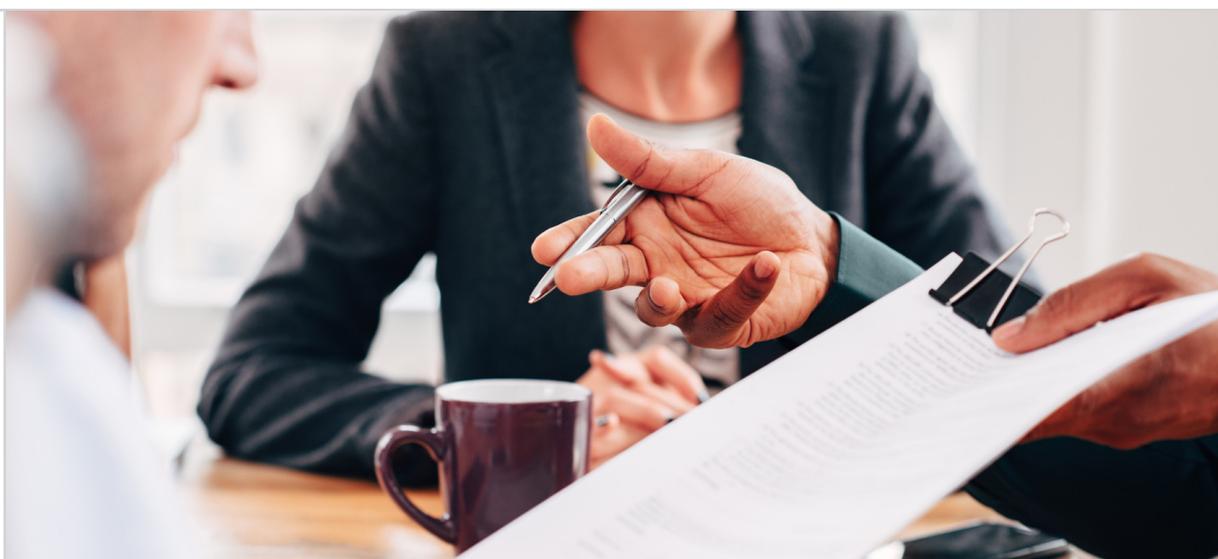


# M&A Trends Reshape the Legal Industry

December 2018



Bloomberg Law

## Big Law Business

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# Contents

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**Law Firm Merger Binge on Pace to Break Record**  
..... 5

---

**Sectors and Companies On M&A's Leading Edge**  
..... 8

---

**Compliance Poses Due Diligence Challenges in M&A**  
.....12

---

**Valuing Intangibles Influences Cross-Border M&A**  
.....16

---

**New Law Guides M&A Investment and Security  
Priorities** .....19

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# Law Firm Merger Binge on Pace to Break Record

By Tam Harbert

As 2018 neared its end, law firm mergers kept a record-setting pace. The total number of mergers and acquisitions through the third quarter had already surpassed the comparable figure for 2017, and analysts expected the total for the year to break the 2017 record of 102.

“Almost every law firm we work with is actively considering its merger options in 2018,” said Eric Seeger, principal of Altman Weil. The firm, which counts announced mergers, tallied 79 deals through the third quarter—the highest number for the first three quarters ever, he said.

Another 23 would set an annual record, and eight more were announced in November. “So we appear to be on pace to break the record,” Seeger said.

Fairfax Associates, which counts completed mergers, tracked 56 through the first three quarters, also a new high.

Cross-border deals were a continuing theme of 2018. (Both Altman Weil and Fairfax count only those deals that involve at least one U.S. firm.) Lisa Smith, principal at Fairfax, said that cross-border mergers have been on the rise for several years, increasing from five in 2015 to 10 completed through the third quarter of 2018, with five more announced. “And we expect that number to go up,” she said.

In a mega-deal early in the year, St. Louis-based Bryan Cave merged with London-based Berwin Leighton Paisner Partners to form a firm of 1,400 lawyers. However, most of the increase in cross-border deals came from Dentons, which has made eight international acquisitions in 2018.

“There is a small number of firms that appear bent on global domination. Dentons and DLA Piper fall into that category,” Seeger said. DLA Piper made two deals this year, acquiring 20-lawyer Noguera, Larraín & Dulanto in Santiago, Chile, in March and 60-lawyer Delacour in Copenhagen in September. Littler also made two cross-border deals, acquiring CLINT, an eight-lawyer Dutch employment boutique in May and the 20-lawyer employment firm Reliance in Brussels in September.

