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LEGAL ISSUES AND DEVELOPMENTS FROM CARLTON FIELDS

NAVIGATING CROSS-BORDER M&A TRANSACTIONS

STRATEGIES FOR SMOOTH SAILING

CARLTON FIELDS

Contents

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EXPECTFOCUS® International is a review of legal issues and developments related to international business, provided on a complimentary basis to clients and friends of Carlton Fields.

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Reform May Mean More CFIUS Filings in Cross-Border M&A Transactions

BY ANDREW J. (JOSH) MARKUS

One aspect of implementing a cross border merger or acquisition transaction is the possibility that a filing with the Committee on Foreign Investment in the United States (CFIUS) may be required.

CFIUS is a cabinet-level committee that reviews investments in national security sensitive U.S. businesses and determines whether they should go forward. CFIUS operates under the direction of the President and is chaired by the Secretary of the Treasury. It includes the heads of the Commerce, Defense, Energy, Homeland Security, Justice, and State Departments, as well as the U.S. Trade Representative and the Director of the Office of Science and Technology Policy. Several other offices also contribute: the Council of Economic Advisers, the Homeland Security Council, the National Economic Council, the National Security Council, and the Office of Management and Budget. In addition, the Director of National Intelligence and the Secretary of Labor are nonvoting members.

While the legislation establishing CFIUS was enacted in 1975, the requirement to file a notice of an investment was more theoretical than actual for many years. There have been a number of legislative fixes to CFIUS over the years that have strengthened CFIUS, almost all in reaction to some perceived threat to the security of the United States at the time. Over the summer, the Foreign Investment Risk Review Modernization Act (FIRRMA) was passed by Congress. FIRRMA amends the process used by CFIUS to assess national security-related concerns about foreign investment in the United States. Before FIRRMA, only controlling investments were required to be notified to CFIUS. Now, with the Trump administration's attention hyper focused on China and foreign acquisitions of U.S. technology and business in general, FIRRMA is the latest legislative fix. It has placed a determination of whether to file notice of an investment with CFIUS front and center and requires all investments, whether controlling or not, to determine if a filing is necessary .

In order to determine whether a CFIUS notification is required, several aspects of a proposed acquisition need to be considered.

Initially, is the investor the type of investor covered under CFIUS? Is it a "foreign investor?" Just because it is a U.S. entity does not mean it cannot be a foreign investor. A U.S. fund with foreign limited partners or general partners may be deemed a foreign investor for the purposes of CFIUS. If a foreign investor is a part of the U.S. investment entity, if the structure grants the investor some type of control rights or the investor is more than a passive investor, the entity may be deemed a foreign investor for CFIUS purposes.

If the investor is deemed a foreign investor, is the investment going to be made in a target business covered by what FIRRMA denominates as a "pilot program industry?" These pilot program industries are companies in sectors deemed critical to U.S. national security. There are 27 industries that have been specifically identified such as biotechnology, telecommunications, aviation, and defense.

In the event that an investment is to be made in an industry that is part of the pilot program, it is mandatory that a CFIUS filing be made no less than 45 days before a closing is to occur. If the investment is not in a pilot program industry, a filing is not mandatory. The benefit of filing is that once an investment is approved, approval cannot be revoked absent false, misleading or incomplete information having been supplied. If a filing is not mandatory, unless some national security implication is present as a result of the transaction, often no notification is made. CFIUS could theoretically invalidate such a non-notified investment at any time but generally such investments are never reviewed.

There is a lot more to CFIUS and filing determinations than can be provided in this short article. Whether or not to file is a judgment call that investors should discuss with their counsel. ■

Legal Due Diligence in Foreign Jurisdictions

BY GIOVANNI BISCARDI AND ARNALDO REGO

Prior to acquiring an equity interest in a foreign company, U.S. investors tend to feel insecure when determining the scope of the legal due diligence process to be conducted.

In these instances, the U.S. investors seek assistance from a local law firm, and are often surprised with the high number of U.S.-trained attorneys available in most foreign jurisdictions. Such attorneys are available to determine the scope of the legal due diligence required for the specific acquisition. However, an understanding by the U.S. investors of basic elements and concepts is helpful to maximize the results of the process.

