

Chemical Industry Update - January 2019

by Troy M. Keller, David Marx, Dave Townsend, and T. Augustine Lo

Government Shutdown and Impact on the Chemical Industry

I had really hoped the partial government shutdown would be over before this issue came out, but here we are. From what we've been hearing, the operations of most in the chemical industry do not appear to have been materially impacted—not so far, anyway. International trade is still flowing, even if some important initiatives are on hold (see more on trade below). In terms of litigation matters, while federal courts are barely operational going forward (e.g., no money for court employees from January 25 on), the dockets of chemical companies tend more to be in state courts anyway. The skeleton crew at the EPA is not believed to be progressing new product reviews under TSCA right now, but that backlog was quite large before the shutdown, so it's hard to say much has changed: again, at least in the short term.

Where the shutdown is having the most immediate impact is on corporate transactions. The primary U.S. regulatory processes that tend to be relevant for chemicals deals include the SEC registration process, the HSR filing and merger review process and—for transactions involving foreign investors—the CFIUS review process. Here is a quick run-down on these areas:

- **SEC.** The fact that the SEC is not reviewing or declaring registration statements effective means securities lawyers need to head to the law library to sort a path for deals involving registered securities (public equity offerings, mergers, exchange offers, etc.). The SEC has offered some guidance, but it is filled with caveats.
- **HSR.** HSR filings are being accepted, but early termination is not being granted, and in the event of competitive issues, second requests are likely to be issued, throwing many transactions into a lengthier and more costly process than they otherwise would have been in.
- **CFIUS.** The timing for CFIUS deadlines and time limits are tolled during the shutdown. This means companies who filed mandatory declarations may find themselves in limbo, potentially until well after the shutdown ends, while the backlog is being worked through. Other transactions face a difficult decision: do they make a CFIUS filing and play the waiting game or do they move ahead with their transaction

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and face the risks of CFIUS review post-closing?

To be clear, deals are still happening, and there are ways to manage these challenges, but buyers and sellers need to enter negotiations having thought ahead about how these factors will impact timing and deal certainty. And unfortunately, even when the shutdown is over, the backlogs will likely remain.

2019 Proxy Season: Disclosure Trends

Proxy season is upon us. There is no one at the SEC to connect with on shareholder proposals and registration statement effectiveness, but that doesn't mean a lot isn't happening in terms of disclosure trends. Chairman Clayton and others in the SEC pushed out views on a number of topics before year-end, noting an expectation to see better disclosure on Brexit's impacts on companies and risks associated with cybersecurity. He also commented on ESG disclosures, acknowledging the trend and the investor interest but suggesting thoughtfulness in how these are approached. We fully agree. There is rising pressure to include sustainability & social responsibility disclosures in SEC filings, and at some point it will be difficult not to have a dedicated section in a company's proxy. Indeed, climate change and sustainability topics made up by far the largest category of shareholder proposals last year. Expect to see more of the same in 2019. But in our view, these disclosures should be considered carefully. We have examined the variety of approaches taken within and outside the industry, and at least for the time being it's hard to do these except in a customized way. To catch up on these trends, Dorsey held useful webinars that are available for playback, both on the 2019 proxy season generally and on ESG trends specifically.

How U.S. Trade is Affected by the Shutdown (including NAFTA 2.0)

The U.S. Government shutdown has significantly impaired the ability of key agencies to address trade-related issues facing U.S. companies. Processing of exclusions from 301 tariffs by USTR, for example, remains on hold. Likewise, the U.S. Department of Commerce, which investigates complaints concerning unfairly priced or subsidized imports, announced that its investigation deadlines are tolled until the government reopens. The U.S. International Trade Commission, which also handles proceedings relating to unfair trade complaints, announced that the shutdown has disrupted its ability to carry out ongoing antidumping, countervailing duty, and intellectual-property related investigations, and that updates to the Harmonized Tariff Schedule will not be made during the shutdown. With the partial or near-total closure of these three key agencies, members of the chemical industry may encounter difficulties in obtaining the attention to their trade-related concerns, such as relief from the Trump Administration's tariff actions.

The shutdown is also diverting attention from U.S. Congressional ratification and implementation of the new trade agreement concluded last year with Canada and Mexico. Formally called the U.S.-Canada-Mexico Agreement ("USMCA"), the popular press has also dubbed it, "NAFTA 2.0." While the USCMA contains some significant deviations from the current NAFTA, such as the provision for automatic termination after 16 years absent agreement to continue in force, the USMCA retains duty-free treatment

for goods that are currently subject to such preferential treatment under NAFTA. Most importantly for the chemical industry, the USMCA proposes to include an Annex 12-A (“Chemical Substances”), which could significantly reduce impediments to cross-border trade in chemical products. That annex specifically addresses the harmonization of chemical regulations among the three countries, including a coordinated approach to assessing the risks of chemical products for regulatory purposes. Actual implementation of this concept, of course, will depend on Congress’s willingness to adopt the text that the Trump Administration negotiated with Canada and Mexico.