“But while large firms are increasingly aggressive about growth, we think an underlying shift in attitude at small and midsize firms—driven by both threat and opportunity—is what is pushing the law firm merger market into record-breaking territory,” Seeger said. “The majority of mergers announced involve acquiring a small firm of 20 lawyers or less.”



**Threat and opportunity are pushing the merger market into record-breaking territory.**

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Seeger cited several examples of small firms merging with their neighbors in October alone. A Canton, Ohio, firm merged with an Akron, Ohio, firm; a Wellesley, Mass., firm merged with a Norwood, Mass., firm; and an Albany, N.Y., firm merged with a Rochester, N.Y., firm. Such mergers are a way to grow, create a larger and broader platform, and serve clients more effectively, Seeger said. They may also be an exit plan if founders or senior partners have not effectively developed their next generation of talent, he added.

Small firms may also be trying to move up-market to compete for more complex, high-value work, Smith said. They can pool their financial resources for more substantial technology investments, not only in more sophisticated and innovative software, but also in the basics such as data security, she noted.

“That can be a significant cost, one that is easier for larger firms to bear. After all, everyone—regardless of size—has the same security and risk pressures,” Smith said.

Another trend driving the increase is midsized regional firms expanding outside their geographic areas, Seeger said. Clark Hill, a 450-lawyer firm based in Detroit, merged with Strasburger & Price, a 195-lawyer firm in Dallas. Nelson Mullins, a 600-lawyer firm in the Southeast, expanded south into Orlando, Fla., by acquiring Broad and Cassel, with 160 lawyers. Philadelphia-based Ballard Spahr, with 500 lawyers, expanded to the Midwest market by acquiring the Minneapolis-based, 140-lawyer firm Lindquist & Vennum.

Firms are expanding their expertise in particular specialties that are complex, technical, and high value. Washington, D.C.-based Venable is merging with intellectual property boutique firm Fitzpatrick, Cella, Harper & Scinto in New York, which will double Venable’s IP team in that city. “We will have a powerhouse IP practice when you combine the lawyers both in quality and number,” Venable chairman Stuart Ingis told Bloomberg Law.

In the midst of all this activity is a conspicuous lack of mergers among the very biggest firms, Seeger said. He cited two possible reasons.

First, they are honing operations. “Many of the firms we work with have a list—either a written list or a mental list—of chronically underperforming lawyers, and they are working through that list to deal with individual situations as fast as they feel they can politically,” he said.

They also are relishing a return to growth. In the downturn, the largest firms were hit hardest, Seeger said. “Today, they are the biggest beneficiaries of an improved environment. They are enjoying increasing revenues and profits driven by greater deal flow and bigger projects.”

*Tam Harbert is an independent journalist specializing in technology, business, and public policy.*



## **Firms are expanding their expertise and geographic reach.**

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# Sectors and Companies on M&A's Leading Edge

By Lisa Singh

Global M&A activity demonstrated robust performance as the year drew to a close. With nearly \$5 trillion in value, deals driven by technology, communications, financial, and consumer non-cyclical industries led the way.

"The top driver for M&A activity is technology asset acquisition, as buyers, particularly strategics, seek to deploy 'buy-versus-build' strategies to maintain or gain competitive advantage," said Suzanne Saxman, chair of the M&A practice group at Seyfarth Shaw.

North America alone has posted \$2.5 trillion in M&A activity in 2018—more than half of all global M&A activity for the year—with 10 percent growth over last year, according to Bloomberg Law. Europe and Asia Pacific came in second and third, generating more than \$1 trillion and nearly \$900 billion, respectively.

Mature players leading industry consolidation also drove activity, particularly in media, communications, and health care. High-profile deals such as AT&T with Time Warner, The Walt Disney Company with 21st Century Fox (slated for completion in January), and Comcast with the British broadcaster Sky, merged entertainment production with distribution, and Cigna-Express Scripts and CVS-Aetna, coupled health insurance with pharmaceutical distribution, analysts note. Bold serial acquirers weren't necessarily the companies setting the tone, however.

"The biggest driver has been the fear of an overwhelming invasion by the tech giants, particularly Amazon and Google," said Charles Korsmo, professor of law at Case Western Reserve University. "They are the firms that are 'leading' M&A activity, in a sense, even if they are not the ones making the big purchases."

