

Clients & Friends Memo

CFIUS Unbound: Foreign Investor Deals Continue to Draw Intense National Security Scrutiny

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The national security implications of corporate deals involving foreign investors continues to be a headline-grabbing topic, now more than ever as the United States engages in heated trade negotiations with China amidst allegations of industrial espionage and theft of intellectual property. Last summer, President Trump signed into law the Foreign Investment Risk Review Modernization Act of 2018 (“**FIRRMA**”), which expanded the types of transactions subject to national security review by the Committee on Foreign Investment in the United States (“**CFIUS**”). As we approach the first anniversary of FIRRMA, it has – unsurprisingly – made it more critical than ever to identify and address whether a cross-border deal involving non-U.S. parties is subject to CFIUS review and approval, and if so, to strategize and plan for such process early in the life cycle of a transaction.

I. Background

Since 1975, CFIUS has consisted of a group of federal agencies responsible for addressing the national security implications of mergers, acquisitions, joint ventures, and other “covered transactions” in which foreigners acquire ownership stakes in U.S. companies.¹ Historically, whether the parties to a covered transaction sought CFIUS pre-approval for the deal was entirely a voluntary decision; however, CFIUS could review any transaction within its purview at any time regardless of whether the parties made such notification. If a proposed transaction fell under CFIUS’s authority, the President had the discretion to suspend, block, or approve it subject to negotiated mitigation measures. If CFIUS chose to scrutinize a transaction after the fact and identified issues that should have been mitigated, it could in certain cases impose civil monetary penalties and even unwind the transaction post-closing.

In August 2018, the enactment of FIRRMA broadened the scope of transactions subject to CFIUS scrutiny while also imposing new mandatory filing obligations on transactions involving certain

¹ See Section 721 of the Defense Production Act of 1950, as amended by the Foreign Investment and National Security Act of 2007, 50 U.S.C. App. 2170, available at <https://www.treasury.gov/resource-center/international/foreign-investment/Documents/Section-721-Amend.pdf>.

industries and technologies.² In October 2018, the Treasury Department issued interim regulations outlining FIRRMA's "Pilot Program" which detailed the declaration process for transactions requiring mandatory review.³ Collectively, these changes reflected the most significant updates to the CFIUS review process in over a decade.

II. Pre-FIRRMA CFIUS Review Process

Prior to FIRRMA, a "**covered transaction**" subject to CFIUS review was limited to mergers, acquisitions, or takeovers by or with a foreign person that could result in foreign "control" of any person engaged in interstate commerce in the United States, and that could threaten the national security of the United States.

A. What Constitutes Control?

"**Control**" – which does not necessarily mean *majority* control – is defined broadly in the CFIUS regulations to include:

*"[t]he power, direct or indirect, whether or not exercised, through the ownership of a majority or a dominant minority of the total outstanding voting interest in an entity, board representation, proxy voting, a special share, contractual arrangements, formal or informal arrangements to act in concert, or other means, to determine, direct, or decide important matters affecting an entity;"*⁴

The pre-FIRRMA CFIUS regulations did not provide a set percentage of what ownership stake constitutes "control"; however, they contained a carve-out for transactions in which a foreign person holds ten percent or less of the outstanding voting interest in a U.S. business, regardless of the dollar value of the interest, provided that the transaction is "solely for the purpose of passive investment."⁵ An ownership interest in a U.S. business is a passive investment "if the person holding or acquiring such interests does not plan or intend to exercise control, does not possess or develop any purpose other than passive investment, and does not take any action inconsistent with holding or acquiring such interests solely for the purpose of passive investment."⁶

B. What Constitutes a Threat to National Security?

If a transaction would result in foreign control of a U.S. business, the next question to ask is whether it presents a potential **threat to the national security of the United States**. This

² Title XVII, Pub. L. No. 115-232, available at https://home.treasury.gov/sites/default/files/2018-08/The-Foreign-Investment-Risk-Review-Modernization-Act-of-2018-FIRRMA_0.pdf.

³ 31 C.F.R. Part 801, available at https://home.treasury.gov/system/files/206/FR-2018-22182_1786904.pdf.

⁴ 31 C.F.R. Part 800, available at <https://www.treasury.gov/resource-center/international/foreign-investment/Documents/CFIUS-Final-Regulations-new.pdf>.

⁵ *Id.* at § 800.302(b).

⁶ *Id.* at § 800.223.

analysis takes into consideration 11 factors⁷ which include the potential effects of the transaction on U.S. international technological leadership, the impact on U.S. critical infrastructure,⁸ and whether the U.S. business would fall under the control of a foreign government or state-owned entity.⁹ In practice, CFIUS has asserted a broad view of the types of companies and industries whose products or services may be considered relevant to U.S. national security.

C. What Did a Traditional CFIUS Submission Entail?

The pre-FIRRMA CFIUS review process was voluntary. If the decision was made to seek CFIUS approval, typically both parties to a covered transaction would prepare and jointly submit the filing which then triggered a 30-day review period. At the end of that period, CFIUS could conclude that no further review was necessary or, alternatively, could initiate an investigation which was to be completed within 45 days. Depending on the results of the investigation, CFIUS could again choose not to take action, could negotiate with the parties to the transaction to mitigate the threats to national security posed by such foreign control, or could refer the transaction to the President for ultimate action. The President then had a 15-day period to suspend or prohibit the deal upon a finding of credible evidence that the transaction would impact the national security of the United States. In such cases, the President's determination was not subject to judicial review or other recourse.

