-digit millions (well, at least where they had not taken in much outside investment). They had the security of going into a large enterprise, getting a steady paycheck, healthcare, oh, and a few million bucks in the bank, during a time when the future was far from certain and no one knew whether the double dip was coming or not.

As for acquisition structure, I would say at less than a $10 million purchase price the big tech acquirers are biased toward structuring it as an asset deal, and in excess of $10 million valuation, they're more willing to structure it as a stock deal (or merger) because of the tax savings involved (and the net result paid to the seller in not having the double layer of tax). I've had a counterintuitive result happen in some very small asset deals where my client, the seller, was a C corp. We were actually trying to push more of the agreed purchase price allocation to the non-compete covenants imposed upon the individual founders by the acquirer because that was going to a single layer of tax versus the actually acquired C corp. assets, which would impose a double layer of tax.

> ***"Even where there may not be a formal overseas subsidiary..., foreign legal issues lurk in the background in a lot of tech deals."*** —TODD RUMBERGER

DOLOBOFF: Welcome to the world of LLCs.

RUMBERGER: Yes, LLCs are becoming more predominant for startup technology companies. And, when I sit down with an entrepreneur to go through the pluses and minuses of a C corp. versus LLC, it can be a complicated conversation because if there is an exit, and it's a single—versus a double, triple, or homerun—it may very well be an asset sale, and the founders would prefer to be in a "pass-through" vehicle like an LLC. So I always want to lay it out and have them make the decision. I would say one in five startups I bring on as new clients might set up initially as an LLC because they can relatively easily convert to a C corp. later.

DOLOBOFF: And foreign companies that come to the U.S. often want to form a U.S. corporation, because the last thing they want to do is to file a U.S. tax return solely because they have a U.S. branch. An LLC will pay the same amount of U.S. tax, but the foreign parent will have to file a tax return in the U.S., which most foreign companies would rather avoid.

RUMBERGER: Sometimes the U.S. market is only that, another market to exploit for the non-U.S. company; if, however, they take in U.S. venture capital, it's likely they will need to relocate headquarters here (or "flip" the ownership from the foreign company into the U.S. company, which becomes the parent entity). It's the reverse of what many U.S. corporate lawyers are used to; namely, instead of running the deal, coordinating and overseeing local counsel in various overseas jurisdictions where subsidiaries or otherwise material operations are taking place, here the seller's parent company remains non-U.S., and we are just another "local" counsel.

MODERATOR: From the lawyer's perspective, as opposed to the business perspective, in your experience of working in M&A, what's changing now? Can you characterize how the practice itself is changing?

SHOESMITH: My experience is that large corporations are handling much of their M&A in-house, although they will still go outside for specialized expertise. But there is still a strategic overlay that experienced lawyers can add to a transaction. In due diligence, for example, it is sometimes relatively simple: collect the documents, see what they say, and you're done. But in China, due diligence requires second-order inferences—making judgments based on facts, not just discovering facts. And that requires a level of experience, not just expertise but experience. So for an outside lawyer the trend I see is towards a more strategic role and not just that of a technician.

RUMBERGER: I recently closed a deal for a primarily foreign-based company buying a Silicon Valley-based software company, and they were looking for our expertise and understanding of the U.S. market and M&A deal term norms, even though they have a significant, experienced, and smart in-house legal team worldwide, including in the U.S. They wanted somebody who understood U.S. (and even California) tech market deal terms to minimize time otherwise spent negotiating for, say, uncapped indemnification or joint and several selling shareholder liability, which may have been the norm in their home jurisdiction, but which would be seen as completely unreasonable by most sellers and their counsel in the U.S. So, I think inbound acquisition work could turn out to be a growing area for California M&A lawyers, a welcome exception to the growing trend of larger acquirers bringing more deal volume in-house.

A lot of companies outside the U.S. are continuing to get more acquisitive and are acquiring California-born and -based technology and talent as customers in all markets, globally, demand the same cutting-edge technology. These companies want to integrate California DNA into their products and even organizations.

LIU: Echoing Todd [Rumberger], I started 15 years ago, and one of my first deals was helping a PRC company list on the NASDAQ. So I thought this is great because then I could use my Chinese language skills and cultural background concurrently with my U.S. legal education. Unfortunately, the boom of PRC companies listing in the U.S. has tapered off significantly and with the various high-profile accounting scandals involving listed PRC companies, I am not sure we will see a new wave of Chinese companies listing in the U.S.. So I'm very happy 15 years later to see an increasing trend of more outbound M&A from China.

DOLOBOFF: I've seen things develop more along the lines outlined by Tom [Shoesmith]. The public company clients that I advise tend to use me repeatedly as special tax counsel. So I get to know the company and to know more or less their strategic goals. Their in-house tax staffs are very sophisticated, and their in-house legal staffs are. So what they do is balance me with other experts and obtain from us exactly what they want—no more, no less.

SHOESMITH: I find in international transactions, although I do the technical stuff, the place where I really add value is as an adviser. I think the legal profession is going in that direction, and I think that's a good thing.

RUMBERGER: And, if you do a good job, for a reasonable price (i.e., you're a good value), they're generally going to stick with you. You build a relationship with the founder, CEO, management, even the board. The relationships in the inbound transactions I've worked on have been similar to the relationships I've had with the earlier stage companies—rather than just marking up the purchase agreement and emailing it back and forth with opposing counsel, foreign buyer clients are looking more for strategy and business feedback on deal points. That's more rewarding—and more similar to my early-stage and venture-backed company practice. So back to my theme: The inbound stuff can be great work. ■