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CFIUS and China: Is This the Year of the Big Showdown?

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Observers of the global trade scene are familiar with the refrain: "The Committee on Foreign Investment in the United States is biased against Chinese investors. Despite vows from policymakers that the process is investor-neutral, apolitical, and focused on core national security issues, the reality is that CFIUS is the bouncer at the door of the U.S. economy regulating entry by our most formidable geopolitical rival." As then-Minister of Commerce Chen Deming complained to U.S. officials in 2011, screening of Chinese investment is "neither fair nor transparent."[1]

Is he right? Maybe. 2016 is shaping up as the year when this debate might well come to a head. In just the first two months, the CFIUS process played a decisive role in turning back three significant Chinese investment deals in the U.S. technology space, and a fourth deal looms. To be precise, in one case CFIUS completed an investigation and rejected proposals by the parties to mitigate undisclosed national security concerns. The second deal never made it to a CFIUS review. Instead, the U.S. target rejected a Chinese bid in favor of a slightly lower offer from a U.S. company, citing the "unacceptable level of risk" that the Chinese takeover would be blocked by CFIUS. And in the third, a routine decision by CFIUS to convert its initial review to a formal investigation opened an escape hatch through which the Chinese investor exited the deal. The coming weeks will also see CFIUS grappling with the reported $43 billion acquisition of Swiss agrotech company Syngenta, which owns chemical and R&D facilities in the U.S., by state-owned giant ChemChina.

There is no question that the pace of Chinese outbound M&A is on the rise. And the United States remains the most stable and desired destination for Chinese companies looking to hedge against asset devaluation in their own economy while securing technological upgrades in the process. There is zero evidence that CFIUS is targeting Chinese acquisitions for heightened scrutiny, but the sheer increase in the number of Chinese deals that will be filed for review sets the stage for an outright economic confrontation between World's economic superpowers.

Three Deals in Four Weeks

The four-week period between January 22 and February 23, 2016, was an ugly one for Chinese investment in the United States, as the market saw three deals halted in part due to CFIUS.

Philips–GO Scale Capital. On January 22, Dutch-based Philips announced that the parties had terminated a $2.8 billion deal, announced the prior year, in which a consortium led by China's GO Scale Capital would acquire an 80.1% interest in the Philips Lumileds division headquartered in California. The deal quickly ran into trouble with CFIUS, with the company indicating as early as

October 2015 that the U.S. was raising "concerns" with the deal.[2] In announcing the termination, Philips' CEO explained that CFIUS's rejection came "[d]espite the extensive efforts of Philips and GO Scale Capital to mitigate" the committee's concerns.[3]

The parties could not disclose the nature of CFIUS's objection, but Lumileds boasts advanced technology for developing semiconductor materials used in LED lighting. Sophisticated electronics technology—including semiconductor manufacturing—features prominently among the targeted industries in China's 13th Five Year Plan, and the U.S. intelligence and national security communities are taking notice. Rejection of the Lumileds deal might well reflect a concern about technology transfers in this space.

Fairchild–CRM. On February 16, Fairchild Semiconductor announced in a securities filing that it was declining a $22-per-share takeover bid from China Resources Microelectronics Ltd and Hua Capital Management Co Ltd, citing concerns over the CFIUS process. Instead, Fairchild elected to go forward with an existing agreement with U.S.-owned ON Semiconductor valued at $20 per share, a deal that poses fewer regulatory hurdles. Fairchild rejected the Chinese offer despite the fact that the buyer offered a "hell or high water" commitment to obtain CFIUS approval and a "reverse breakup" fee of $108 million in the event CFIUS approval was not obtained. In its filing, Fairchild reported that, while its board was "generally of the view that there is a substantial probability" the Chinese-led transaction would obtain CFIUS approval, it also determined that forgoing the benefits of the ON Semiconductor proposal, including the shareholder premium presented by that deal, in favor of the Chinese bid would cause the company and its stockholders to bear "an unacceptable level of risk for a failure to obtain CFIUS approval."[4] This risk, the board concluded, was not adequately offset by the $108 million reverse breakup fee. This might be the clearest case in which the mere risk of a CFIUS rejection, even where the company found a "substantial probability" of approval and stood to collect a large breakup fee if it were not obtained, defeated the efforts of a Chinese party seeking to compete with a U.S. rival whose lower economic offer did not face similar regulatory barriers.

Western Digital–Unisplendour. On February 23, exactly one week after Fairchild's announcement, U.S. storage technology company Western Digital revealed that China state-owned Tsinghua Unisplendour had pulled out of a deal to acquire 15 percent of the company, a transaction valued at $3.78 billion. Western Digital's shares fell 7% on news of the pullout, which is also expected to complicate WD's subsequent bid to acquire flash memory company SanDisk. Unisplendour took advantage of an unusual provision in its investment agreement that provided either party with a 15-day window to walk away from the transaction if, after an initial review, CFIUS determined that it would conduct a formal investigation. The parties must have known that this escape hatch was likely to open; a high number of cases filed with CFIUS move from initial review to the investigation stage—52 out of 147 covered transactions in 2014, according to the latest CFIUS annual report.[5] Most of those are cleared without restriction.

There is a strong indication that Unisplendour's decision to terminate was based more on the unfavorable economics of the deal than on a concern that CFIUS would ultimately block or restrict the transaction. Unisplendour would have been obligated to pay a substantial premium over market for the WD shares, and the Wall Street Journal reported that the chairman of Unisplendour's parent company believed that the investment would have been detrimental to both companies' investors.[6]

The Next Big Thing

As has been widely reported, the parties to the ChemChina/Syngenta acquisition have elected to file for CFIUS review, given the business operations maintained by Syngenta in the United States. The review period could extend into the summer. No significant information has come to light suggesting that obtaining clearance will be problematic or controversial, but should the deal run aground 2016 would go on record as the toughest year to date for Chinese investment in the United States. And that could cause China's simmering frustration with the CFIUS process to break into open criticism that the nonpublic review process is casting an unacceptable shadow of uncertainty on bilateral investment flows between the two nations.

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[1] "Suspicions Dampen Inflows," *China Daily USA* (Dec. 9, 2011).

[2] http://www.newscenter.philips.com/main/corpcomms/news/press/2015/philips-third-quarter-results-2015.wpd#.Vtc4KHMUWUk.

[3] http://www.newscenter.philips.com/main/standard/news/press/2016/20160122-philips-and-consortium-led-by-go-scale-capital-terminate-lumileds-transaction.wpd#.Vtc1SnMUWUk.

[4] https://www.fairchildsemi.com/about/investors/sec-filings/iframe/phoenix.zhtml?c=249110&p=irol-SECText&TEXT=aHR0cDovL2FwaS50ZW5rd2l6YXJkLmNvbS9maWxpbmcueG1sP2lwYWdlPTEwNzQzMDAwJkRTRVE9MCZTRVE9MCZTUURFU0M9U0VDVElPTl9FTlRJUkUmc3Vic2lkPTU3.

[5] https://www.treasury.gov/resource-center/international/foreign-investment/Documents/Annual%20Report%20to%20Congress%20for%20CY2014.pdf.

[6] "Chinese Firm Ends Investment in Western Digital, Complicating SanDisk Tie-Up," *Wall Street Journal* (Feb. 23, 2016).