III. How the Process Has Changed Under FIRRMA

While leaving the existing CFIUS review criteria and processes largely in place, FIRRMA layered on a number of new parameters and requirements that make the system substantially more intricate.

A. No Longer Limited to Foreign "Control"

FIRRMA broadened CFIUS's authority to review a wide range of foreign investments that do *not* result in foreign control if the U.S. business at issue is involved in **critical infrastructure**, **critical technology**, or the **personal information of U.S. citizens**. FIRRMA also subjected to CFIUS review certain real-estate transactions where the property at issue is in close proximity to a U.S. government or military installation, transactions involving changes in foreign investor rights, and transactions involving a foreign government. This means that, even in the absence of "control," parties to an international transaction will need to identify whether their deal falls within any of these new categories.

⁷ 50 U.S.C. App. §§ 2170(f)(1)-(11).

⁸ "Critical infrastructure" means "systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems or assets would have a debilitating impact on national security." *Id.* at § 2170(a)(6).

⁹ *Id.* at § 2170(b)(1)(B).

B. Mandatory Declarations for Critical Technology Industries

FIRRMA modified the historically voluntary CFIUS process with a mandatory filing requirement. Under FIRRMA's Pilot Program, parties to certain types of investments in U.S. businesses that produce, design, test, manufacture, fabricate or develop one or more "**critical technologies**" in one of twenty-seven identified industries must file a mandatory declaration.¹⁰ This streamlined application is shorter and contains less detail than the traditional CFIUS submission, but CFIUS can require the parties to a transaction to subsequently submit a full CFIUS filing which can effectively lead to multiple filings prior to deal closing.

C. Revised FIRRMA Review Period

The life cycle for pre-FIRRMA CFIUS filings was intended to be no more than 90 days from submission to Presidential action. Under FIRRMA, the mandatory declaration process consists of a 45-day period for CFIUS review of the declaration, a 45-day investigation period which can be extended by CFIUS for an additional 15 days if necessary, and 15 days for review and determination by the President. As a result, parties to a transaction that may require a mandatory declaration under FIRRMA should build in even more time than was required under the traditional CFIUS process.

IV. Serious Issues for Chinese Investors

To date, six of the seven transactions that Presidents have blocked or unwound through CFIUS involved Chinese investors (the seventh was the 2018 blocking of the Qualcomm acquisition by Singapore-based Broadcom).¹¹ The FIRRMA statute is not specific to Chinese firms and contains only a generalized "sense of Congress" that adds as a factor to consider whether a covered transaction involves a country of "special concern."¹² However, CFIUS has long been viewed as a serious tool to be used by the United States Government to scrutinize prospective Chinese investors in U.S. businesses,¹³ and in December 2018, Assistant Attorney General for National Security John Demers confirmed that China had become the largest single source of CFIUS filing in

¹⁰ Annex A to 31 C.F.R. Part 801.

¹¹ *CFIUS Reform: Foreign Investment National Security Reviews*, Congressional Research Service (Updated May 2, 2019), <https://fas.org/sqp/crs/natsec/IF10952.pdf>; see *Christina Farr and Ari Levy, UnitedHealth buys PatientsLikeMe, which faced Trump administration scrutiny over Chinese investor*, CNBC (June 24, 2019), <https://www.cnbc.com/2019/06/24/unitedhealth-buys-patientslikeme-after-cfius-forced-sale.html>.

¹² An earlier legislative version of FIRRMA would have limited CFIUS' jurisdiction to investors from certain nations but that reportedly met resistance from the Treasury Department. There have been reports that forthcoming CFIUS regulations may contain a "black list" of foreign countries whose investors will undergo additional scrutiny, such as China and Russia. See David Hanke, *Foreign Investors Are Watching For CFIUS 'Good' or 'Bad' List*, Law360 (May 23, 2019), <https://www.law360.com/articles/1162435/foreign-investors-are-watching-for-cfius-good-or-bad-list>.

¹³ See Keith Gerver, *Investing in the United States: CFIUS Concerns for Chinese Investors*, Cadwalader, Wickersham & Taft LLP (July 9, 2015), <https://www.cadwalader.com/resources/clients-friends-memos/investing-in-the-united-states-cfius-concerns-for-chinese-investors>.

the last few years.¹⁴ Not surprisingly, it is reported that foreign direct investment in America by Chinese firms has plummeted recently due to CFIUS scrutiny.¹⁵

In April 2019, CFIUS ordered that a Chinese firm that in 2016 had purchased 60% of Grindr, an online dating application, divest its ownership stake due to national security concerns about the geolocation data collected on its users.¹⁶ That same month, China's ENN Ecological Holdings Company pulled out of a deal to purchase Toshiba's U.S. liquefied natural gas business due to CFIUS approval concerns.¹⁷ According to the U.S. Department of State, China is engaged in a "military-civil fusion" strategy to break down barriers between the civilian sector and its military industrial base to achieve economic development and military modernization.¹⁸ As long as these concerns continue, CFIUS will continue to be a significant factor for any potential corporate transaction with a Chinese counterparty.¹⁹

