

Insights Conversations: Debunking CFIUS Myths

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The Committee on Foreign Investment in the United States (CFIUS) is a critical component of cross-border deals involving U.S. targets. The head of Skadden's CFIUS practice, Ivan Schlager, and Palo Alto corporate partner Ken King recently discussed with *Insights* editor Robin Davidson the current trends and myths associated with CFIUS.

Insights: Ivan, can you give a basic overview of the CFIUS process?

Ivan: CFIUS is an interagency task force that reviews foreign acquisitions in the U.S. which could potentially threaten or impair national security. It's a two-pronged review process: First, a threat and risk assessment is done on the foreign buyer. For the second prong of the review, a lead agency or sometimes co-lead agencies will be appointed to assess the incremental risk associated with the foreign investment of that particular asset.

CFIUS will sometimes recommend that the foreign acquirer agree to undertake certain steps to mitigate the national security threat that the acquisition poses. And we have been at the forefront of coming up with creative structures and negotiating mitigation agreements that, for Chinese acquisitions in particular, enable a buyer to acquire an asset while protecting U.S. national security interests.

Insights: Let's talk more about China and the myth that no Chinese tech deal can win CFIUS approval. How do you complete deals in an industry that obviously contains sensitive assets and with a country that is involved in such a high volume of CFIUS reviews?

Ken: China has made a priority of growing its semiconductor capability. As a result, there are a number of funds and companies in China that have tremendous resources earmarked for potential investment and expansion in the industry. With these deals, you very quickly get into CFIUS issues. The deal track record is still nascent, but deals have been done. It's important to think about who the acquirer is — not all Chinese companies are the same in terms of the risk profile they present to CFIUS. Not all semiconductor companies have a specific defense application, either. You have to take a hard look at both the acquirer and target companies and entities involved.

Ivan: It also requires careful preparation and an understanding of the technology. Chinese tech deals that involve low-margin, high-volume businesses without sophisticated technology and for which components are already assembled in Asia can get done because the agencies see the economic rationale for migrating this low-margin work to Asia and China.

The more problematic transactions usually involve sensitive software and telecommunications technology. Or it's a sector in which the U.S. has a clear leadership position, and the acquisition may allow a Chinese state-owned enterprise to catch up. That said, we have completed a number of tech deals with state-owned entities. The key to getting those transactions done is to be proactive and aggressive. Do your homework. Understand what the technology is and, more importantly, what it isn't. Anticipate the security issues and develop a mitigation strategy. Don't wait for the government to tell you how they want to mitigate.

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Insights: With regard to mitigation, the myth is that the remedies CFIUS demands are usually intolerable and damaging to the business, but it sounds like your suggestion is to be out front with your own mitigation strategy.

Ivan: Yes. If you wait for the government to come up with their mitigation plan, it will almost always be intolerable. If you are ahead of the curve, anticipate the issues and offer a remedy upfront, you help set the agenda.

Insights: How does that ultimately impact transactions?

Ken: Beyond value and pricing, the significant issue from the standpoint of any target company is deal certainty. As people gain more experience with CFIUS, the thinking becomes more refined about how to approach risk allocation issues in transactions. The tools are quite similar to how you approach antitrust or other kinds of regulatory risk allocation, but there are some differences.

With antitrust, for example, considerations include whether there are divestitures that an acquiring party is willing to undertake. CFIUS concerns often can't be addressed with a divestiture remedy but may involve security arrangements, putting people on the board, isolating certain technologies and a whole range of other options.

In many cases, it's harder to predict what CFIUS may focus on. For example, buying a company that has a factory next to an important Defense Department location can raise national security concerns. Or maybe the issue is a contract with the Department of Defense that is insignificant in terms of dollars but happens to be critical to DOD. In many cases, these issues can be buried deep in the fabric of the target company. It's not publicly visible; it's not even visible on cursory due diligence. Trying to spend time on the front end uncovering potential issues is really important so they can be addressed between the parties.

Insights: Connected to the myth about Chinese deals is the somewhat related idea that the profile of the foreign acquirer is what matters most, and the U.S. target is less important. What are your views on that?

