

## MANAGING FOREIGN INVESTMENT CLEARANCE RISK IN CROSS-BORDER DEALS

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The decades-long, Western consensus that most foreign inbound investment is benign is being tested like never before. This policy and political shift has been most visible in the case of the United States, where, for at least a decade, the Committee on Foreign Investment (“CFIUS”) has visibly and powerfully exercised its statutory authorities to review the national security implications of certain transactions that may result in foreign “control” of U.S. businesses. And

even in the U.S., the trend towards increasing skepticism about foreign investment on national security grounds seems poised to accelerate.

The U.S. Congress is currently considering a CFIUS reform proposal that would broaden the scope of CFIUS’ jurisdictional ambit to include joint ventures outside of the U.S., certain licensing agreements, and investments in “critical technologies” or “critical infrastructure” if the foreign investor would have a board seat, board observer rights, or special information rights.<sup>1</sup> The bill also encourages the President to work with other countries to develop CFIUS-like national security review processes for foreign investment.

### IN THIS ISSUE:

<b>Managing Foreign Investment Clearance Risk in Cross-Border Deals</b>	<b>1</b>
<b>M&amp;A Tax Aspects of Republican Tax Reform Proposal</b>	<b>7</b>
<b>The FTC’s Challenge of Red Ventures-Bankrate: Antitrust Risks in Deals Backed by Private Equity Minority Shareholders</b>	<b>10</b>
<b>How Delaware Has Radically Changed M&amp;A Law In Recent Years</b>	<b>11</b>
<b>How Does Antitrust Fare in the Required Reduction in Federal Regulations?</b>	<b>15</b>
<b>From the Editor</b>	<b>21</b>

But while the shift has been most visible in the U.S., it has not been limited to the U.S. Indeed, a similar concern about the national security implications of inbound investment is emerging in a number of important industrialized economies. This concern has important strategic and tactical consequences for cross-border transactions, particularly when one or more of these jurisdictions is implicated in a given transaction. Recently, Canada, Germany, the United Kingdom, and the European Union have each either adopted or proposed new requirements to evaluate the national security implications of certain foreign investment in their respective domestic markets or geographies. Although the developments vary in their scope and particulars, they share a policy conviction that “national security risk” can arise across multiple transaction types and with respect to industries and technologies that extend well beyond the defense sector, often implicating questions of “technological leadership” and the protection of the sensitive personal data of their citizens.

While these national security reviews can and

do present transaction execution risks, timely and thoughtful consideration of their relevance and impacts can typically mitigate such risks to a great extent.

This article discusses these new developments in Canada, Germany, the UK, and EU, and suggests some helpful transaction-planning considerations for dealmakers.

## Germany

### Overview

Under the Foreign Trade and Payments Regulation (the “AWV”), Germany’s Federal Ministry for Economic Affairs and Energy (the “BMW”) is empowered to review investments from parties outside of the European Union or European Free Trade Association that will result in acquisition of at least 25% of the voting rights of a German company. Certain highly-sensitive types of businesses are subject to a “sector-specific review,” while all others are subject to a “cross-sector review.” Under either review scenario, the BMW may block or impose mitigation on a transaction

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if the BMWi perceives that the transaction would threaten German “public order or security.”<sup>2</sup>

### Recent Developments

In July 2017, the German Federal Government amended the AWV to increase scrutiny of direct and indirect acquisitions and public takeovers of German companies, with a focus on those operating in “critical infrastructure” sectors (*e.g.*, software, telecom, energy). The changes were widely perceived as a response to Chinese takeovers of German technology companies, including the \$5 billion acquisition of KUKA, a German robotics company, by China-based Midea, which closed in 2016 following investment clearance in Germany and receipt of CFIUS clearance in the United States.<sup>3</sup> As a result, notifications to the BMWi are now mandatory for a broader universe of investments, irrespective of the size of the investment, and review periods of the BMWi have been extended.