Talent acquisition is also spurring M&A considerations, particularly in a tight labor market.

"Buyers will also continue to employ M&A as a quick entry point to new markets," said Saxman of Seyfarth. "M&A will also be used strategically by some buyers as a tool to secure supply chains and respond to trade regime changes and tariffs."

Meanwhile, cross-border deals remain strong.

"The energy industry is one to keep an eye on in 2019, having seen the highest cross-border deal value of all sectors in [the third quarter], at \$71 billion," said Sarah Shaw, partner at Hogan Lovells. Continued recovery in oil prices, growing private equity and investment fund activity across the sector, and renewable energy growth are all contributing factors, she added.



**The top driver for M&A activity is technology asset acquisition.**

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## **Dramatic market declines could shift focus to new markets.**

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However, geopolitical tensions loom large, particularly in high-tech industries.

“The semi-conductor industry is Exhibit ‘A,’” Korsmo said, citing Broadcom’s proposed purchase of Qualcomm, blocked by the U.S., and Qualcomm’s purchase of NXP, blocked by China. High-stakes losses are increasing the need for coordination among global partners.

As cross-border deals become a bigger share, and as more regulated businesses become involved, said Peter Harwich, partner at Latham & Watkins and member of the firm’s M&A group, “We see clients increasingly recognizing the imperative of close coordination early in the transaction planning and structuring process among experienced multidisciplinary and multijurisdictional teams of regulatory and antitrust specialists with deep industry knowledge.”

Adam August, partner in the corporate, M&A, and securities practice group at Holland & Knight, said, “Law firms need to be full-service and scalable, with resources that are knowledgeable about cutting-edge nuances in regulatory regimes.” He cited recent changes in the policies of the Committee on Foreign Investment in the United States as one such factor in client considerations.

With opportunity comes potential pitfalls. Regulatory developments in the U.S. alone contributed to nearly 15 percent of deals between public and private entities terminated as of the third quarter.

Among additional transactions, the German pharmaceutical company Fresenius dropped its \$4.3 billion agreement to purchase an American generic pharmaceuticals manufacturer, due to regulatory compliance and market performance concerns—a decision backed by the Delaware Court of Chancery.

“This [court decision] amounts to something of an earthquake, as no buyer had ever before been permitted to walk away from a deal due to a material adverse change clause being triggered, certainly in Delaware—by far the most important corporate law jurisdiction—and to my knowledge, anywhere else,” said Korsmo, who anticipates renewed attention to the design of clauses and the mutual risk that the buyer and seller assume before closing.

He stressed the importance of target boards disclosing all potential problems that could arise, to avoid a catastrophe before closing.

Furthermore, market performance is crucial to consider.

“Deal advisors need to be more attuned to the form of consideration being paid in a deal,” Korsmo said. “Where a substantial portion of the merger consideration is stock in the acquirer, target boards need to consider whether and how to protect their stockholders from dramatic declines in the acquirer’s stock price.”

Dramatic market declines could shift focus to new markets.

“The volatility of the public stock markets makes the middle market all the more attractive for investors and business owners,” said August of Holland & Knight.

Citing industrial, commercial, and consumer services sectors, as well as technology services, Saxman said, “In the middle and lower middle market, a huge number of private industrial and other businesses owned by baby boomers continue to enter the M&A market.

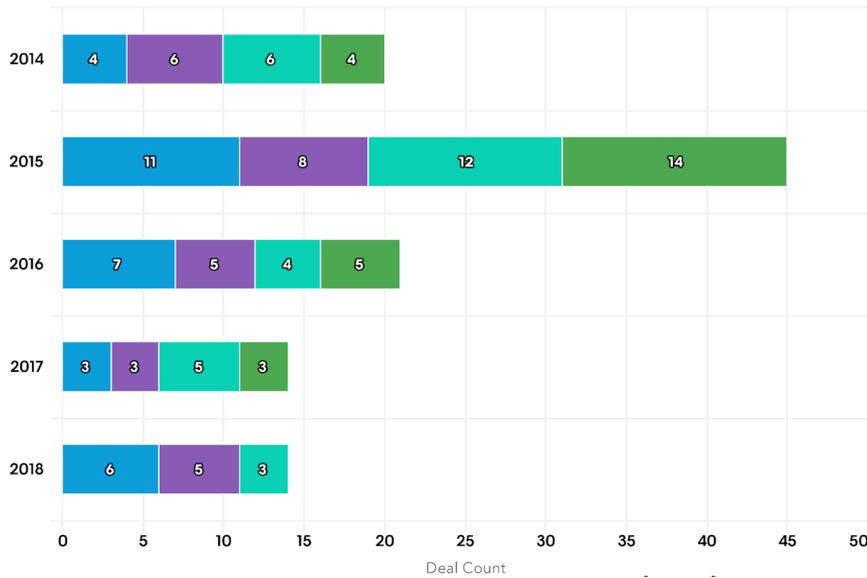
“Positive trends are likely to continue into 2019, particularly in the middle market, driven by companies actively redefining their business portfolios and seeking to achieve competitive advantages through M&A transactions.”