Update on 301 Exclusion Applications

Since July 2018, the Trump Administration has imposed three sets of tariffs under Section 301 of the Trade Act of 1974, which have had a significant impact on the chemical industry. Citing allegations of forced intellectual property transfers targeting U.S. businesses operating in China and Chinese industrial policy, the Trump Administration’s tariffs cover approximately one-half of goods originating from China. These Section 301 tariffs are in addition to other tariffs that American importers must pay on these goods.

The first round of tariffs issued in July 2018, covering approximately \$34 billion in annual imports, primarily targeted machinery and related goods, and thus had limited impact on the chemical industry. The second list, however, imposed in August 2018 includes a large number of organic chemical compounds and other items valued at approximately \$16 billion in imports, subjecting them to 25% ad valorem tariffs. Because of the impact on downstream consumers in the United States, a number of affected companies unsuccessfully opposed this second list before it was finalized, and have asked for exclusions from the tariffs under procedures issued by the Office for the U.S. Trade Representative (“USTR”). To date, USTR has not granted exclusions under the second list, although most of them remain under consideration by USTR. By comparison, USTR issued approximately 1000 exclusions under the process for the first list; another 1730 requests have been denied.

The third list of goods subject to tariffs, by far the largest set, covers approximately \$200 billion in annual imports from China. This list includes a wide range of organic and inorganic chemical products, as well as goods made from plastics and synthetic materials. Initially taking effect at 10% ad valorem in October 2018, the Trump Administration had promised to increase the rate to 25% ad valorem in January 2019. However, in early December 2018, the White House and Beijing announced a pause in new tariffs such that the USTR would delay increasing the rate for the third list until early March 2019, pending the outcome of bilateral negotiations intended to resolve the trade tensions that led to the imposition of the Section 301 tariffs. While the outcome of those negotiations remains uncertain, the USTR recently indicated a willingness to establish an exclusion process for affected importers if the rate increases later this year to 25% ad valorem.

Chemicals M&A in 2019: The Advantages of Bolt-Ons

Predictions about deal activity in 2019 have been mixed. For the chemical industry, the slow-down in terms of *quantity* of deals is already happening. The number of chemicals deals \$25mm or larger dropped an estimated 40% from 2017 to 2018. And in 2019, there are a number of headwinds that won't help, including trade wars, increased regulatory hurdles and slowdown of major economies.

One category of transactions that can be advantageous, headwinds notwithstanding, is the bolt-on or tuck-in transaction. These deals typically range in size from \$5 to \$200 million and involve a product line or roll-up of a facility that can be tucked into an existing business unit. On the legal front, a significant advantage is that bolt-ons often don't require an antitrust review due to their size. This avoids major expense and potential for delay. Foreign investment reviews, if applicable, are also simpler in a deal that involves one or two product lines or a single facility.

At Dorsey, we love these transactions because they can be executed on quickly and efficiently if approached in the right way. Having an industry-tailored and process-based approach to due diligence is the top priority. Reps & warranties insurance is available even on very small deals and can help bridge across differences in terms of risk appetite. In our view, earn-out provisions, while popular, tend to be the trickiest parts of these transactions. Recent caselaw reinforces this view and suggests that efforts to reduce the contractual standard (e.g., from best efforts to commercially reasonable efforts) will be lost on the court, so designing simple, clear objectives and obligations is key.

Notes from All Over

After much anticipation, the Alliance to End Plastic Waste was launched last week by a consortium of industry companies. Chemical Week's article summarizes the initiative well.

China is considering upgrading its chemical regulation program. From initial signs, the proposed law's requirements would rival those of other major chemical regulation regimes around the world. As we've noted before, the proliferation of rigorous chemical laws (and retailer chemical policies) is inevitable, but without better coordination these costs will become a material burden on global manufacturers.

On December 21, 2018, the California Court of Appeals upheld the enforceability of forum selection clauses in bylaws of a Delaware corporation. For public companies that have a forum selection clause, this is positive news, as it appears more and more likely these will be enforced outside of Delaware and plaintiffs won't have venues they can run to circumvent validly adopted bylaws. This good news is tempered by the trend in recent years for plaintiff lawyers to make securities law based claims rather than fiduciary ones, even in the M&A context, and so they can bring those claims in federal court, or in some cases other state courts.

Parliament warns that the UK Government has failed to prepare for chemical registration post-Brexit, suggesting risks that UK products may not be valid for sale in the EU post-Brexit.

The latest issue of Dorsey's Anti-corruption Digest is available. Great reporting of the more interesting cases and investigations all around the world.

Helpful background and analysis from Dorsey's environmental team regarding the ongoing uncertainty surrounding the application of the Clean Water Act to waters of the United States (WOTUS).

A House bill titled the Energy Innovation and Carbon Dividend Act of 2018 was proposed late last year and gets points for creativity. It would tax carbon emissions at the production end (refineries, coal mines, natural gas lines) and use the proceeds to pay a dividend out to all U.S. citizens.

If there was ever any doubt, new California Governor Gavin Newsom seems to be picking up the baton from outgoing Governor Jerry Brown on environmental topics. This from Newsom's inaugural address: *"California has always helped write America's future . . . People's lives, freedom, security, the water we drink, the air we breathe – they all hang in the balance. The country is watching us. The world is waiting on us. And the future depends on us. And we will seize the moment."*

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