

Getting the Deal Done *China, Semiconductors, and CFIUS*

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Investing in U.S. semiconductor sector companies has become an increasingly challenging task for Chinese investors as the interagency Committee on Foreign Investment in the United States—better known as CFIUS—has increased its scrutiny of these deals. In the last few weeks alone, CFIUS concerns served to scuttle several potential transactions, forcing Chinese investors and U.S. companies to re-evaluate the potential impact of national security issues on getting the deal done.

Fairchild Semiconductor International Inc. recently rejected a topping bid from a consortium consisting of China Resources Microelectronics Ltd., a state-owned company, and Hua Capital Management Co., Ltd., a China-based investment fund, citing concerns over its ability to obtain CFIUS approval, among other factors. In comparison with the deal Fairchild had signed with an American acquirer, Fairchild deemed the higher China Resources offer too uncertain and the proposed \$108 million CFIUS reverse termination fee insufficient to justify proceeding with the higher offer.

In a filing with the U.S. Securities and Exchange Commission, Fairchild gave several reasons for rejecting the China Resources bid, including added complexity due to certain necessary asset dispositions, the likelihood that closing could be delayed by an additional four to eight months, and an “unacceptable level of risk” that the deal with the consortium would be rejected by CFIUS (although Fairchild’s board was “generally of the view” that there was a “substantial probability” that the consortium offer could in fact win CFIUS approval). In particular, Fairchild indicated that the \$108 million termination fee did “not adequately justify” risking loss of the significant premium for Fairchild stockholders that was already present in the American buyer’s prior bid.

A few days after the Fairchild announcement, China’s Unisplendour Corp Ltd., a unit of China’s state-backed Tsinghua Holdings Co. Ltd., terminated its agreement to purchase approximately 15% of Western Digital Corp. for approximately \$3.8 billion on news that a CFIUS review

of the deal would proceed, as is becoming more common, to the investigation phase.

As Fairchild did not pursue and Western Digital did not complete its CFIUS review, it is uncertain whether CFIUS would have approved either transaction. As noted below, despite the headlines from these deals, CFIUS has approved Chinese acquisitions of U.S. semiconductor companies – even though it is clear that these transactions are subject to increased scrutiny.

The policy reasoning behind CFIUS’ increased scrutiny of these deals cannot be known with certainty as, given the sensitive nature of its work, CFIUS has strict statutory obligations to keep its deliberations confidential. However, in the unclassified version of its 2014 Annual Report, issued in February 2016, CFIUS stated its belief that there “*may be an effort among foreign governments or companies to acquire U.S. companies involved in research, development, or production of critical technologies for which the United States is a leading producer.*”² Although no specific foreign government was identified in the public version of this Annual Report, the Chinese government stated in its most recent five-year plan that the semiconductor industry (a sector CFIUS determines to be within the regulatory definition of “critical technology”) is a “core industry.”

This article reviews CFIUS issues presented by Chinese-owned companies’ investment in the U.S. semiconductor industry and related sectors, directly through the acquisition of U.S. businesses or indirectly through the acquisition of non-U.S. companies with U.S. operations. Given that the CFIUS process is entirely confidential, the following discussion is based entirely on public sources.

CFIUS Review Process

The CFIUS review process involves four potential stages: (i) pre-filing consultation, (ii) an initial 30-day review, (iii) an extended 45-day investigation period, and (if there remain unresolved issues) (iv) a 15-day

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Presidential review and final determination. Since 2000, only five transactions were presented to the President for review. The most recent of these occurred in 2012, when the President blocked an acquisition by Ralls Corporation, an entity ultimately owned by a Chinese company, of certain wind farms in Oregon, due to their proximity to a Naval Air Station.

The pre-filing consultation period gives transaction parties a valuable opportunity to proactively engage CFIUS staff members on the deal and assess potential threshold national security issues. Where the parties anticipate issues, extended pre-filing consultations with CFIUS and the interested member agencies are common and can help determine how best to address those issues, such as through the use of mitigation agreements (discussed further below). If there are no anticipated issues, the parties will present CFIUS with a complete “draft” of the joint notification for review prior to its formal submission. The consultation process can take several weeks, but it can help CFIUS members and the transaction parties to identify and deal with potential national security issues. Once CFIUS provides comments on the draft filing, the formal notification is submitted, and once accepted by CFIUS—typically a few days after submission, though it can take longer—CFIUS will commence its initial 30-day review. CFIUS usually requests additional information during the review period and may even request in-person meetings as the staff conducts their analysis.