Following are 11 different areas of legal and/or documentary review that are usually covered by legal due diligence of a foreign target.

Corporate

The primary objective of corporate legal due diligence is to determine whether the seller of the target has title to the shares, or equity interest, being sold, and whether such shares are encumbered by some form of lien or other encumbrance for the benefit of an uninvolved third party. In most jurisdictions upon request, a commercial registry will issue official documents setting forth the shareholders, or equity interest holders, of the target. However, depending on the jurisdiction where the commercial registry is located, these searches may take several days or even weeks to become available, possibly causing a delay in the acquisition process.

If the acquisition does not involve all of the shares, or equity interest, of the target, the relevant Shareholders' Agreement should be reviewed and analyzed. In many cases, such agreement will be renegotiated between the U.S. investors and the remaining shareholders of the target prior to the completion of the acquisition, setting forth the terms and conditions governing the U.S. investors' participation in the target as a shareholder and how the target will operate going forward.

Regulatory

To determines whether the target is, and has been, in compliance with regulatory legal due diligence, all applicable regulatory requirements. Local counsel must first determine whether the target is engaged in any regulated activities and if so, what local agencies regulate such activities. Once the determination has been made, local counsel should assess the regulatory requirements that are applicable to the target's regulated activities, and whether the target has been in compliance.

If the target has not complied with all applicable regulations, local counsel should determine whether it is possible for the target to become compliant without the application of any relevant fines or penalties levied by the applicable regulatory agency, following the completion of the acquisition. In the event the target is subject to any fines or penalties, local counsel should present an assessment of such fines and/or penalties to the U.S. investors so they can make an informed decision on whether to proceed with the acquisition and what contingencies, if any, they want to include in the acquisition agreements.

Real Estate

The primary real estate legal due diligence objective is to determine whether the target owns or leases any real estate, or a combination of both. If the target owns any real estate, local counsel should undertake the appropriate process in the relevant jurisdiction to determine who has valid title to the real estate property, and if there are any encumbrances such as liens or easements. As with the shareholder searches in the commercial registries, real estate registry search results may take several days or even weeks to become available, possibly causing a delay in the acquisition process.

If the target leases one or more real estate properties, local counsel should analyze the terms and conditions of the lease agreement(s) and whether the laws of the jurisdictions supersede, modify or supplement certain terms of lease agreements, to determine whether the consummation of the transaction will have any effect on the leases, such as requiring any waivers or assignments.

Non-Financial Contracts

Prior to reviewing any non-financial contracts, local counsel and U.S. investors must first determine which contracts are material and should be the subject of review. Considering the business and size of the target, local counsel and the U.S. investors should establish a threshold (most commonly the monetary value involved in the contract) in order to determine which contracts are material. However, other contracts that do not meet this threshold but are strategic to the operation of the target's business, should also be considered material and subject to review.

Once the material contracts are identified, local counsel should review each contract's terms and provide a due diligence report setting forth the parties, the amounts involved, whether any penalties and/or termination rights exists, and whether the contract is terminable or automatically terminates as a result of a change of control (possibly as a result of the relevant transaction). In the event any contracts include a change of control provision that would be triggered as a result of the transaction, the target may be required to seek a consent/waiver to such condition from the counterparty to the contract.

Financial Contracts

Similar to non-financial contracts legal due diligence, local counsel and U.S. investors must establish a threshold for determining which financial contracts are material, determined largely by the size of the target and the amount of indebtedness and financial arrangements into which it has entered. Given the nature of financial contracts, however, materiality will be more closely tied to the monetary value of the contract as opposed to its strategic nature, as these agreements are mostly finance- and debt-related.

Once the material contracts are identified, local counsel should review their terms and provide a due diligence report setting forth the parties, the amounts involved, whether any penalties and/or termination rights exists, if the contract is terminable or automatically terminates as a result of a change of control, whether the acquisition of the target would accelerate any maturity date or cause an event of default under any contract, and if any such occurrence would result in cross default of other financial contracts. In the event any financial contracts include a change of control provision that would be triggered as a result of the transaction, or results in a default and possibly cross default, the target should seek a consent/waiver to such condition from the counterparty.

