

Review of China Deals in the U.S.: More, Broader, Stricter

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To those who work with Chinese investment into the U.S., 2014 has started with a bang with the announcement at the end of January of Lenovo's acquisition of Motorola Mobility from Google. This followed a 2013 that had landmark explosions of its own, led by the largest acquisition ever by a Chinese company of a U.S. business: the \$7 billion purchase of pork-processor Smithfield Foods by Shuanghui International.

Everyone knows that the pace of Chinese investment in the U.S. is accelerating. And everyone knows it is growing more complex and varied, as Chinese consumer companies like Lenovo and Shuanghui move to use their financial resources across a global footprint, to secure supply lines and technology advances for rapidly maturing Chinese consumer tastes, and to find ways to leap up the curve in access to the American market.

Figuring out how this will all unfold, particularly in terms of potential roadblocks from the mandate of the Committee on Foreign Investment in the United States (CFIUS) to assure that foreign acquisitions do not damage U.S. national security or critical infrastructure, is not so easy.

Our firm had the privilege of handling the deal for Shuanghui, and – so to speak – got to see the sausage made up close as it worked its way through CFIUS review. But for others who did not enjoy that vantage point, the CFIUS landscape is about as blurred as any zone of federal regulation, in part because of the studied opacity of the CFIUS process.

Two new reports shed some interesting light on the subject – though one of them is unfortunately a bit stale on arrival. That is CFIUS' own Annual Report to Congress,¹ issued in the waning days of December 2013 – and covering the year 2012. Though the statute calls for the annual report to handed to Congress by July 31, in this field late – at least late in release to the public, since the report may well have been sitting in Congress' idle hands for a while – is better than never.

The second report comes from the ever-alert Rhodium Group, which opened the new year with a comprehensive report on Chinese investment in 2013.² The Rhodium report provides valuable color in evaluating where the trend lines are pushing the CFIUS process. And it supplies one key data point not available from CFIUS until we get the 2013 annual review: the value of inbound Chinese deals literally *doubled* from 2012 to 2013, largely led by the Shuanghui/Smithfield transaction.

The CFIUS Annual Report

Still, the 2012 CFIUS Report tells us some important things that can shape 2014 thinking about Chinese investment.

China is now #1 -- in deals reviewed. In 2012, for the first time, more investments from China underwent CFIUS review than from any other country. The former title-holder, the U.K., slipped from 26 reviewed deals in 2010 to 17 reviewed deals in 2012. For China, the number of reviews for those years nearly quadrupled, from 6 to 23.

- This tells us two important things. First, the escalation rate for Chinese reviews is as rapid as those of us practicing in the field have guessed. Second, the level of sophistication among CFIUS agencies and staff on Chinese investment is compounding as well – they know more, they know how to evaluate information better, they understand better what information they can and should seek, and they know better how to counsel the CFIUS applicants who take advantage of the pre-filing consult mechanism in hopes of getting a short – or at least an easier – CFIUS ride.

“Innocent” deals can crash. Who would have suspected a Chinese buyer of a wind farm would become the first deal to attract a Presidential veto since the days of Bush 41? And who would have predicted, a few years ago, that geographic “proximity” to sensitive locations would become a dominant element of CFIUS’ analysis?

- The 2012 Report notes that the President blocked the acquisition by Ralls Corporation of an Oregon wind farm project composed of “sites [that] all are within or in the vicinity of restricted air space at Naval Weapons Systems Training Facility Boardman,” which the Navy advertises as its “primary training range on the west coast for conducting low altitude, air combat maneuvers.”³ It is no surprise that having Chinese eyes posted on wind towers off the Oregon coast did not go down smoothly inside DoD. But the Ralls case also brought to the forefront the importance of “proximity” for any routine deal. A company like Smithfield, with hog processing facilities in hundreds of locations and a headquarters not far down the road from the Tidewater Virginia naval complex, learned to expect a penetrating “proximity” analysis even if its most complex product was cured ham.

Chinese deals do crash. The 2012 Report reveals that 22 transactions were withdrawn in 2012, by far the largest figure in recent CFIUS history.⁴ Of these, nearly all – 20 – were withdrawn during the second-phase 45-day investigation, signaling that there were problems with the transaction that, at minimum, could not be ironed out with CFIUS before the statutory clock expired. And of these, nearly half – 10 of 22 – were not refiled. That suggests those deals were cratered by an inability to pass CFIUS muster, even if additional time was taken to revise the deal structure to address the concerns of the military or intelligence agencies.