Lisa Singh is a writer specializing in business and technology matters

## M&A - Quarterly Mega Deals

U.S. Targets as of Q3 2018

■ Q1 ■ Q2 ■ Q3 ■ Q4

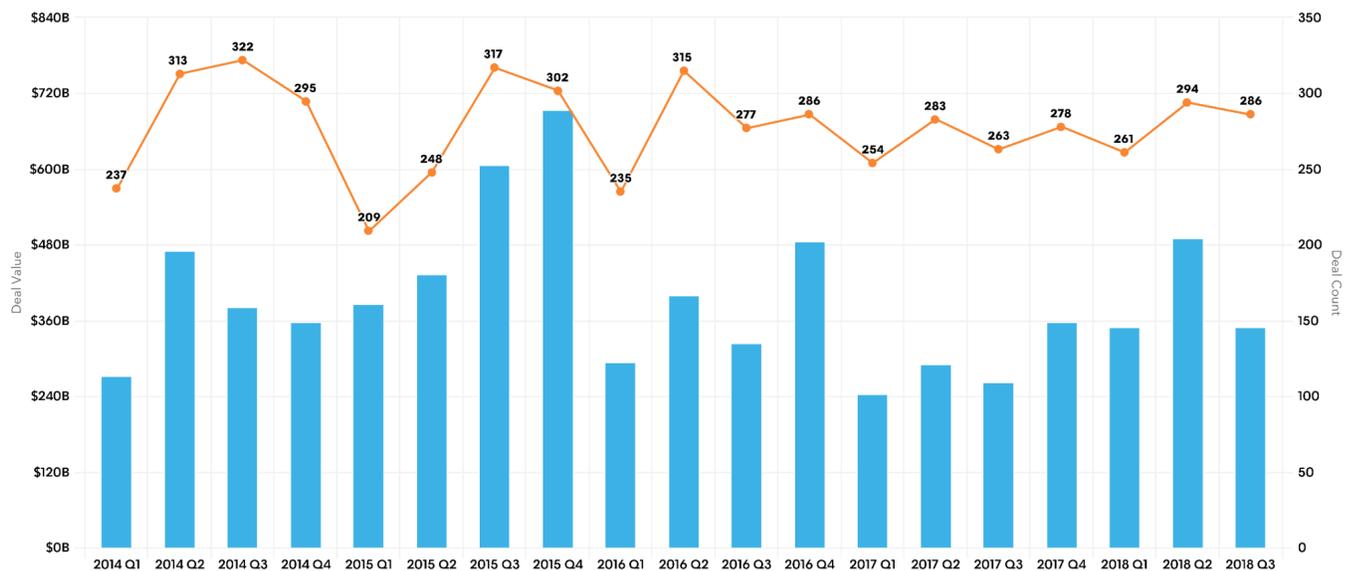


Source: Bloomberg Law

## M&A - U.S. Targets

Deal Count & Value as of Q3 2018

■ Deal Value (USD) ■ Deal Count



Source: Bloomberg Law

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# Compliance Poses Due Diligence Challenges in M&A

By Katherine Gustafson

Merger and acquisition value is on track to increase about 7 percent in 2018 from the year before, reaching a robust \$4 trillion. Joining this growth in high-value deal-making is an increased interest in transformational deals in which acquirers leverage purchased companies to drive change instead of just to grow.

Both trends indicate a need for better M&A compliance due diligence. Increased M&A activity necessitates added due diligence in general, as well as more compliance due diligence in particular due to ongoing regulatory uncertainty. Additionally, designing transformational deals adds risk to the acquisition process, which can be managed in part by assertive compliance due diligence.