Ken: With due diligence, you need to spend a significant amount of effort on issues with the target and the acquirer. It's a two-step approach. Before you start talking about risk allocation, you need to get clarity on where issues may come up, recognizing that there's always going to be an element of the unknown.

Ivan: From the CFIUS point of view, the U.S. target can sometimes be the most important. If the technology has been developed in U.S. government research labs, or Sandia National Labo-

raries, or Brookhaven National Laboratory, those are going to be tough deals. You need to understand the technology and explain it to the government in a way that makes it nonthreatening. That being said, understanding who the buyer is and the buyer's willingness to be transparent are also very important.

Insights: Do you find that explaining the technology is sometimes the biggest hurdle?

Ivan: Yes, we have on a number of occasions actually brought the device into our CFIUS meeting with engineers who explain how the device works.

Insights: Ivan, you mentioned, and CFIUS' most recent annual report highlighted, the need for transparency. (See March 1, 2016, client alert "[CFIUS' Annual Report to Congress Highlights Decrease in Investigations, Need for Transparency.](#)") Why would a company want to be less than forthcoming, and why is that flawed logic on their part?

Ivan: Sometimes there is a cultural divide. I'll give you an example. With CFIUS, there are certain structures that need to be put in place if a company is controlled by a foreign government. In one deal, a European company asserted with absolute certainty that it was not controlled by a foreign government. It argued that the government had board seats and some ownership but did not control the company. I pointed out that their securities filings stated the company was government-controlled, and the general counsel looked at me and said, "That's this year's filings." I think they genuinely believed they were not government-controlled because the government was not making day-to-day decisions. But from a CFIUS standpoint, they were government-controlled.

We say to companies, "Tell us the facts. Don't tell the committee the story you think they want to hear, because they have the ability to collect their own information about you."

Insights: Politics is an underlying theme to much of this discussion, and another CFIUS myth is that the process is completely political. How do you debunk that myth for clients?

Ivan: We recently were on the other side of a competitive situation in which the company mounted an aggressive political campaign to block a Chinese deal, and it did not work. It really is a narrow national security review. And while CFIUS has to pay attention to the political arena, it takes its responsibility and the bilateral relationships between governments seriously. In our experience, politicizing a transaction may make the review process more vigorous and last longer, but it is not going to be dispositive. It is not an inherently political process.

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Insights: Do you find there's a steeper learning curve for clients in countries that are relatively newer players in the global economy, like China?

Ken: There were plenty of missteps last year by Chinese companies that approached potential deals without fully understanding the issues or concerns that a U.S. company would have. They're just beginning to understand how the game is played in the U.S. — how an M&A deal progresses — because it's not intuitive. There can be a lot of misreading of signals if you haven't done many of these deals. But we are seeing companies in China get better and better advice, and they are showing more willingness to follow it.

Ivan: I agree that Chinese buyers are becoming more sophisticated as they continue to do transactions in the U.S. But you still have to spend a fair amount of time overcoming some of the myths, such as that it is an inherently political process and you can hire a political fixer to get through the process. Or that all U.S. law firms are alike in this area.

CFIUS requires a real expertise, and only a handful of firms are good at it. I think Chinese buyers are beginning to recognize that. The thing that worries me is that a poorly handled deal can chill the market. In general, however, the U.S. is still wide open to foreign investment.

Insights: What do you see in the near term as far as CFIUS trends?

Ivan: It is obviously going to be a big year for Chinese deals, and a number of them will be approved. When transactions get in trouble, it is usually because people don't understand the process. You have to read each deal individually. There is no real trend or pattern. So it is really important to have people who understand the nuances of the process.

Ken: They need to understand — and this isn't novel to Chinese companies — the U.S. legal system and the legal framework in which companies operate, the market practice, what the expectations are, the timing and pace of deals, what the issues are going to be and how you deal with them. It's surprising to many companies outside the U.S. that when they talk to a CEO and think they have a deal, that's not the end of the story. There is a board of directors behind the CEO that is required by law to have real input into any process. The shareholders are ultimately going to have a role as well. For someone on the outside, the dynamics involved when a U.S. company is pursuing a transaction aren't obvious. Making sure you can bridge those cultural and legal gaps as an adviser is extraordinarily important.