- The CFIUS Report does not expressly disclose the nationalities of the withdrawn reviews. It is safe to surmise, though, that a large percentage were Chinese: the jump in the number of withdrawn transactions from 2011 to 2012 largely mirrors the jump in the number of Chinese transactions undergoing review.

Mitigation measures continue to be the name of the game. The 2012 Report is less transparent on the use of mitigation measures, the primary tool to solve agencies’ concerns about adverse effects on their programs. It notes that, in 2012, mitigation measures were used in 8 transactions, or 7% of

the total reviewed. That figure is consistent with prior years – suggesting that 2012 was the first year in which more deals actually cratered entirely through withdrawal than were revamped via mitigation negotiations.

- Again, the data are not broken down by originating country, but there is little reason to doubt the lesson: Chinese deals may be more subject to unresolvable CFIUS hangups than others, which may more easily be fixed through board siloing, appointment of cleared security officers, carve-outs on defense contracts, or carve-outs of foreign nationals permitted to work on specific projects.
- The 2013 report should reflect what, from public reporting, appears to be stepped-up mitigation activity in the CFIUS space, including the hiving-off of A123's U.S. Government business in order to facilitate Wanxiang Group's acquisition of the remaining assets from bankruptcy in January 2013, CNOOC's agreement to take a "hands-off" posture on some of Nexen's U.S. assets to get clearance of that deal in February 2013, and unprecedented concessions by SoftBank to clear its acquisition of Sprint in the summer of 2013.

"Coordinated strategy." One final aspect of the 2012 Report of intriguing interest to watchers of the China/CFIUS intersection: the Committee's "finding" that "the U.S. Intelligence Community (USIC) judges it unlikely that there is a coordinated strategy" among any foreign country or company to acquire U.S. companies "involved in research, development, or production of critical technologies for which the United States is a leading producer."

The statute instructs CFIUS to make an annual finding in its report on the presence of a "coordinated strategy" to acquire critical technology companies. In its report for the preceding year (covering 2011), CFIUS reported that "the U.S. Intelligence Community (USIC) *judges with moderate confidence* that there is *likely* a coordinated strategy among one or more foreign governments or companies" ⁵ to acquire critical American technologies. The report for 2010 had reported an opposite USIC view, using the same "unlikely" formulation that reappeared in the 2012 report. ⁶ But in years prior to that, the Committee had opined directly on its own behalf (using the royal "we"): "*We judge it unlikely* that there is a coordinated strategy among one or more foreign governments or companies to acquire United States companies involved in research, development, or production of critical technologies for which the United States is a leading producer." ⁷

Little wonder, with the "intelligence community" unable to come to a steady conclusion on the question, that the CFIUS agencies have now retreated behind "the judgment of the USIC" for this aspect of its annual report. Though it has not been specifically stated that China was the target of the "moderate confidence" judgment, it has been widely assumed that is the case. One may also assume that Congress has acquiesced in having this concern offloaded to intelligence sources, but one wonders what internal disagreements within CFIUS this head fake conceals about suspicions of Chinese aims. And one may ponder what hiccup in 2011 led to the "moderate confidence" finding, and what actions (if any) China took in 2012 to iron that wrinkle out of the new report.

In any event, to the extent close readers of the public CFIUS report drew concerns last year that some hammer might be about to fall on Chinese investment as the result of the "moderate confidence" finding, this year's report casts us back to the view that, while foreign governments and companies are vigorously using espionage to obtain sensitive technologies, none of them are conducting a coordinated strategy aimed toward doing so. That means that private Chinese acquirers – companies like Lenovo or Shuanghui – need not start with fear that the merits of their deal will founder on the

basis of an unspecified suspicion that a grand scheme is in play to extract American technologies in a coordinated fashion.

The Rhodium Report

The Rhodium Group sheds considerably more light on the year just past in its 2013 report on Chinese foreign direct investment (FDI). It notes that private Chinese firms – companies like Lenovo and Shuanghui – accounted for more than 80% of the transactions, and more than 70% of the transaction value, in inbound Chinese investment into the U.S. in 2013. Among its key findings:

- The number of Chinese transactions went up in 2013, and the size of the deals grew significantly. The Shuanghui/Smithfield deal drove the numbers – and it still dwarfs later deals like Lenovo/Motorola in size – but the relative size of other deals also grew from the prior year.
- The sectors most impacted were food, energy, and real estate. Deals in advanced manufacturing were “mostly small and medium in size.”
- Chinese acquirers are becoming increasingly visible in local U.S. economies. The number of jobs for Chinese companies in the U.S. grew to more than 70,000, a more than 8-fold increase since 2007.

