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US-China Deal Considerations Amid Cross-Border Uncertainty

By **Dan Levine and Scott Anthony** (January 16, 2025, 3:24 PM EST)

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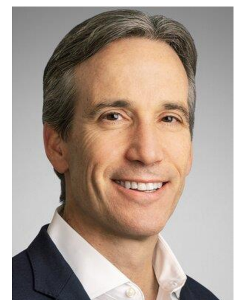

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It seems that nary a day goes by without bearish news about the trajectory of U.S.-China relations and the prospects for cross-border business.

In recent years, most legal and regulatory hurdles have come from Washington:

- Increased restrictions on inbound investment;[1]
- A new regime, in order to screen outbound investment;[2]
- Tightened export controls;[3]
- A national security-based regulation of bulk personal data flows;[4]
- Multipronged efforts to remove China from supply chains for critical industries;[5]
- Increased scrutiny of Chinese-origin software,[6] and other information and communication technologies;[7] and
- The ever-looming possibility of congressional investigations.

These rules often aim to mitigate risks presented by companies that U.S. policymakers perceive as vulnerable to Chinese government influence.

With the incoming administration advocating so-called strategic decoupling[8] and the aggressive use of tariffs,[9] and China poised to respond with export controls on strategic items,[10] the environment for economic cooperation, including through cross-border transactions, looks bleak.

In fact, the increasingly complex political and regulatory environment creates both imperatives and opportunities for global businesses. Companies on both sides of the Pacific should be looking at deals and internal changes to mitigate risks and overcome hurdles to their strategic plans.

Many already are. And financial investors, in addition to thinking about their portfolio companies, should be looking for ways to use capital to unlock value despite — and even on account of — the political and regulatory challenges.

Geographic Carveouts

The first question for many businesses has been whether to maintain both China-based and U.S.-based operations under common ownership, or whether the legal, regulatory and reputational risks and costs of doing so exceed the benefits.

If a company opts to change its footprint, it must decide whether to divest or simply wind-down operations, and where to draw geographic lines.

Carving out "China" may mean separating mainland China, Greater China — including Hong Kong, Macao, and possibly Taiwan — or a broader territory.

When the optimal buyer for the carved-out business is a globalized Chinese company that principally faces challenges to its business in the United States, a carveout of all ex-U.S. operations may realize the most value.

For a China-headquartered or controlled company, a partial carveout — such as selling a U.S. entity or facility but retaining a noncontrolling equity interest — may make sense if U.S. local control can increase value or mitigate risks.

The next question is how to effect the geographic separation. Tax, accounting and local law considerations often drive the choice of structure, with stock sales or asset sales being the most common.

Spinoffs or splitoffs are possible, but because they do not change the business's ownership mix, they generally do not solve regulatory challenges caused by such ownership mix.

Companies must also decide when to begin the separation. A company that runs a sale process for its to-be-carved-out business may commence the restructuring in advance of the auction in order to create the most robust auction among competing bidders.

The thorniest issues arise from the need to unwind the internal plumbing of cross-border businesses. Transition services agreements are commonly used to enable the remaining business to perform historically shared functions, such as information technology or human resources, for the carved-out business until the carved-out business can operate on a stand-alone basis.

Likewise, because global businesses often use China-based facilities for a portion of their manufacturing, carving out China may disrupt a company's internal manufacturing flows.

Supply agreements among the separated entities, whether for components or finished goods, may thus be needed to allow each to operate their business in the ordinary course after closing.

In addition, maintaining historic manufacturing flows can be important in regulated industries, such as life sciences, until new manufacturing sites can be validated by regulators.

Splitting intellectual property implicates additional questions. The divested business will first need to own or in-license the IP necessary to conduct its existing operations.

But parties to a geographic carveout will also need to consider who owns the right to exploit

improvements to existing products — and, in the case of trademarks, who owns the right to use the historic marks for new products — in the respective territories. Geographic carveouts are thus as much about dividing up future business as they are about the present.

Internal Restructurings

Rather than taking the painful step of fully severing geographies, many global companies are trying to navigate U.S.-China hurdles through internal actions. This is done every day by companies who limit information flows among affiliated companies to comply with export controls.

But the challenges run deeper. Many companies, when thinking about their long-term strategic plans for the U.S., want to mitigate the potential risks associated with their China-based ownership, management or operations. Others worry about how operations outside of China can present risks within China, for example, as a result of China's Countering Foreign Sanctions Law[11] or its "unreliable entities" list.[12]

In the current environment, changes to voting, governance and management of U.S. operations alone are unlikely to address the full range of concerns that current U.S. policymakers have regarding China-connected companies.