If CFIUS is unable to complete its review during the 30-day period, it will trigger an extended 45-day investigation, which is increasingly common, particularly for transactions involving state-owned entities. As a result, parties should expect that the CFIUS process—from the initial pre-filing consultation to final resolution—will take about ninety days. The process can take even longer if CFIUS agrees that the parties can “withdraw and refile” their notification, as was the case in the Unisplendour-Western Digital transaction noted above. Refiling typically occurs when the parties and CFIUS believe it will take more time to address national security issues. A withdraw-and-refile scenario can also occur if there has been a “material change” in the information provided in the CFIUS notice, such as a significant change in the ownership or consortium membership of the acquiring party, or the

U.S. target company’s acquisition of another company.

Mitigation Measures

If CFIUS identifies national security concerns with the transaction, it may require the parties to enter into a mitigation agreement to address these concerns. Examples of the mitigation measures imposed on companies as a condition of CFIUS approval include:

- ensuring compliance with specific guidelines (including access protocols) for handling existing or future U.S. government contracts and U.S. government customer information;
- ensuring that only U.S. persons handle certain technology, products, and services and that certain activities and products are located and/or sold only in the United States;
- notifying relevant U.S. government parties of any material introduction, modification, or discontinuation of a product or service, as well as any potential vulnerabilities or security incidents;
- restricting physical access to facilities and electronic access to network systems; and
- ensuring continued production of certain products for relevant U.S. government parties for specified periods.

Parties and their counsel should plan to negotiate the terms of the mitigation agreement with the CFIUS staff. Identifying mitigation issues early in the process and addressing them appropriately in the resulting terms of the agreement can be critical in preserving the commercial viability of a transaction for the foreign buyer, even where potential national security issues may exist. CFIUS is also required to monitor and evaluate the parties’ ongoing compliance with a mitigation agreement entered into as a condition of approval. If the acquirer breaches a mitigation agreement and CFIUS deems the breach to be material, CFIUS may assess penalties or even start a new 30-day review of the transaction.

CFIUS Review Trends – 2014 Annual Report

CFIUS issues an Annual Report containing general information on the number of CFIUS reviews and transactions by country of investor and industry. The 2014 Annual Report reported that there were 147 notices submitted for the year (compared to 97 the prior year), and over one third of all notifications entered the extended 45-day investigation phase. Nine notices were

withdrawn, of which only one was resubmitted.

The Annual Report does not break out which of these transactions involved Chinese investors. However, Chinese investors filed the most CFIUS notifications for three recent consecutive years: 23 notices in 2012; 21 notices in 2013; and 24 notices in 2014.³ Nearly three quarters of the notifications filed by Chinese investors were for transactions in the Manufacturing and Finance, Information, and Services categories—the categories that include semiconductor businesses. In 2014, when broken down by North American Industrial Classification Codes, there were 29 transactions notified to CFIUS that fell under the Computer and Electronic Products Code, 12 of which were under the Semiconductor and other Electronic Component Manufacturing category.

Deal Flow Trends – China, Technology and Semiconductors

The increased influx of Chinese investment in the United States in general, and in the semiconductor sector in particular, reflects China's continuing focus on accessing cutting-edge technology to fuel its economic development. Chinese investors attempted to acquire 21 different overseas chip makers in 2015 and have already made five attempts this year, based on data reported by M&A analytics provider Dealogic. Many of these bids were for U.S. businesses.

Beyond recent headlines, it is important to bear in mind that CFIUS should not be viewed as an automatic 'red light' for every transaction involving a Chinese acquirer of U.S. technology. Several recent notable transactions have received CFIUS clearance, including Uphill Investment Co.'s acquisition of Integrated Silicon Solution Incorporated (ISSI) and Hua Capital Management Co. Ltd.'s acquisition of OmniVision Technologies, Inc. Another recent case, albeit outside the semiconductor sector is CFIUS' clearance recently of the acquisition by a PRC state-owned enterprise's SZSE-listed subsidiary of a leading U.S. manufacturer and supplier of life sciences, fine chemicals, and diagnostics products.

Parties should also be clear that other deals, such as the Fairchild and Western Digital transactions noted above, were in fact discontinued by the parties themselves, before CFIUS had a chance to actually rule on any national security issues presented. Uphill is a Chinese consortium vehicle, owned by private and state-affiliated investment entities that encountered a challenging CFIUS review in its acquisition of ISSI. Before ultimately clearing the transaction,

CFIUS required the parties to withdraw and refile their notification to give CFIUS additional time to review the transaction. Unlike Fairchild's decision regarding its potential Chinese acquirer, ISSI selected Uphill, despite a competing (and lower) offer from Cypress Semiconductor. Hua Capital, which had also been a member of the Uphill consortium, was able to obtain clearance for its acquisition of OmniVision. As a result of being among the earlier semiconductor deals to be reviewed by CFIUS, Uphill and Hua Capital may have enjoyed something of a first mover advantage.

