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M&A Guide to CFIUS: How the Review Process Can Impact Your Transaction

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Article 1 of 4

The Committee on Foreign Investment in the United States ("CFIUS" or "the Committee") has received much attention over the past several months for its role in blocking two separate Chinese acquisitions of US semiconductor companies. In September 2017, President Trump issued an **Executive Order** prohibiting Canyon Bridge Capital Partners, an investment firm with ties to the Chinese government, from acquiring Lattice Semiconductor Corporation (Lattice). In December 2016, President Obama similarly **blocked** the acquisition of the US subsidiary of Aixtron SE (Aixtron), a German semiconductor company, by Fujian Grand Chip Investment Fund LP, another entity tied to the Chinese government.

These highly publicized actions represent one extreme in the range of impacts the CFIUS review process can have on cross-border mergers, acquisitions and investments involving perceived potential threats to US national security. Although less widely discussed, several other recent transactions have been abandoned because the parties could not resolve national security concerns raised during the CFIUS review process. For example, in January 2016, GO Scale Capital, a consortium of Asian investors, withdrew its offer to acquire an 80% interest in Lumileds, a US subsidiary of Dutch company Royal Philips, after failing to receive CFIUS clearance following a lengthy review process. More recently, in June 2017, L1 Energy, which is backed by Russian billionaire Mikhail Fridman, withdrew from CFIUS review and abandoned its plan to invest $700 million in ExL Petroleum Management. Although the vast majority of foreign investment transactions will never suffer this drastic outcome, potential investors and targets should understand the scope of CFIUS' review authority and the complex factors involved in its analysis of national security concerns.

This is the first in a series of four articles aimed at helping companies and their counsel (i) understand how the CFIUS review process can impact a transaction, (ii) decide whether to voluntarily submit to CFIUS review, (iii) proactively address potential national security concerns, and (iv) anticipate the future trends and changes likely to affect the CFIUS regime. This article will provide a general overview of the CFIUS review process, including its purpose and authority to review certain types of transactions.

CFIUS overview and history

CFIUS is an interagency committee of the US government chaired by the Department of the Treasury. Its members include representatives from eight other federal departments and offices: the Department of Justice, Department of Homeland Security, Department of Commerce, Department of Defense, Department of State, Department of Energy, Office of the US Trade Representative and Office of Science & Technology Policy. The Director of National Intelligence and the Secretary of Labor also are non-voting members of CFIUS and provide input on issues related to their respective areas of responsibility. The Office of Management & Budget, Council of Economic Advisors, National Security Council, National Economic Council and Homeland Security Council are observer members who participate in CFIUS activities as appropriate. Other agencies with relevant expertise may be asked to participate in CFIUS reviews on an ad hoc basis.

CFIUS was created to review foreign investments in US businesses for potential national security concerns. It was formed by President Ford in 1975 in response to concerns that "petrodollar investments" from oil-producing countries in the Middle East would be used to gradually exert control over key US industries. In 1977, Congress enacted the International Economic Emergency Powers Act, which allowed the president to prohibit a transaction involving a foreign person and any US property, after first declaring a national emergency.

In the 1980s, security concerns shifted to Japanese investments in US emerging technology sectors, the most notable of which was the attempted acquisition by Fujitsu Corporation of Fairchild Semiconductor Corporation. In response, Congress passed the Exon-Florio Amendment in the Omnibus Trade and Competitiveness Act of 1988, giving the president the power to prohibit a foreign investment *without* declaring a national emergency. However, in order to prohibit such a transaction, the new law required the president to find “credible evidence” that the investment could threaten US national security and that other provisions of law are not adequate to protect against this threat.

To date, the president has used this power to formally block or unwind a transaction only four times. In addition to the recent Lattice and Aixtron transactions, President George H.W. Bush in 1990 ordered the China National Aero-Technology Import and Export Corporation to divest its controlling interest in MAMCO Manufacturing, which supplied parts to the aerospace industry. In 2012, President Obama ordered Ralls Corporation (Ralls), which was owned by Chinese nationals, to divest its interest in various windfarm projects in Oregon, citing concerns about the windfarms’ proximity to a sensitive naval air station and restricted airspace.

Initially, the CFIUS review process focused on the US defense industry and whether foreign control of key aspects of that industry could compromise US preparedness to meet national security needs. In the 1990s, this focus expanded to include considerations of transactions with the potential to facilitate the transfer of military and other sensitive technology to countries, entities and individuals targeted by US sanctions and export control laws. In 2007, following heightened public interest in national security issues and a congressional investigation of 9/11, Congress passed the Foreign Investment and National Security Act (FINSA), which broadened the definition of "national security" for purposes of CFIUS review and added more specific requirements with regard to the types of transactions CFIUS must review with greater scrutiny. For example, FINSA expanded the scope of CFIUS' mandated review to include transactions implicating US "critical infrastructure" and "critical technologies" and requiring CFIUS to conduct a full investigation of all transactions involving a foreign government-controlled investor.

The scope of the CFIUS review process

Under FINSA, CFIUS has jurisdiction to review "covered transactions," which the law defines as "transactions" pursuant to which a "foreign person" gains "control" of a "US business." The components of the jurisdictional definition are themselves broadly defined, and as a result, the range of activities that can constitute "covered transactions" may be surprising and counterintuitive.