Tax Liabilities

The primary purpose of tax legal due diligence is to determine the tax liabilities to which the target is subject. There are two categories of tax liabilities: materialized and contingent liabilities.

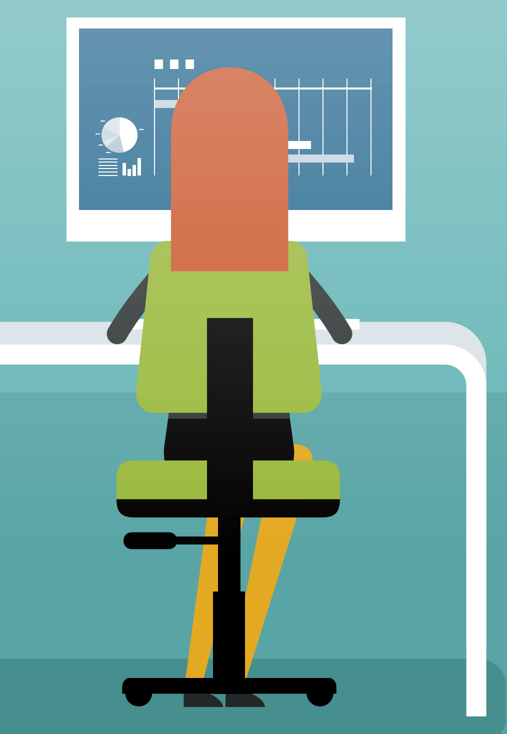
Materialized liabilities are those that actually have been incurred or are currently known and/or the subject of a judicial or administrative tax proceeding. Generally, local counsel should analyze the materialized liabilities and conduct a risk assessment analysis, categorizing the materialized liabilities as either generating a (i) remote chance of loss, (ii) possible chance of loss, or (iii) probable chance of loss.

Contingent liabilities are those that are not subject to any administrative or judicial proceeding, but could arise as a result of the practices and policies adopted by the target in its operations. Auditors engaged by U.S. investors in the financial due diligence process should conduct

an analysis of such practices and policies to determine the contingent liabilities and the amounts involved, and should request that local counsel assess the risk (i.e., classify the contingent liability as generating a remote, possible or probable chance of loss).

Labor Liabilities

Similarly to tax legal due diligence, labor legal due diligence determines the labor liabilities to which the target is subject. Like tax liabilities, labor liabilities are either materialized or contingent, and local counsel should analyze the materialized labor liabilities and conduct a risk assessment analysis while the financial auditors conduct a risk analysis of the practices and policies adopted by the target to determine the contingent labor liabilities.



Civil Litigation Liabilities

Unlike tax and labor legal due diligence, civil litigation legal due diligence only focuses on materialized liabilities. Given the nature of civil litigation, it is usually impossible to determine the effect of the practices and policies adopted by the target on potential civil litigation. Generally, local counsel should analyze the materialized civil litigation liabilities, conduct a risk assessment analysis, and categorize them as either generating a remote, possible, or probable chance of loss.

Intellectual Property

Prior to engaging in intellectual property (IP) legal due diligence, local counsel and U.S. investors must first determine whether the operations of the target are heavily dependent upon intellectual property. If so, local counsel will review the target's IP registrations and filings to determine whether they have been properly secured in all applicable jurisdictions.

Environmental

Environmental legal due diligence determines whether the target's operations require any environmental licenses and, if so, which environmental liabilities are relevant to the target.

Local counsel must first determine whether the target is engaged in any activities subject to environmental licenses and laws, and what agencies regulate such activities. Once this is determined, local counsel should assess which requirements are applicable to the relevant activities and whether the target has been in compliance. Similarly to civil litigation due diligence, local counsel should also analyze any materialized environmental litigation liabilities and conduct a risk assessment analysis.

Depending on the nature of the target's operations, U.S. investors may also consider engaging an environmental consultant to analyze the target's policies and practices, and any potential contingent liabilities.