Due to the recent amendments to the AWV, a written notification to the BMWi is not only required for a sector-specific transaction, focusing in particular on defense- and/or encryption-related products, but also for cross-sector transactions if the target company:

- is an operator of “critical infrastructure,” which includes the telecommunications, water and energy, information technology and telecommunication, healthcare, transport and traffic, and finance and insurance sectors, as well as nutrition;
- develops or amends software to operate such “critical infrastructure”;
- manufactures, has manufactured or is aware of telecommunication technology to imple-

ment governmental telecommunication surveillance measures;

- delivers certain cloud computing services; or
- holds a permit to deliver telematics infrastructure for the health industry.

Following initial notification of a transaction, the BMWi has three months to decide whether it wants to start a review process, which may take up to an additional four months in cross-sector reviews and up to three months in sector-specific reviews, provided all documents necessary for the review have been submitted to the BMWi. The review period authorized by statute may be extended, however, as the clock is tolled during negotiations on mitigation between the parties and the BMWi. The initial period of a cross-sector review might be shortened if the parties, instead of only notifying the BMWi, decide to submit an official application including all relevant documents and forms, similar to a sector-specific notification. In this case, the BMWi has two months to decide whether it starts a review process or issues a clearance statement (the so-called *Unbedenklichkeitsbescheinigung*).

While pre-closing filings are not required, the parties bear the risk of closing during the pendency of a BMWi review. Consequently, parties might consider initiating confidential discussions with the BMWi in an early stage of the transaction and should include BMWi review periods when contemplating their transaction timeline. In transactions involving so-called “critical infrastructure,” parties will tend to submit an official application immediately, instead of starting an informal notification procedure first, in order to avoid extending the review period even further.

The BMWi reportedly anticipates approximately ten additional applications per year due to the AWW amendments. However, given stated concerns of “fair competition” and the call to secure “better protection in corporate acquisitions,”<sup>4</sup> the reality will most probably look different, and result in a deeper scrutiny of foreign transactions and lengthened review periods by the BMWi.

## United Kingdom

### Overview

The UK has not historically maintained a separate national security review regime. The Enterprise Act 2002 (the “EA2002”) permits competition reviews of acquisitions where a target company’s UK business meets certain value or market share standards. The Secretary of State for Business, Energy and Industrial Strategy (the “Secretary”) is permitted to intervene in such reviews on national security grounds, but has done so only in rare cases.<sup>5</sup>

In the absence of notification by the parties under the EA2002, the Secretary may intervene only in certain defense-related cases. To date, all decisions, with one exception, have implicated UK businesses operating in the defense sector.<sup>6</sup> Decisions are public, and reviews by the Secretary on national security grounds may take up to 24 weeks, or longer.<sup>7</sup>

### Recent Developments

In October 2017, the UK government issued a Green Paper, entitled *National Security and Infrastructure Investment Review* (the “Paper”), setting forth proposals for strengthening the UK’s ability to monitor and review investments that

may raise national security concerns.<sup>8</sup> The Paper noted that the United Kingdom “need[s] to be alert to the risk that having ownership or control of critical businesses or infrastructure could provide opportunities to undertake espionage, sabotage or exert inappropriate leverage,” and cited the fact that “other developed and open countries [maintain] equivalent regimes.”<sup>9</sup>

- The Paper proposes that the UK government lower the monetary threshold for review from £70 million to £1 million, and would permit reviews even if a merger does not result in consolidation in the market. Notably, these two proposals would apply only to transactions involving (1) the military and dual-use sector, and (2) parts of the “advanced technology sector,” *i.e.*, multi-purpose computing hardware and quantum-based technology.<sup>10</sup>
- The Paper additionally notes that longer-term protection of national security may require additional measures, including mandatory notification of certain transactions involving “essential functions” (*e.g.*, civil nuclear and defense sectors).<sup>11</sup>
- The UK government will accept comments on aspects of the Paper through January 2018. Regardless of what reforms are ultimately implemented, the Paper reveals the considerations that are top of mind for the UK government. One such consideration—the prospect that even minority investments may present significant national security risk—is widely shared by key U.S. government officials, including Secretary of Commerce Wilbur Ross.<sup>12</sup>

## European Union

### Overview

Currently, there is no EU-wide framework for national security reviews of inbound investment. And until recently, the idea of a unified EU national security review process had been virtually absent from global discourse on foreign investment. While 12 EU member states currently maintain foreign direct investment screening mechanisms,<sup>13</sup> the nature and scope of these regimes vary widely. However, an EU-wide national security review framework may begin to take shape in a meaningful way in the near term, as Europe begins to display more unease with foreign direct investment. Some of EU's skepticism may be traced to populist undercurrents, but more of it, particularly at the political level, relates to EU-wide strategic concerns.