M&A transactions have the highest likelihood of long-run success if the due diligence process exposes all of the associated risks. Complexities can be introduced into M&A deals when seller compliance issues present unexpected costs or reputation risks for the acquirer.

"The most important reason for examining compliance regimes in M&A transactions is that it can serve as a way to ferret out inchoate risks that may not otherwise present themselves until after the transaction closes," said Kwaku Andoh, a partner at Cohen & Gresser, an international law firm. "A thorough review of a company's compliance regime may identify issues that could have material financial or reputational consequences for a buyer."

Understanding a company's financials requires knowing which factors move them, including proper reporting of business operations in various compliance contexts. Compliance due diligence examines whether the basic conditions are present for financial optimization or even basic financial health. Companies that fail to investigate acquisition prospects for compliance issues are putting their financial sustainability at risk.

"A compliance regime consists of a company's processes and procedures that are undertaken behind the scenes," Andoh said. "If there is something wrong with the compliance regime, it will, sooner or later, result in real costs to the company. A buyer that doesn't review such a regime carefully is flying blind."

Financial risk and compliance are intimately related, since unnoticed compliance problems may undermine financial statement consistency. For example, a health-care company that appears to be pulling in \$100 million in revenue may be doing so by not accurately coding procedures, a problem that will be revealed in a compliance due diligence process.



**Unnoticed compliance problems may undermine financial statement consistency.**

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Overcharging for a process or procedure invalidates the financial statements themselves. Even if they are accurate, they don't indicate how the business should be running, which is the point of compliance due diligence.

Compliance considerations vary drastically from industry to industry. Accordingly, compliance due diligence starts with understanding the context of the industry in question.

Some compliance concerns cut across all or many industries, such as protection of customer data and financial information. Other issues are industry-specific, such as compliance with the Health Insurance Portability and Accountability Act and Medicare regulations among health-care providers, Sarbanes-Oxley in the financial space, or National Institute of Standards and Technology standards in fields such as cybersecurity and disaster resilience.

Orienting compliance due diligence toward the future is savvy. It's a good idea to look at the demands that could arise as a result of emerging compliance trends, such as the new emphasis on customer communications represented by the EU's General Data Protection Regulation or the potential for regulation of social media platforms in the wake of disinformation campaigns targeting recent U.S. elections.

A sound approach to evaluating a company's compliance to a given set of standards is to define the rules that govern the compliance in question, experts say. In assessing compliance with the Foreign Corrupt Practices Act, for example, analysts must agree on who qualifies as a foreign official. A shared definition of what a suspect transaction looks like is key to an analysis of disbursements to the company's business partners.

Another essential piece of judging compliance is examining future risk. In the case of cybersecurity, a company that has been out of compliance with consumer data privacy standards for some time may have been breached in the past. Did the company comply with regulations in informing its customers of any breaches? Stolen customer data may be used any time in the future, presenting an ongoing compliance risk if notification procedures weren't followed.

Compliance assessment requires not only firm definitions and a sense of context, but also sufficient breadth. There may be compliance concerns on several fronts, or on a single front in relation to multiple stakeholders. In health care, for instance, hospitals often face a variety of competing compliance demands.

William Chapman, partner in transaction advisory services at Baker Tilly, remembers a merger of Catholic hospitals that was delayed due to such dynamics: "They had to get permission from the Vatican and had to jump through hoops with the Justice Department, and then the local union filed suit to keep that merger from happening. It took three or four years for that to come together."

While buyers are typically those seeking help with due diligence in M&A processes, sellers are increasingly working ahead to anticipate potential challenges and get into compliance in any areas of concern.



## **Orienting compliance due diligence toward the future is savvy.**

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Called sell-side due diligence in the U.S. and vendor due diligence in Europe, this process was becoming a trend five or six years ago and is now an accepted—and even expected—part of M&A. Sell-side due diligence gives sellers the ability either to fix an issue or present mitigating circumstances.

“Get your house in order, essentially,” Chapman said. “That’s what I’d recommend if you’re thinking of putting your business on the market.”

*Katherine Gustafson is a freelance writer specializing in business topics including accounting, management, and innovation.*

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# Valuing Intangibles Influences Cross-Border M&A

By Ellen Sheng

Intangibles, whether intellectual property, a brand, customer relationships, a patent, or a trademark, make up the majority of a company's value these days. Yet valuing these intangible assets is notoriously difficult. For corporate merger and acquisition deals, this key valuation often is fraught with differing opinions and confusion.