For example, the types of "transactions" that may fall within CFIUS' scope of review can include not only traditional mergers and acquisitions, but also investments in which a foreign person acquires a small minority investment in a target – in some cases as little as 10 percent or less of the outstanding voting stock in a US company. Covered transactions also can include the formation of a joint venture or even certain long-term leases.

The definition of a "foreign person" also is broader than many investors and target companies might expect. Under the CFIUS regulations, a foreign person includes any entity over which a foreign national, foreign government or foreign entity exercises or has the power to exercise control. For purposes of CFIUS review, a foreign person can include a US subsidiary of a foreign business or a US-based investment fund controlled by foreign investors. Accordingly, when considering whether a particular transaction could be subject to CFIUS review, it is important for parties in a transaction to think broadly about the identity of the investor and to understand the investor's ownership chain.

The CFIUS regulations define a "US business" to include any entity engaged in interstate commerce in the United States,

regardless of who owns it or where it is formed or headquartered. As demonstrated by the blocked Aixtron transaction discussed above, this broad definition gives CFIUS the authority to review investments by foreign businesses (e.g., Fujian Grand Chip Investment Fund LP) in other foreign businesses (e.g., Aixtron), to the extent the deal involves assets of the target engaged in US interstate commerce, such as a US subsidiary or sales office. Indeed, the Executive Order issued in the Aixtron case was notable in that it included in the scope of Aixtron's "activities in interstate commerce" any interest in patents issued by or pending with the US Patent and Trademark Office. As a result, parties to a covered transaction also must carefully consider the scope of the US business activities that will be controlled by the foreign investor post-closing.

Among all the key CFIUS definitions, the term "control" is perhaps the most expansive and counterintuitive. For CFIUS purposes, "control" means the power, direct or indirect, whether or not exercised, "to determine, direct or decide certain important matters affecting an entity." As discussed above, control of a US business can manifest in a number of ways, including by the acquisition of a minority ownership interest, board representation, formal or informal voting arrangements or certain other contractual agreements. Notably, the CFIUS regulations include a "safe harbor" provision specifying that a transaction that (i) results in the acquisition of 10 percent or less of the outstanding voting stock in a US business, *and* (ii) is conducted "solely for the purpose of passive investment," is *not* a covered transaction within CFIUS' review jurisdiction. The safe harbor provision in the regulations include examples of certain minority shareholder protections that, in themselves, will not be deemed to confer control over a US business.

CFIUS as a voluntary regime

One of the most notable aspects of the CFIUS review process is that it is in certain respects a voluntary regime. That is, even where a contemplated transaction falls within CFIUS' review jurisdiction, the parties do not have an affirmative legal requirement to notify CFIUS of the transaction. That said, CFIUS has authority to unilaterally initiate a review of a covered transaction, either before or after it closes, if it perceives the deal to pose a national security threat.

For example, in November 2010, CFIUS asked Huawei Technologies to retroactively submit to a review of its acquisition of certain assets of 3Leaf Systems – a transaction that had closed in May 2010 without a voluntary notification to CFIUS. In February 2011, Huawei "voluntarily" divested its interest in the 3Leaf assets after CFIUS indicated it would recommend that the president order such a divestment.

When the parties to a covered transaction decide that the circumstances of their deal warrant a voluntarily filing with CFIUS, the Committee will conduct an initial 30-day review of the transaction. In most cases, CFIUS will approve or clear the transaction at the conclusion of the initial review period. In a significant minority of cases, however, CFIUS will determine that further review is warranted by potential security concerns or required under FINSA (e.g., where the investor is controlled by a foreign government). In such cases, CFIUS will initiate a subsequent 45-day investigation in which it will assess the specific effects the transaction will have on US national security and identify appropriate mitigation measures to which the parties agree in order to receive CFIUS clearance. If the Committee's national security concerns cannot be resolved within the 45-day investigation period, CFIUS will either ask the parties to withdraw and refile their notice to allow for more time to reach a resolution or inform the parties that CFIUS will refer the matter to the president with a recommendation to prohibit, suspend or impose additional mitigation measures on the transaction. The president must announce a decision to take such an action within 15 days of receiving a CFIUS recommendation.

Due in part to the voluntary nature of the CFIUS regime, the Committee reviews only a small percentage of transactions involving foreign investment in the United States. Between 2009 and 2015 – the latest calendar year for which official data are available – CFIUS received 770 notices of covered transactions. Of these, CFIUS initiated an investigation of 310 transactions, or approximately 40 percent of the transactions for which it received a notice. As discussed above, during that period, the president ultimately prohibited only one transaction: the Ralls windfarm acquisition in 2012. Notably, however, an additional 57 notices were withdrawn from the review process after CFIUS initiated an investigation, indicating that these transactions likely were significantly

modified or abandoned because the parties anticipated that they would not receive CFIUS clearance.

Because of the uncertainty and high stakes involved, parties to a covered transaction must carefully weigh the potential costs and benefits of filing a voluntary notice with CFIUS versus the costs and benefits of not filing a CFIUS notice. Where the parties decide to submit to CFIUS review, they will incur additional fees and may face delays in closing the transaction. If the deal receives CFIUS clearance following review, however, it will be protected from future CFIUS interference. Conversely, parties that forego CFIUS review can avoid the costs and delay associated with the process. However, their deal will remain subject to uncertainty, as CFIUS may unilaterally initiate a review of a covered transaction even after it has closed.

The next article in this series will address these potential costs and benefits, as well as the analysis that CFIUS counsel can perform to assist parties in weighing these factors in the context of a specific transaction.

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