### Recent Enhancements

On September 13, 2017, in his annual State of the Union Address, European Commission ("EC") President Jean-Claude Juncker proposed a new framework for screening foreign investment into the EU.<sup>14</sup> The proposed framework builds on existing country-level national security regimes, and does not restrict the ability of EU member states to adopt any new review mechanisms. Nor does the EU proposed framework require countries to implement national security review mechanisms. Under the proposal, the scope of the EC's review of foreign direct investments is limited to projects or programs of interest to the European Union in the areas of research, space, transport, energy and telecommunications networks. The framework proposed encourages (but does not require) EU member states and the EC to consider the security and

public order effects that an investment would have on the following sectors:

- Critical infrastructure;
- Critical technology;
- Security of supply of critical inputs;
- Access to or ability to control sensitive information; and
- Control of the investor by the government of a third party.<sup>15</sup>

Notably, the proposed framework's emphasis on "critical infrastructure" and "critical technology" strongly aligns with the framework CFIUS uses to assess the national security implications of foreign direct investment in the United States. Moreover, the ability of a foreign investor to access sensitive information mirrors proposals for new national security factors in FIRREA.<sup>16</sup> This overlap suggests an emerging consensus between the EU and the United States on the aspects of foreign investment that are most likely to intersect with national security matters.

By the end of 2018, the EC plans to conduct an in-depth analysis of foreign direct investment flows into the EU, focusing on strategic sectors (such as energy, space, transport) and assets (key technologies, critical infrastructure, sensitive data) whose control may raise concerns for security, or public order reasons. Whether this analysis will yield formal regulatory changes remains to be seen.

### Transaction Planning Considerations

- Much of the global push for tighter restrictions on foreign investment stem from cross-border concerns regarding Chinese



acquisitions of technology and software companies, as well as other acquisitions in sectors that the Chinese government has deemed to be a strategic priority (e.g., biotech). As a result, deals involving Chinese parties or non-Chinese parties with ties to the Chinese market will continue to require advance consideration, careful planning, and precise drafting of relevant provisions in transaction documents.

- Every deal bears a different national security risk profile, and requires bespoke consideration. The analysis of whether to make a national security filing in a particular deal may change considerably based on the country of origin of the foreign buyer, among other things.
- Foreign investment clearance considerations are highly relevant—and complex—for private equity sponsors across the investment lifecycle. An evaluation of the regulatory DNA of the manager, fund, and any co-investors is often critical to a proper assessment of a proposed transaction against the various legal regimes.

#### ENDNOTES:

\*Available at [www.kirkland.com/cfiusbook](http://www.kirkland.com/cfiusbook).

<sup>1</sup>Mario Mancuso, Boyd Greene, and Luci Hague, “New Bipartisan CFIUS Reform Begins to Take Shape,” *Law 360*, (Nov. 13, 2017, 6:14), <https://www.law360.com/articles/983836/new-bipartisan-cfius-reform-begins-to-take-shape>; see also Mario Mancuso, *A Dealmaker’s Guide to CFIUS* (2017), available at [www.kirkland.com/cfiusbook](http://www.kirkland.com/cfiusbook).

<sup>2</sup>See Federal Ministry for Economic Affairs and Energy, “Investment Reviews,” <https://www.bmwi.de/Redaktion/EN/Artikel/Foreign-Trade/i>

[investment-reviews.html](https://www.bmwi.de/Redaktion/EN/Artikel/Foreign-Trade/investment-reviews.html), (last visited Nov. 17, 2017).

<sup>3</sup>See, e.g., Guy Chazan, “Germany Expands Power to Block Takeovers,” *Financial Times* (Jul. 12, 2017), <https://www.ft.com/content/5087c106-66fc-11e7-9a66-93fb352ba1fe>.