Companies need to consider, among other things:

- Product integrity — where and by whom the company's products, including software, are being developed, tested, manufactured and installed;

- Policies including the personnel responsible for the company's IT-cybersecurity, data, trade controls and anti-corruption policies;

- Customer access — or what access the company has over customer systems and information, who has such access, and how do maintenance, support and updates work; and

- Facility and systems segregation — whether ex-China operations are physically and logically separate from China operations, and whether China-based facilities have access controls or serve any monitoring functions.

The cost of addressing such questions through internal operational, technological and personnel changes can be significant. Even more problematic is the lack of a defined endpoint to such steps.

Absent a clear regulatory requirement, such as conditions required by the Committee on Foreign Investment in the United States, or CFIUS, there rarely are legal processes for companies to determine when they have sufficiently separated their China-connected operations to mitigate the risk that U.S. policymakers will consider them vulnerable to Chinese government influence and take actions to mitigate such vulnerabilities.

As a result, rather than incurring certain costs to yield uncertain policy mitigation benefits, many companies are choosing to hold off on internal restructurings even as policy risks complicate their long-term strategic planning.

IP Licenses and Structures

In recent years, expanded authorities and stricter scrutiny by CFIUS have sharply limited opportunities

for U.S. companies to partner with China-connected companies through U.S.-based equity structures.

Meanwhile, the pending outbound screening regime, as well as perceptions of political and economic risk, have reduced the U.S. appetite for investment in China. Opportunities nonetheless exist for cross-border collaboration through structures that do not involve equity investment.

U.S. companies interested in Chinese technologies should consider in-licensing U.S.- or ex-China rights to such technologies through intellectual property licenses.

Such structures may be attractive to Chinese companies that wish to avoid the policy risks of operating in the United States through equity structures, just as U.S. companies wary of establishing subsidiaries in China have long partnered with Chinese companies through IP licenses and other contractual collaborations.

With a combination of royalties and milestone payments, such arrangements offer significant flexibility for parties to tailor their economic arrangement.

License structures are not, however, immune from policy risks. In industries where the U.S. government seeks greater independence from China, U.S. policymakers have scrutinized license arrangements and have encouraged license agreements to contain safeguards for U.S. industry.

An example of such safeguards appears in regulations implementing the Section 30D consumer vehicle tax credit under the Inflation Reduction Act.

To incentivize automakers to remove China from their battery supply chains, Section 30D withholds credit eligibility from vehicles whose batteries contain critical minerals or battery components from foreign entities of concern, which include companies owned by, controlled by, or subject to the jurisdiction or direction of the Chinese government.

The U.S. Department of Energy has read this to cover, among others, companies anywhere in the world that are "effectively controlled" by Chinese companies through contracts, including IP licenses.

The DOE, however, provided that a licensee would not be considered effectively controlled if, under the arrangement, the licensee retained certain rights — including rights to control production at the licensee's facility and "to access and use any intellectual property, information, and data critical to production, for the duration of the contractual relationship."

In short, the DOE was willing to extend the credit program to batteries produced by facilities that use IP in-licensed from China, but only if such arrangements did not provide the Chinese licensors with the ability to disrupt production at the facility for the duration of the license. A similar approach may be useful in other contexts.

Although license structures typically involve a strategic licensee immediately capable of exploiting the subject technology, U.S. financial investors may likewise participate in in-licensing structures by funding a new entity to serve as the U.S. licensee. Such so-called Newco structures typically involve the creation of a U.S. entity that will be broadly independent of the China-connected licensor, in order to best position the entity for an eventual U.S. initial public offering or sale.

Versus a typical license, the structure obviates the need for the licensor to identify a long-term strategic

licensee before the technology has been developed in the U.S. market.

The licensor and the financial parties can choose whether to compensate the licensor with Newco equity, typically in a noncontrolling position, to make the license royalty-bearing, or to use a combination of both, and thereby to better align the parties' economic interests in an exit transaction.

The structure is well-suited to China-connected licensors whose anticipated paths to an IPO have been delayed by the downturn in the Hong Kong IPO market in recent years.

Conclusion

Uncertainty in the U.S.-China bilateral relationship promises to be a key factor in global business planning for the foreseeable future. It can also be a driver for transactions and transaction structuring.

By forging new models for collaboration that respect the policy concerns of each government, the business community has the potential to help stabilize the bilateral relationship and deliver economic benefits to both countries.

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