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RECENT DEVELOPMENTS IN CHINESE FDI IN THE UNITED STATES

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2012 was a record year for Chinese outbound investment in the United States. And after a slow-down in the fourth quarter of the year, the first months of 2013 has seen a renewal of activity by Chinese companies. According to a recent report by the Rhodium Group, in the first quarter of 2013 Chinese companies spent $2.2 billion on acquisitions and Greenfield projects in the United States. 2013 has also seen the continuation of a trend that began at least several years earlier: the growing importance of Chinese private companies in U.S. investment activity. The proposed acquisition of Smithfield Foods by Shuanghui is but the latest example. While the SOE's continue to account for the major share of FDI by value, private firms are accounting for an ever-increasing share in the number of transactions According to Rhodium, 16 out of the 17 deals closed in Q1 2013 by Chinese companies, were done by privately-owned enterprises. There are a number of reasons for this trend. Many privately-owned companies are getting bigger and more sophisticated and are thus getting more comfortable in considering overseas acquisitions. In addition, the areas of FDI expansion are broadening from the focus on resources and high tech to brand building, distribution in industries where private firms may have a stronger representation. Finally, many provincial governments have been encouraging privately owned firms in their regions to "go out," This trend, if it continues, has important implications not only economically and financially, but on the regulatory and legal front as well, as we discuss below.

A great deal has changed in the landscape of Chinese outbound investment in the U.S. since CNOOC launched its unsuccessful and very public offer for Unocal in 2005. But that attempt, together with several other failed acquisition efforts by Chinese companies, such as Huawei, have continued to have a pervasive influence on how many Chinese companies think about potential investments in the United States. National security, CFIUS and the related political challenges remain a key concern of many Chinese companies, in some cases dissuading them from even thinking about investing in the US, no matter how strong the business case for making a particular acquisition may be.

There is no question that national security issues and the CFIUS process are a critical component in thinking about and effectuating an acquisition by any Chinese company of a US business or assets. There is equally no question that concern about Chinese investment often goes beyond legitimate national security concerns, just as it did 30 years ago when the Japanese started buying high profile U.S. assets, like Rockefeller Center. But a large number of successful acquisitions over a broad range of industries should also make it clear that with proper planning, Chinese companies can be just as successful in making acquisitions as other foreign companies; that the US market is not closed to Chinese investment.

But one can't emphasize enough how important advanced planning is to successfully completing a transaction. One thing that it is often difficult for Chinese companies to appreciate is that in the U.S. interested parties will often try to utilize the political process and play on national security fears for purely economic or competitive interests. Anticipating and planning how to counteract these adverse interests and their use of the political process is a critical key to success. Equally important, but often difficult for Chinese companies, is having the flexibility to deal with issues that arise to defeat the original plan. But flexibility is facilitated by anticipation and by understanding that deals rarely go exactly according to plan. A good example of this is Wanxiang Automotive's recent acquisition of the battery manufacturer A123 Systems. Wanxiang had originally entered into an memorandum of understanding to acquire an 80% stake in A123 for $465 million. However, that deal collapsed as a result of strong political opposition in Congress, on the grounds that the Chinese would benefit from advanced electric battery technology that had been paid for in part by US taxpayers through a multi-million dollar government subsidy to the company. Following the failure of that transaction A123 declared bankruptcy. As part of the bankruptcy proceeding, the bankruptcy court conducted an auction for A123's assets. And Wanxiang returned and won the auction for A123's electric car battery business for $257 million against competition from a large US public technology company. The deal was approved by the bankruptcy court and in January 2013 approved by CFIUS, with Wanxiang agreeing to divest A123's government business. What is noteworthy here is that the political opposition continued even after bankruptcy court and CFIUS approval; but the bankruptcy itself changed some of the political dynamics. While there continued to be congressional opposition on the grounds that the Chinese would be acquiring technology that had essentially been paid for by the government, there was now a local constituency that supported the transaction. For the acquisition now guaranteed the continued employment of thousands of employees who might otherwise have been out of a job if the bankrupt business had been shut down. Importantly, Wanxiang promised, as part of its offer, to continue to keep the A123 factory open and continue to employ the workforce.