<sup>4</sup>See Federal Ministry for Economic Affairs and Energy, Press Release, Minister Zypries: “Fair Competition and Better Protection in Corporate Acquisitions,” (Nov. 16, 2017), available at <https://www.bmwi.de/Redaktion/EN/Pressemitteilungen/2017/20170712-zypries-besserer-schutz-bei-firmenuebernahmen.html>, (last visited Nov. 16, 2017).

<sup>5</sup>See Enterprise Act 2002, c.2, s.58.

<sup>6</sup>See, e.g., Decision Notice, “Proposed Acquisition by Hytera Communications Corporation Limited of Sepura PLC—Secretary of State Accepts Undertakings,” (May 12, 2017), [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/613788/sepura-hytera-decision-notice.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/613788/sepura-hytera-decision-notice.pdf) (last visited Nov. 16, 2017).

<sup>7</sup>See Enterprise Act 2002, c.2, s.46.

<sup>8</sup>Department for Business, Energy & Industrial Strategy, *National Security and Infrastructure Investment Review*, (Oct. 2017), [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/652505/2017\\_10\\_16\\_NSII\\_Green\\_Paper\\_final.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/652505/2017_10_16_NSII_Green_Paper_final.pdf), (last visited Nov. 16, 2017).

<sup>9</sup>*Id.* at 6.

<sup>10</sup>*Id.* at 36.

<sup>11</sup>*Id.* at 40.

<sup>12</sup>Wilbur Ross, “American Genius Is Under Attack from China,” *Financial Times* (Aug. 15, 2017), <https://www.ft.com/content/e283773a-801a-11e7-94e2-c5b903247afd>.

<sup>13</sup>Those countries are Austria, Denmark, Finland, France, Germany, Italy, Latvia, Lithuania, Poland, Portugal, Spain and the UK.

<sup>14</sup>See European Commission, Press Release, State of the Union 2017 - Trade Package: European Commission proposes framework for screening of foreign direct investments (Sept. 14,

2017), available at [http://europa.eu/rapid/press-release\\_IP-17-3183\\_en.htm](http://europa.eu/rapid/press-release_IP-17-3183_en.htm).

<sup>15</sup>*Id.*

<sup>16</sup>Mancuso, et al., *supra* note 1.

## M&A TAX ASPECTS OF REPUBLICAN TAX REFORM PROPOSAL

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The White House and Republican congressional leadership are moving closer toward passing a comprehensive tax reform package before Christmas, with the House having passed its bill and the Senate Finance Committee having reported its bill to the full Senate (as of November 17, 2017).

It remains to be seen which provisions reflected in the Senate and House bills will survive the legislative process and make their way into the Code. Regardless, adoption of several of the key provisions, like a corporate tax rate cut, will have a significant impact on M&A activity. In addition, there are also many less obvious provisions that may indirectly, but powerfully, affect the M&A market if adopted. The following article outlines some of the key areas with which the M&A market will be particularly concerned.

### Corporate Rate Cut and Individual Rate Cut

A reduction in the corporate income tax rate is expected to have a positive impact on M&A activity. Both the House bill and the Senate bill have maintained a permanent 20% corporate tax rate, without any sunset (unlike individual rates). The House version of the bill would make the tax cut effective for tax years beginning January 1, 2018, whereas the Senate bill delays the implementation of the tax cut until 2019. In either case, lower tax rates may induce many corporations that were worried about a high tax bill to be more willing to sell assets or subsidiaries to a prospective buyer. Lower tax rates for corporations may also make corporations more useful as an acquisition vehicle, as compared to partnerships or LLCs, depending on how the pass-through tax rate changes are finalized, as discussed below.

Lower individual rates may also spark additional M&A activity, particularly for individual sellers of LLCs or S corporations.

However, until an actual rate cut is passed, M&A activity may be chilled in the short term because parties will be hesitant to trigger a tax bill today that could be lower tomorrow if they wait. This is particularly true if the Senate's one-year delay in the corporate rate cut is passed, giving companies a strong reason to wait until 2019 before closing deals.

### Interest Deductibility

The current proposal contains limits on deductions for net interest expense to 30% of adjusted taxable income (or a corporation's proportionate share of its international group's net interest