Insurance

Insurance legal due diligence provides U.S. investors with a clear understanding of the coverage that has been contracted by the target to protect its assets and operations, so that U.S. investors may confirm whether the target is appropriately and sufficiently insured.

Conclusion

Although U.S. investors may rely on local counsel to ensure all relevant aspects are covered in a legal due diligence performed in a foreign jurisdiction, an educated U.S. investor familiar with the process will be better positioned to extract the most out of it, positioning itself to better negotiate the terms of the transaction, and determine whether to:

i. decrease the purchase price;

ii. include additional contingencies;

iii. include contingent/staggered payouts;

iv. increase amounts to be held in escrow; and/or

v. ultimately consummate the transaction. ■

The E-2 Visa: A Potentially Useful Tool in Cross-Border M&As

BY MARIA MEJIA-OPACIUCH

Changes to corporate structure, including mergers and acquisitions, can have enormous implications for the U.S. immigration status of key workers and potential new hires. When a U.S. company is acquired or formed because of a merger, and is majority-owned by a foreign entity or foreign national from an E-2 country, the E-2 Investor Visa may be available. In addition, the E-2 visa provides protections to cross-border investment between the two countries and the option to resolve investment disputes through international arbitration.

Who Can Use the E-2 Visa?

Typically, the E-2 visa is available to the principal investor as well as managerial, executive, or essential-skilled employees with the same nationality as the E-2 country, and the nationality of the majority owners of the E-2 company. To qualify, E-2 applicants must show they are actively investing or have invested a substantial amount of capital in a bona fide enterprise. An E-2 visa, issued for five years at the U.S. consulate overseas, allows an E-2 spouse to work and any E-2 children under 21 to study in the United States.

What Must the E-2 Visa Applicant Show?

The E-2 applicant, who submits the application directly to the E-2 visa offices at the pertinent U.S. consulate overseas, must include evidence of: 1) ownership; 2) nationality; 3) the substantial investment at risk explaining the path of the E-2 investment funds; 4) the corporate documentation of the E-2 company — in the cross border M&A transaction, this includes the purchase of the acquisition or the formation of the newly-merged company, evidencing 50 percent or more ownership by treaty national or nationals; 5) the applicant's qualifications to direct and operate the E-2 company; 6) a detailed and complete business plan if the newly-formed U.S. company has existed for less than a year; and any other evidence the U.S. consulate requires.

How Does the U.S. Government Determine an Investment Is 'At Risk'?

General E-2 visa processing considerations for founders, principal investors, or employees (those to be transferred from overseas or new hires) are to ensure that the substantial investment be one that is "at risk." This means the capital must be subject to partial or total loss if investment fortunes reverse. Further, the E-2 applicant must show irrevocable commitment of funds to the U.S. E-2 company. The U.S. immigration rules allow the placement of funds in escrow pending approval of the E-2 visa with a legal mechanism that irrevocably commits funds but also protects investors if the E-2 application is denied. Commercial investments must be active (not passive), entrepreneurial, and cannot be made in nonprofit institutions.

What Constitutes a 'Substantial' Investment?

To establish that an investment is substantial, the U.S. Department of State uses a relative proportionality test that considers the amount of qualifying capital invested weighed against the total cost of purchasing or creating the E-2 company; the amount of capital normally considered sufficient to ensure the investor's financial commitment to the success of the E-2 company; and the magnitude of investment to support the likelihood that the investor will successfully develop and/or direct the E-2 company. Thus, the lower the cost of the E-2 company, the higher, proportionally, the investment must be to be considered "substantial." The E-2 investment cannot be marginal to only support the E-2 principal. The January 2017 Buy American, Hire American executive order is now an oft-cited requirement in E-2 investment applications. The E-2 investment must show the potential for hiring Americans and inducing economic growth in the area of the E-2 investment.

Conclusion

The U.S. government is more closely vetting immigration applications, and work visas like the E-2 in particular. To determine whether the E-2 visa may be the right option in light of a cross-border M&A, it is critical that foreign nationals consult with their immigration counsel. ■

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