"Intangibles are often misvalued," said Baruch Lev, professor of accounting at New York University Stern School of Business. "The information about intangibles is terrible ... these are not transparent markets," he said. Also, the fact intangibles usually are unique to individual companies inevitably makes them hard to value. The patents for drugs at Pfizer versus Eli Lilly are very different, making it hard to come up with a value from comparables like you would with other assets.

As the share of intangible assets on company balance sheets generally is higher now because of the growing importance of technology and branding, accounting methods have not kept pace. The balance sheet and income statement can provide a realistic value for a typical manufacturing operation, but for many companies today, particularly internet or tech players, the financials don't offer a full picture. Facebook, for instance, has some \$14 billion in hard assets against a market capitalization of about \$380 billion.

The task gets even trickier in international M&A, because different jurisdictions treat intellectual property and other intangibles differently. Recent tax changes in the U.S. and put forth by the Organization for Economic Cooperation and Development have made valuing intangibles even more difficult.

One complication of international M&A deals with lots of intangible assets, such as intellectual property, is figuring out where the intellectual property resides, which often is not where the income is located.

"What you find frequently is that intellectual property within an organization will reside in just a few jurisdictions," said Philip Antoon, managing director at Alvarez & Marsal.

For instance, a company might have IP in the U.S. that it uses in various jurisdictions outside the country. Companies also may domicile the IP in a non-U.S. location, such as Ireland, from which it's then licensed to all using entities. When trying to come up with a valuation, many companies—or their accountants—will value the entity by looking at the overall profit margin of the company. The problem is, the entity doesn't actually own any IP.



**Different jurisdictions treat intellectual property and other intangibles differently.**

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## **Tax authorities are now demanding more substance from holding companies.**

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Even companies that just want to know how much their intellectual property is worth may need to consider where the IP resides. Depending on this factor, companies could end up paying a lower tax rate. Also, different jurisdictions have different standards for IP and rules are quite specific. Software code could be eligible for amortization, but customer relationships may not be. "In a sizable acquisition, that could be worth tens of millions of dollars," Antoon said.

Recent tax and accounting changes add more uncertainty when it comes to valuing intangibles.

In a bid to stop multinational tech companies, such as Apple, Facebook, and Amazon from operating in member jurisdictions while paying little or no corporate income tax, the OECD introduced its base erosion and profit-shifting initiative, making it harder for companies to shift profits to low- or no-tax locations. Around the same time, the U.S. introduced mandatory repatriation and global intangible low-taxed income, which imposes a tax of 10.5 percent on certain profits earned by non-U.S. subsidiaries.

As a result of these and other measures, tax authorities are now demanding more substance from holding companies that exist mostly to invest in stock, debt, or intangibles. Many countries also are trending toward requiring that income be attributed to the location where intangibles reside.

The result? A lot of guesswork and some delays.

Companies might be having trouble estimating the earnings they're planning to keep overseas. They'll face a one-time transitional tax on foreign earnings kept overseas, so there's no tax incentive to keeping funds offshore. But those with foreign operations will still need to keep some cash overseas and provide the appropriate disclosures.

PayPal's 2017 acquisition of TIO Networks, a Canadian payment processing company, for \$238 million offers an interesting example of the intangible valuation problem. TIO's \$238 million purchase price comprised \$66 million in technology and customer-related intangible assets, \$2 million of net assets, and goodwill of \$170 million.

In November 2017, PayPal suspended TIO's operations after discovering a security problem on its platform. PayPal then wrote off \$30 million of customer-related intangible assets. Such impairments to goodwill can be avoided through due diligence focused on the compliance issues often related to intangibles ahead of the deal closing.

Companies looking at international deals need to do a lot of spade work on how to structure the transaction. Complex valuations are just the beginning.

"All of a sudden, they're going to have to think about all the time and effort that will have to go in to just complying with these standards," Antoon said. "And I have seen that some companies aren't really ready for that necessarily. They weren't fully prepared for the onslaught of new compliance that they would have to deal with."

*Ellen Sheng is a writer and editor with a focus on business finance, fintech, and U.S.-Asia investments.*



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# New Law Guides M&A Investment and Security Priorities

By Lisa Singh

The Foreign Investment Risk Review Modernization Act, which was passed in August, will cast a wider net over the mergers and acquisitions playing field. The new law reflects the most substantive change in more than a decade to the process in which acquisitions receive approval from the Committee on Foreign Investment in the United States.