To this one might add that in 2013, Chinese buyers showed increased comfort and dexterity in dealing with sensitive American properties and issues. In acquiring Smithfield, Shuanghui not only bought several iconic American brands in the pork business; it also acquired a largely unionized workforce, a first for a Chinese acquirer, and it carried out the acquisition with union support. In buying several marquee pieces of New York real estate – the GM Building and Chase Manhattan Plaza – Chinese buyers stepped into a spotlight they had tended to avoid, and one that proved a debacle for Japanese real estate investors 20 years ago.

Rhodium notes one risk that emerged over 2013 as the shrinking faction opposed to Chinese investment in virtually any form sought a basis to oppose the Smithfield Foods acquisition by a private Chinese buyer: efforts to broaden the “national security” rationale for CFIUS review into a wider “net benefit” test that would call for inclusion of non-security economic consideration in the analysis. We can expect variants of the “food security is national security” argument used in Shuanghui/Smithfield to surface again as transactions closer to mainstream technologies – like Lenovo/Motorola – arise.

But the CFIUS process has shown little inclination to expand into new territory from its already difficult and demanding responsibilities in the zones of military, intelligence, and advanced technology. Its staff faces considerable strain in collecting and synthesizing agency views on the national security issues within the tight timelines specified by the law. Already it seems clear that in a number of cases in which 45-day investigations have been commenced, that result has been driven as much by the difficulty of assembling and evaluating the facts – even when acquirer and acquiree parties come to the transaction with a ready package of data and analysis – as by the need for a deeper second-phase dive into the details.

Looking ahead

We expect 2014 to bring the hardest challenges yet to the CFIUS process. As the American economy rebounds and the U.S. becomes regarded again as both a safe and an expanding venue for investment, more acquisitions are surely in the works.

Now that Chinese buyers see, from the 2013 examples of Shuanghui/Smithfield and CNOOC/Nexen, that the playing field is not rigged to make large-scale Chinese acquisitions fail – and that the U.S. foreign investment process will be guided in at least some difficult instances by merit, even in the face of political pressure – it is our expectation that the data in CFIUS' 2014 report will show an even more dramatic expansion of Chinese FDI in U.S. companies. But some of these will be hard cases.

And just as hard cases make for bad law, they make for potentially bad outcomes in the CFIUS process. Those risks are aggravated as the U.S. begins an election cycle leading up to the 2014 Congressional elections, in which a few districts may determine control of both the House and the Senate – and in which a hot-button issue such as a Chinese acquisition of a major employer in one of those districts can reshape the candidates' debate or swing the results. So as always, nothing is more important than careful preparation, advance anticipation of problems and issues, full assembly of a public relations and legal team, and dexterous use of the opportunities the CFIUS process presents to prepare the groundwork well before an acquisition is announced.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings Washington, D.C. lawyers:

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¹ [CFIUS Annual Report to Congress.](#)

² [Chinese FDI in the US: 2013 Recap and 2014 Outlook.](#)

³ See <http://greenfleet.dodlive.mil/rsc/airspace-compatibility>.

⁴ There was a bump in withdrawn deals in 2008, but 18 of the 23 withdrawals that year occurred during the initial 30-day clock at CFIUS – that is, likely not because approval of deal was in jeopardy, but because of the economic collapse that occurred over the course of 2008.

⁵ CFIUS 2011 Report, <http://www.treasury.gov/resource-center/international/foreign-investment/Documents/2012%20CFIUS%20Annual%20Report%20PUBLIC.pdf>.

⁶ CFIUS 2010 Report, <http://www.treasury.gov/resource-center/international/foreign-investment/Documents/2011%20CFIUS%20Annual%20Report%20FINAL%20PUBLIC.pdf>.

⁷ E.g., CFIUS 2008 Report, <http://www.treasury.gov/resource-center/international/foreign-investment/Documents/2009%20CFIUS%20Annual%20Report.pdf>.