V. Post-FIRRMA Practice Tips

Since it is less than a year old, the new CFIUS regulatory regime has made it difficult to gauge exactly just how broadly it will expand and what types of deals it will capture under FIRRMA. But as we approach FIRRMA's one-year anniversary there are some practical takeaways that deal lawyers in this space should keep in mind:

- **Know if the U.S. business implicates a FIRRMA-designated category.** With the concept of "control" no longer dispositive, be aware of whether the U.S. business involves one or more "critical technologies" that could cause a deal to implicate mandatory declaration

¹⁴ *Statement of John C. Demers for a Hearing Before the United States Senate Committee on the Judiciary on China's Non-Traditional Espionage Against the United States: The Threat and Potential Policy Responses*, U.S. Department of Justice (December 12, 2018), available at

https://www.justice.gov/sites/default/files/testimonies/witnesses/attachments/2018/12/18/12-05-2018_john_c_demers_testimony_re_china_non-traditional_espionage_against_the_united_states_the_threat_and_potential_policy_responses.pdf.

¹⁵ See Noah Smith, *U.S.-China Trade War Raises Risks of a Real One*, Bloomberg Opinion (June 5, 2019), <https://www.bloomberg.com/opinion/articles/2019-06-05/u-s-china-trade-war-raises-risks-of-military-conflict>.

¹⁶ See Sarah Bauerle Danzman and Geoffrey Gertz, *Why is the U.S. forcing a Chinese company to sell the gay dating app Grindr?*, The Washington Post (April 3, 2019), https://www.washingtonpost.com/politics/2019/04/03/why-is-us-is-forcing-chinese-company-sell-gay-dating-app-grindr/?utm_term=.3250d29bb009.

¹⁷ See Yuka Obayashi et al., *China's ENN to scrap deal for Toshiba's U.S. LNG business*, Reuters (April 11, 2019), <https://www.reuters.com/article/us-toshiba-lng-sale/chinas-enn-to-scrap-deal-for-toshibas-u-s-lng-business-idUSKCN1RN1R4>.

¹⁸ *Testimony of Dr. Christopher Ashley Ford, Assistant Secretary, Bureau of International Security and Nonproliferation, to the U.S.-China Economic and Security Review Commission* (June 20, 2019), <https://www.state.gov/technology-and-power-in-chinas-geopolitical-ambitions/>.

¹⁹ See Eric Rosenbaum, *1 in 5 corporations say China has stolen their IP within the last year: CNBC CFO survey*, CNBC (March 1, 2019), <https://www.cnbc.com/2019/02/28/1-in-5-companies-say-china-stole-their-ip-within-the-last-year-cnbc.html>.

obligations. This includes so-called “**emerging and foundational technologies**” which have yet to be defined pending Commerce Department final rules expected later this year.²⁰

- **Negotiate potential mitigation steps in advance.** If the U.S. business involved in the transaction deals in sensitive technology, significant data of U.S. persons, or other factors that are particularly likely to draw CFIUS scrutiny, tee up potential mitigation strategies before CFIUS does. There is no reason to wait until late in a transaction’s life cycle to construct mitigation efforts that are acceptable to the parties and (hopefully) to the U.S. Government. Getting out in front of mitigation early could help avoid an eleventh-hour scramble.
- **Consider a hedging strategy.** Some U.S. sellers have resorted to requiring foreign investors to deposit a reverse break fee in a U.S.-dollar escrow account upon deal signing. Others have sought protection with CFIUS risk-insurance products, with premiums typically at ten-to-fifteen percent of the reverse break fee and potentially higher based on perceived regulatory risk. Depending on the stakes, the insurance expense may be worthwhile for the peace of mind of having a hedge against a delayed or failed transaction.

VI. Conclusion

Since FIRRMA and its Pilot Program regulations have gone into effect, it has become clearer than ever that a CFIUS analysis must be a part of any M&A deal involving foreign investors. The range of transactions subject to review has become broader, the application process has become more complicated, and the consequences for non-compliance have become more severe. At the same time, the Justice Department’s National Security Division recently sought increased funding for FY 2020 to hire additional personnel to handle CFIUS matters.²¹ With higher stakes and increased regulatory scrutiny, it is essential that deal lawyers anticipate the CFIUS implications of a transaction early in its life cycle, know what to look for and what questions to ask during the due diligence process, and determine whether to apply for and obtain CFIUS approval well before a transaction closes.

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²⁰ See Industry and Security Bureau Proposed Rule, 83 FR 58201, “Review of Controls for Certain Emerging Technologies” (November 19, 2018), <https://www.federalregister.gov/documents/2018/11/19/2018-25221/review-of-controls-for-certain-emerging-technologies>.

²¹ U.S. Department of Justice FY 2020 Budget Request, National Security and Cyber, <https://www.justice.gov/jmd/page/file/1142631/download>.

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