The new reporting requirements could turn disclosures of these deals into a more complex and time-consuming task, experts say.

“For covered transactions, the new requirements could add weeks, and maybe months, of delay to many transactions before they can close,” said Kevin Wolf, a CFIUS member during the Obama administration and current partner with Akin Gump’s international trade practice.

Transactions that previously were deemed low-risk could be significantly affected. This includes non-U.S. acquisitions of small U.S. technology companies.

“On any given day, scores of these M&A transactions were not being notified to CFIUS,” said Harry Clark, chairman of the global trade and compliance practice at Orrick. “Now parties to many of these transactions will be required to notify CFIUS, even if, frankly, CFIUS isn’t very interested in them.”

While previous regulations focused on the assessment of national security risk posed by a foreign person acquiring control of a U.S. business, the new law expands this scope to include influence from non-controlling foreign investments in U.S. businesses involved in critical infrastructure and technologies, those handling sensitive personal information of U.S. citizens, and certain real estate transactions, including undeveloped land, near government sites.

The law is slated for full implementation no later than March 2020. The Treasury Department, which chairs CFIUS, has issued two interim rules: The first lengthens a transaction’s review period from 30 to 45 days, and the second establishes a temporary pilot program requiring parties to transactions involving critical technologies to notify CFIUS before closing. The latter includes the option to provide a short declaration allowing for an expedited, 30-day process for most transactions. But it’s not guaranteed.



**Transactions that previously were deemed low-risk could be significantly affected.**

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The added scrutiny and steep penalties for noncompliance—as much as the value of the transaction, for both the buyer and the seller—are prompting a reexamination of transaction structures.

“With the influx of sovereign wealth and other foreign investment in U.S. private equity funds, many private equity investors are now tripping over CFIUS requirements, even when a U.S.-based fund is investing in a U.S.-based target, if their underlying investor base includes foreign entities,” said Kevin Robbins, cofounder of a Washington, D.C., area consultancy that advises investors and companies across national security and civilian marketplaces. Sidecar investment arrangements are also a focus in this environment.

Antonia Tzinova, a partner in the international trade practice of Holland & Knight, said, “Private equity firms with passive foreign participation have been shielded from CFIUS jurisdiction, provided the foreign subscription is truly passive and control is fully within the hands of U.S. nationals.”

Meanwhile, the current environment may shut out more foreign buyers, especially Chinese and Russian ones, Robbins added. He cites the increased scrutiny of Chinese companies buying U.S.-based cloud-hosting companies to exert influence.

“Some of the real estate clauses in FIRRMA take direct aim at these transactions, since the hosting deals can sometimes look like innocent real estate plays,” Robbins said.

FIRRMA’s reach isn’t limited to Chinese investments. “Most investments in critical technologies and infrastructure have been from our closest allies... U.K., Canada, and EU countries,” Tzinova said. “While there is an added layer of review, these types of investments will likely continue if they make business sense.”

Still, U.S. buyers may face “more muted” competition from foreign buyers, said Bob Kipps, managing director of aerospace and defense-focused investment bank KippsDeSanto. Where competition is strong, foreign buyers may include a risk premium over a U.S. buyer’s offer to win over a U.S. seller, he said.

The broad definition of “control” under CFIUS requires due diligence at the outset, experts say. “Involve your CFIUS counsel before you sign the purchase agreement,” Tzinova said. “And be ready to be flexible in adopting a deal structure that might allow the investment to go through.”

There are additional considerations that are important.

“For the U.S. business, consider its [U.S. government] contract work, proximity to government facilities, and sensitive research or information held by the U.S. business,” Wolf said.

“For the foreign buyer, consider its ownership structure, any foreign government ties, links to sanctioned parties, and agenda for the U.S. business,” he said. “Determine whether non-controlling foreign investors gain broad rights, informational access, or involvement in certain decision-making.”



## **The broad definition of “control” under CFIUS requires due diligence at the outset.**

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As FIRRMA settles into practice, timeline issues may eventually ease.

“While everyone has been focusing on the expanded CFIUS jurisdiction,” Tzinova said, “FIRRMA introduced some procedural changes and allocated resources to CFIUS, which hopefully will speed up the review process for transactions that do not warrant [being] blocked.” Additionally, regulatory refinement and guidance are likely to occur, experts say.