The Western Digital/Unisplendour transaction presents interesting issues, as the parties took the position publicly that the 15% investment with one board seat was not a "covered transaction"—for CFIUS purposes, meaning that it did not result in the acquisition of a controlling interest in Western Digital—and that the parties instead were making the CFIUS filing "out of an abundance of caution."⁴ The parties withdrew and refiled the initial notification once and then abandoned the transaction after CFIUS determined that it was a covered transaction and extended its review to the 45-day investigation phase. There was no public discussion by the parties as to whether this action was taken due to CFIUS concerns or other considerations.

Earlier this year, GO Scale Capital, the lead Chinese company in a consortium, attempted to acquire 80% of the Philips Lumileds light emitting diode (LED) business based in the Netherlands, but CFIUS clearance of the deal was not forthcoming for apparently unspecified reasons. This transaction highlights a separate, noteworthy CFIUS trend—review of Chinese acquisitions of European companies with a U.S. nexus. The Lumileds unit had a U.S. subsidiary based in San Jose, California that carried on research and development as well as manufacturing activities and was deemed a U.S. business for purposes of CFIUS review. Press reports suggest that notwithstanding the parties' best efforts to develop a mitigation plan that would satisfy CFIUS and address concerns regarding the potential transfer to China of semiconductor technology used in making LEDs, they were unable to reach agreement and secure CFIUS clearance.

CFIUS and Semiconductor Deal Considerations

Semiconductors are a key component in nearly every electronic device and represent the core of a long list of systems with potential military applications. As a result, it is not surprising that

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CFIUS views semiconductors as “critical technology” and subjects proposed transactions to intensive scrutiny given that foreign acquisition of this technology “may adversely affect national security and pose a national security risk” as stated in its 2014 Annual Report.⁵ CFIUS also noted that “foreign governments are extremely likely to continue to use a range of collection methods to obtain critical U.S. technologies.”⁶ Accordingly, the U.S. government will continue to undertake critical reviews of transactions involving the semiconductor industry and other critical technologies, particularly where there is actual or perceived government ownership or control of the foreign acquiring entity.

When assessing whether to pursue a specific transaction—especially in semiconductor or other technology sectors—transaction parties should pursue proactive CFIUS diligence as a priority, in order to identify potential national security issues as early as possible and, based on this information, determine whether and on what basis mitigation is likely to be required. This will enable the parties to both negotiate appropriate risk allocation in transaction documents and effectively engage with CFIUS to identify commercially acceptable mitigation measures. For example, recent cases highlight the importance of being able to present CFIUS with a clearly developed plan to carve out assets or technologies that may present a higher national security risk. Ideally, the buyer will have pre-negotiated carve-out terms with an already-identified U.S. buyer. Although results will vary depending on negotiating leverage and deal factors such as the presence of pre-existing bids and resulting stockholder premiums (as was the case in Fairchild), a contractual package of regulatory covenant commitments and a reverse termination fee structure

appropriately calibrated to incent target boards to pursue transactions where clearance appears possible can also help parties to mitigate CFIUS completion risk.

It remains to be seen whether recent CFIUS-related terminations of Chinese direct and indirect investment in the semiconductor sector are the beginning of a long-term reality based on U.S. government policy to protect the industry and U.S. critical technology. The key take-away from recent transactions is that Chinese acquirers and their counterpart U.S. or European semiconductor targets will need to focus on addressing CFIUS risks as a priority in executing any deal.

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Footnotes

- 1 Messrs. Spiliotes <http://www.mofo.com/people/spiliotes-nicholas-j>, Bayz <http://onlinedirectory/ODAdvSearch.aspx?&LastName=bayz&FirstName=&Office=1>, and Gizaw <http://www.mofo.com/people/gizaw-betre-m> are attorneys in Morrison & Foerster’s National Security Practice in the Washington, D.C. office specializing in CFIUS matters.
- 2 Committee on Foreign Investment in the United States – Annual Report (CY 2014), issued February 2016 (“2014 Annual Report”). Page 29, available at <https://www.treasury.gov/resource-center/international/foreign-investment/Documents/Annual%20Report%20to%20Congress%20for%20CY2014.pdf>.
- 3 2014 Annual Report, page 19.
- 4 Western Digital Corporation, “WDC Equity Investment by Unisplendour Corporation (Unis) FAQ,” September 29, 2015, page 2, available at <http://www.wdc.com/en/company/investor/library/20150929FAQ.pdf>.
- 5 2014 Annual Report, page 25.
- 6 2014 Annual Report, page 32.

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