On the other hand, bankruptcy itself does not guarantee that a Chinese acquisition will be successful. In May 2012, the airplane manufacturer Hawker Beechcraft filed for bankruptcy protection and thereafter entered into exclusive negotiations with China's Superior Aviation Beijing to acquire its jet and other aviation operations for $1.8 billion. Those discussions fell apart, however, in the fall of 2012. While the reasons for the breakdown in talks were never disclosed publicly, it appears that the difficulties in separating Hawker Beechcraft's commercial airplane business from its defense and military business, which would have been required for CFIUS approval, were the main reason.

One of the difficult problems in advising Chinese clients on CFIUS issues is the lack of transparency in the process. CFIUS generally does not disclose the reasons why it rejects a particular transaction. In addition, many more deals are abandoned by the parties out of an inability to obtain CFIUS clearance than are actually decided and then rejected by CFIUS. CFIUS does not disclose the substance of discussions it has or the demands it may make for "mitigating" a particular concern and thereby allow the transaction to proceed. And the parties themselves rarely disclose the reasons why their transaction is rejected or abandoned. Thus it is often the case that one can only speculate as to the precise reasons why a transaction does not proceed. And in many cases, a transaction will be abandoned for CFIUS reasons even before it is publicly disclosed. However, a few things are clear: Any acquisition by a Chinese company involving the acquisition of military or defense-related assets or technology will be rejected by CFIUS, unless there is a way to meaningfully separate those military/defense assets from the rest of the business being acquired. The inability to accomplish this in the Hawker Beechcraft transaction was apparently the reason it was abandoned. What we don't know is to what extent this was the result of serious substantial technical difficulties in separating the business that would have made the deal economically undoable or the result of the buyer's unwillingness for other reasons to undertake the requisite separation.

Another area in which CFIUS has demonstrated particular concern is the acquisition of assets by Chinese companies that are geographically close to U.S. military bases or other sensitive government facilities, apparently out of concern that such proximity may provide greater opportunities for espionage. In 2009 CFIUS blocked the attempt by a Chinese Company, Non-Ferrous International Co., to acquire a goldmine in Nevada on the grounds that the mine was located near a military base. More recently, CFIUS recommended that that the U.S. President order Ralls to divest a recently acquired wind-farms in Oregon located near a Navy base. One can question the reasoning of CFIUS in these cases. For there were certainly other ways that the Chinese—or any other foreign power—could have gotten close to these military installations that CFIUS could not have prevented. Simply renting some land near the military facility, for example, would not have been subject to CFIUS review. But one must also question in the recent Ralls case, whether Ralls' initial attempt to make its acquisition without notifying CFIUS had an impact on CFIUS' decision-making. Certainly one of the lessons of many of these recent transactions is that working co-operatively with the CFIUS authorities and having the patience and flexibility to deal with any concerns that the authorities may have will substantially increase the likelihood of success. As Wanxiang America's President Pin Ni stated after successfully completing the A123 battery acquisition, "You just need to understand the rules, follow the rules, be very transparent and let them make the decision." Another lesson, demonstrated by the Ralls attempted acquisition, as well as by Huawei's attempted acquisition several years ago of certain intellectual property and other technology assets of 3Leaf, is that no matter how small the size of the transaction, CFIUS at some point is very likely to learn about it. CFIUS has the authority to recommend to the President that he order divestiture of any assets, even if the acquisition has been completed, if CFIUS determines that it poses a national security risk. This is what happened in the Ralss transaction as well as the Huawei transaction, both of which were very small deals in dollar value. No deal is too small, and thus if there is any question that a transaction might draw CFIUS interest, it is better to make a notification before the acquisition is completed. The acquirer avoids the risk of being perceived as trying to circumvent the process. And as a business matter, the forced divestiture of assets is likely to be at an extremely low price.

While one generally tends to hear more about those transactions that are rejected or abandoned for CFIUS reasons, the fact is that a large number of transactions by Chinese companies are successfully getting through the CFIUS review process. And as noted at the beginning of this article, acquisitions by privately-owned Chinese companies, which are increasing as a percentage of transactions, are not subject to the required extended review process for government-owned enterprises mandated in the CFIUS regulations. It remains the case that there are very few acquisitions by Chinese companies of U.S. publicly-listed companies, as opposed to acquisitions of privately-owned businesses or subsidiaries. But the reasons for that generally are not due primarily to CFIUS regulations or issues. And one can expect that as Chinese companies become more experienced and comfortable with overseas acquisitions and the U.S. market, in particular, they will become less reluctant to enter into the very different and more transparent arena of public-company acquisitions.