“I think virtually everyone would agree they’re overbroad, they’re catching too many transactions,” said Clark of Orrick. In the meantime, M&A activity will proceed, yet with an expanded scope of review for transactions.

“It’s just a complication that parties will go through to complete a transaction,” Clark said. “There may be delays—and a hassle factor, by virtue of the need to notify CFIUS—but the deal will normally close.”

*Lisa Singh is a writer specializing in business and technology matters.*

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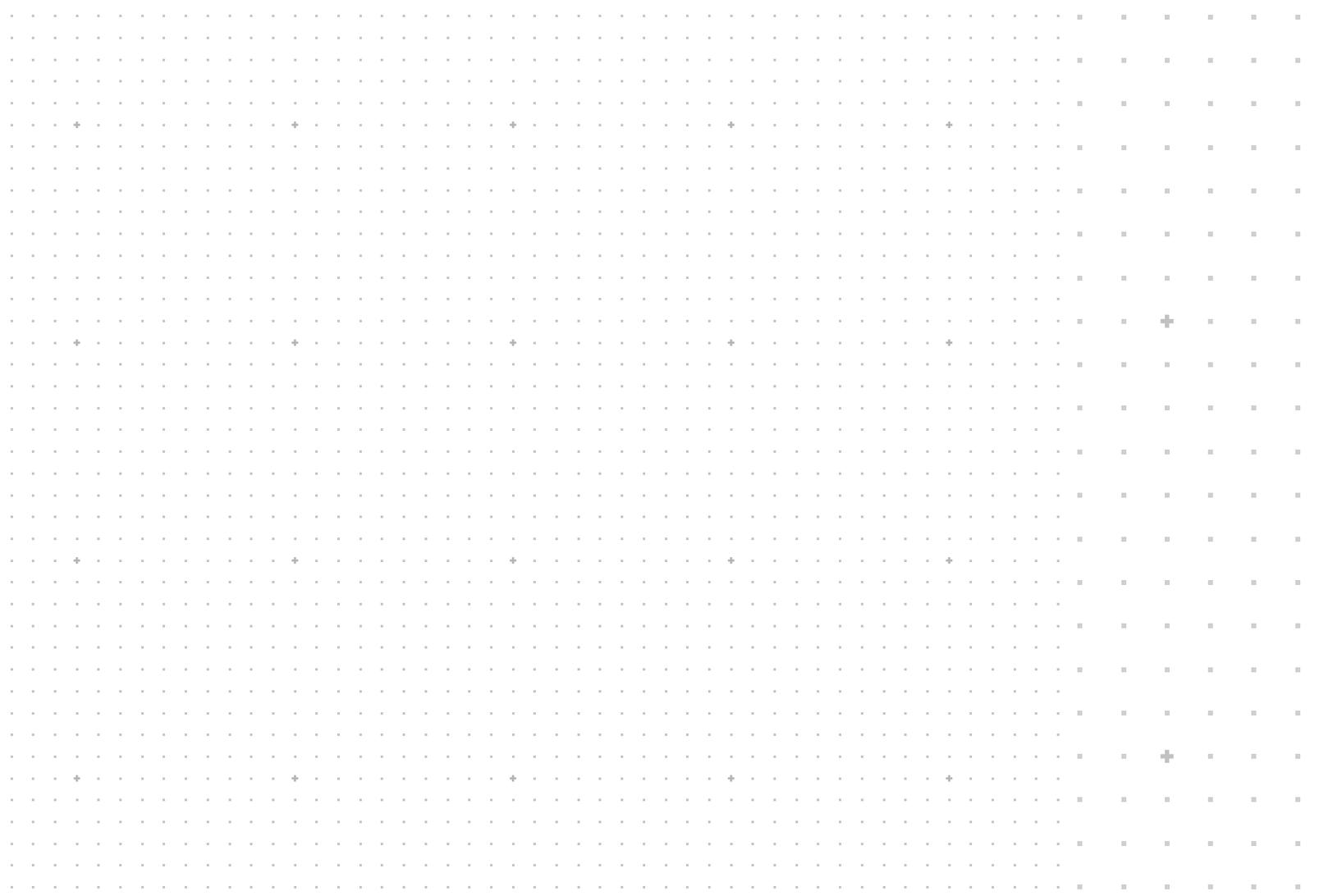
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