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Magnachip CFIUS Case Underscores Focus of U.S. Government on Semiconductor Supply Chain Security

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Background:

In March 2021, Wise Road Capital, a China-based private equity fund that focuses on investments in the semiconductor and other high-tech industries, entered into an agreement and plan of merger with Magnachip Semiconductor Corporation,¹ a semiconductor design and manufacturing firm headquartered in South Korea that trades on the New York Stock Exchange. Two months later, Wise Road and Magnachip were notified by the U.S. Department of Treasury on behalf of the Staff Chairperson of the Committee on Foreign Investment in the United States (“CFIUS”) that the proposed merger would be reviewed by CFIUS. As directed, in June 2021, the parties submitted a formal notice of their proposed merger. Within days, CFIUS presented the parties with an interim order barring them from closing the transaction pending the completion of its review.² At the end of August 2021, Magnachip disclosed, in a filing with the U.S. Securities and Exchange Commission (“SEC”), that CFIUS had identified risks to the national security of the United States arising from the proposed merger and had not identified any mitigation measures that would adequately resolve those risks. Absent identification of adequate mitigation, CFIUS anticipates that it will refer the matter to President Joe Biden for further action, including action to block the merger.³ In its most recent SEC filing, Magnachip stated that CFIUS granted the parties’ request to withdraw and immediately refile their notice, which resets the statutory deadlines for review, in order to give the parties more time to try to discuss mitigation.⁴ As this disclosure states, there is no assurance that the parties will be able to develop or agree to proposals short of abandoning the merger that would address the national security risks identified by CFIUS.⁵ Meanwhile, in June 2021 the Korean Ministry of Trade, Industry and Energy also asserted its review jurisdiction over the proposed merger, notifying Magnachip that its approval is required before the proposed merger can be consummated.⁶ For its part, China’s State Administration for Market Regulation approved the proposed merger in July 2021.

Analysis and Takeaways:

That CFIUS would identify national security risks in, and move to block, the proposed takeover of a semiconductor design and manufacturing firm by a Chinese investor is unremarkable. What is notable is that the U.S. Government took such quick and decisive action against *this* merger—a move that appears not to have been fully anticipated by the parties.

The apparent surprise is understandable. CFIUS’s jurisdiction is triggered by a takeover of (or certain types of investments in) a “U.S. business.” Other than the Delaware parent, which essentially serves as a holding company, Magnachip has no U.S. entities, no U.S. employees, and its research, development, and functional operations are all located and conducted outside the United States.⁷

Even though its shares trade on the New York Stock Exchange and it engages in a modest amount of sales into the United States (through third-party distributors and resellers), these minimal touchpoints may not have been regarded by the parties and their lawyers as sufficient to constitute a “U.S. business” for purposes of CFIUS jurisdiction.

However, arrayed against what is admittedly a weak basis for asserting CFIUS authority is the imperative—seen as urgent within the U.S. defense, intelligence, and national security community—that the supply chain for semiconductors be protected. In early June 2021, less than ten days after CFIUS contacted the parties about the Magnachip transaction, the White House published a report underscoring the urgent need to ensure resilient supply chains in the semiconductor sector.⁸ The report recommended several measures,⁹ including a continued effort to conduct national security reviews of transactions that involve the semiconductor industry.¹⁰

The Magnachip-Wise Road transaction fell directly within the crosshairs of this initiative. Although Magnachip’s touchpoints to U.S. commerce are few, and Wise Road’s connections to China appear tangential and somewhat dated (a managing partner of Wise Road used to be an executive of one of China’s sovereign wealth funds), the timing and combination of factors at play in this transaction would have alerted experienced CFIUS counsel that a proactive filing may have been warranted, if not outright required, under the new and robust CFIUS regime.

Viewed through the lens of the heightened CFIUS risks posed by this kind of transaction, parties and their counsel can consider a number of measures to address CFIUS concerns:

1. Reporting:

Wise Road and Magnachip did not report the proposed merger to CFIUS, likely on the basis that, even though the parent company is listed on a U.S. stock exchange, it is a holding company with no assets or operations in the United States.¹¹ However, CFIUS’s intervention in the proposed merger shows its willingness to assert jurisdiction and review transactions in strategic sectors that have any nexus to the United States. Under CFIUS’s recently expanded regime, some transactions (including takeovers of companies with technology subject to U.S. export controls) must be reported. However, even in those cases where the mandatory filing triggers are not present, a voluntary filing is still warranted. Parties should not overlook the possibility that regulators could intervene after definitive agreements are signed and sometimes even after closing had been consummated for years.

2. Break-up fees:

Break-up fees are typically carefully structured and negotiated to allocate financial responsibility for termination due to regulatory proceedings such as CFIUS. In the proposed merger, Wise Road, as the buyer, would be responsible for a \$70.2 million reverse break-up fee (5.0% of the deal value) if the failure to consummate the proposed merger is related to U.S. government proceedings and a \$84.3 million reverse break-up fee (6.0% of the deal value) if the failure to consummate the proposed merger is related to Korean government proceedings. The break-up fee figures, while within range of market averages for reverse break-up fees, are on the high side. This potentially shows Wise Road’s initial confidence that the proposed merger would not encounter regulatory hurdles. Parties to transactions that involve sensitive industries, particularly the semiconductor industry, should view the payment of break-up fees as a potentially likely event and not as a theoretical risk.

3. Termination and exclusivity:

Parties to a transaction should consider implementing a mechanism to extend the termination date of the transaction if the failure to close the transaction by a certain date is due to a

regulatory proceeding. Similarly, any kind of exclusivity period should also be adjusted based on the parties' speculation on whether the transaction would be subject to any regulatory proceeding. The legal advisors on the proposed merger must have discussed the risk of CFIOUS review during the preliminary discussions, as it is usually one of the first issues raised and discussed at length in similar transactions.

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¹ <https://www.sec.gov/Archives/edgar/data/1325702/000119312521191587/d191052d8k.htm>.

² <https://www.sec.gov/Archives/edgar/data/1325702/000119312521191587/d191052d8k.htm>.

³ <https://www.sec.gov/ix?doc=/Archives/edgar/data/1325702/000119312521259848/d207727d8k.htm>.

⁴ <https://www.sec.gov/ix?doc=/Archives/edgar/data/1325702/000119312521271932/d220403d8k.htm>.

⁵ <https://www.sec.gov/ix?doc=/Archives/edgar/data/1325702/000119312521259848/d207727d8k.htm>.

⁶ <https://www.sec.gov/Archives/edgar/data/0001325702/000119312521192612/d161156ddefa14a.htm>.

⁷ <https://www.sec.gov/ix?doc=/Archives/edgar/data/1325702/000119312521177243/d185128d8k.htm>.

⁸ <https://www.whitehouse.gov/wp-content/uploads/2021/06/100-day-supply-chain-review-report.pdf>.

⁹ *Id.* at 74.

¹⁰ *Id.* at 80.

¹¹ <https://www.sec.gov/ix?doc=/Archives/edgar/data/1325702/000119312521177243/d185128d8k.htm>.