Earlier this year, BGI Shenzhen acquired Complete Genomics, a NASDAQ listed company, by means of a negotiated merger agreement and tender offer. But that was a rare exception to the general pattern of Chinese FDI in the U.S., which has been generally done through private acquisition or Greenfields development. Indeed, the two largest and most well know public company bids by Chinese companies were both failures. As is broadly known and written about, CNOOC failed in its effort to acquire Unocal in a competitive bidding situation with Chevron, primarily because of political opposition that was encouraged by Chevron and its allies. In 2005 Haier made a proposal to acquire appliance maker Maytag for over $1 billion. That, too was greeted by political opposition. But Haier ultimately withdrew its proposal less out of political opposition than over the economics, not wanting to compete over price with Whirlpool, which ultimately made the acquisition. Recently Shuanghui, China's largest pork producer, announced its agreement to acquire Smithfield Foods for over $4 billion. Smithfield is of course a US public company. And while there is every reason to believe as this is written at the beginning of June that the transaction with be closed successfully, there are still many hurdles to overcome, including the risk of a higher competing bid being made by a third party.

There are a number of reasons why public company acquisitions pose more risks to completion than private deals. First, by definition they must be carried out in the public arena and are therefore likely to attract more public and political attention. And as we have seen, there may be any number of groups or constituencies that may use the politics and publicity to try to derail a bid that is not in their interests. Competing acquirers, industry competitors, labor unions and employees, suppliers—they may all have reasons to try to defeat the acquisition by a Chinese company, and they will not hesitate to try to use the threat to national security, however far-fetched, as a reason to defeat the deal. (For example, industry competitors sought to derail BCI's acquisition of Complete Genomics by arguing that Chinese access to genome technology would somehow be detrimental to U.S. national security). Secondly, directors of public companies that are involved in a change-of-control transaction have a fiduciary duty to sell the company to the highest bidder, which means that public company merger agreements will always be subject to a competing offer. There is simply no way to "lock up" a deal until it actually closes. This can put Chinese bidders at a competitive disadvantage in two ways. First, directors may be reluctant to support a bid by a Chinese company, even at the highest competitive price, if there is any serious political or regulatory uncertainty. Secondly, even if supported by the board of directors, a Chinese buyer may be at a competitive disadvantage if CFIUS notification requirements slow down the process compared with a competing U.S. bidder and create uncertainty among shareholders whether the deal will get done. Finally, a public acquisition, which requires the filing of various disclosure documents with the U.S. Securities and Exchange Commission, such as a proxy statement and/or tender offer document, may entail a degree of transparency that some Chinese documents are not comfortable with.

There are several other additional risk factors involved in a public transaction that may make such transactions unattractive to many Chinese companies. The opportunity for in-depth and extensive due diligence will generally be far less in a public company acquisition, where the buyer must rely primarily on the target's public financial and other disclosure statements. Additionally, in contrast to most private deals, a public company transaction will involve far fewer representations about the business and there will be no selling owner to provide any indemnification if those representations turn out to be wrong.

Notwithstanding these additional risks, where there is a strong strategic and business case for a particular transaction, I believe that Chinese companies, like many other foreign companies before them, will go ahead with public company deals; and with proper planning and preparation, there is no reason why such deals should not be successful, assuming they make financial and business sense.

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In summary, acquisitions of US businesses by Chinese Companies has been increasing and is expected to increase in the coming years as the focus of interest widens beyond resources and technology to consumer products, real estate and construction, for example. CFIUS should never be ignored or taken for granted in these acquisitions. But except in a few key areas, such as military/defense, telecommunications and power distribution and infrastructure, CFIUS, as a general matter should not be an unassailable hurdle to such acquisitions. Attention must also be paid, however, to the political process and potential use of political opposition to support other financial or competing interests that may oppose a particular transaction. While there will certainly be some acquisitions of public companies, given the added risks and greater transparency, it is likely that private company acquisitions will continue to be the prevalent form of acquisitions transactions, at least for the next few years.

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