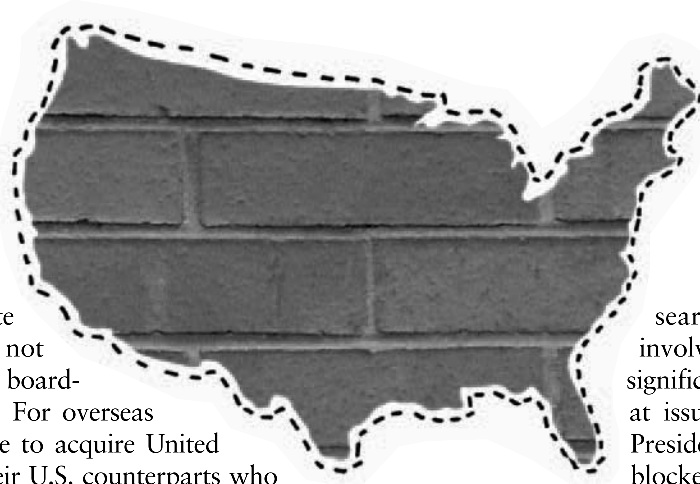
Executive COUNSEL
C-LEVEL INSIGHTS FOR BUSINESS LEADERS

Many Transnational Deals Now Face a Security Review

Address "CFIUS" Concerns in Advance

By Jamie S. Gorelick and Stephen W. Preston



International corporate acquisitions are not resolved just in the boardrooms of the parties. For overseas dealmakers who hope to acquire United States companies — and their U.S. counterparts who wish to court foreign investors — the question of whether a merger or acquisition conflicts with U.S. national security interests is an increasingly vital concern.

Of special interest today, growing numbers of cross-border transactions are being subjected to the review process conducted by the Committee on Foreign Investment in the United States ("CFIUS").

CFIUS — a panel of officials from over a dozen federal agencies and offices — is charged with thoroughly vetting all acquisitions by foreign corporations (whether stock purchases or acquisitions of assets) that could affect U.S. national security. CFIUS has the authority to mount an intrusive and detailed inquiry that one government official recently characterized as a "full body search" of the companies involved. CFIUS can demand significant alterations to a deal at issue or recommend to the President that a transaction be blocked or rescinded.

Because of the ambiguity as to what might raise a "national security" concern, a CFIUS review may be necessary even in circumstances that one would not necessarily associate with our national security. The proposed deal needn't be in sophisticated munitions to trigger a CFIUS review; transactions involving communications equipment or energy properties could also prompt a review. Even deals involving companies chartered in countries considered staunch and trusted allies may be fair game. Moreover, the CFIUS process may be used as the trigger for clearance by other agencies of the U.S. government, such as Federal Communications Commission approvals of license transfers.

In the post-9/11 environment, the Committee's scope has expanded and is likely to expand further as the national security community increasingly focuses on China, and as Chinese companies seek more foreign acquisitions. Indeed, recent bids by Chinese interests to acquire prominent U.S. companies were vigorously opposed by those concerned about China's long-term strategic objectives in the Pacific Basin and beyond.

CFIUS has the authority to mount an intrusive and detailed inquiry that one government official recently characterized as a "full body search."

IBM's proposed sale of its personal computer business to the Chinese company Lenovo prompted CFIUS to investigate, delay approval, and eventually impose conditions on the transaction. The bid by Chinese oil company CNOOC Ltd. to purchase California-based Unocal Corp. for $18.5 billion set off a firestorm of protest in the United States, with some seeking to block the transaction asserting a national security interest in preserving domestic oil production and refining capabilities. Seeing the opposition, CNOOC withdrew its bid.

Adding to the attention that CFIUS has received is the recently issued Government Accounting Office report criticizing CFIUS for taking an overly narrow view of "national security" and for its alleged lack of transparency. The report led some senators to propose revisions to the CFIUS review process, including one that would more than double the length of the review period. The GAO criticism has led some participating agencies to consider how broadly they should be defining the national security interests they are charged with protecting.

Whether a proposed merger or acquisition involves a company from China or elsewhere, charting a successful course through the CFIUS process requires anticipation and assessment of potential national security concerns and a plan to address the concerns of each "stakeholder" agency on the Committee.

HOW THE CFIUS PROCESS WORKS

CFIUS was created in 1975 to monitor the impact of and to coordinate U.S. policy on foreign investment in the United States. Its current role is rooted in the 1988 "Exon-Florio Amendment" to the Defense Production Act of 1950. That amendment authorized the President to block any merger, takeover, or acquisition of a U.S. corporation by a foreign entity if it would threaten to impair national security. Before the President can block a transaction – or force a divestiture of a completed transaction – there must be credible evidence that the "foreign interest exercising control" over the acquired U.S. corporation "might take action that threatens to impair the national security" and that other measures would not provide adequate protection. The President must reach a decision within 90 days of official notification of the transaction.

CFIUS was set up to make a recommendation to the President on transactions like these. The Secretary of the Treasury chairs the panel; Treasury's Office of International Investment coordinates and manages Committee activities. Other members include the Secretaries of Defense, State, Commerce and Homeland Security, the Attorney General, the Chairman of the Council of Economic Advisors, the United States Trade Representative, the National Security Advisor, the Director of the Office of Management and Budget, the Director of the Office of Science and Technology Policy, and the Assistant to the President for Economic Policy. The nature of the transaction dictates which members are most active on that transaction.

The CFIUS review process consists of four steps: (1) a voluntary "notice" filed with CFIUS by the parties to the transaction; (2) a 30-day review of the transaction by the Committee; (3) a potential further 45-day investigation, if warranted; and (4) a decision by the President to permit or deny the transaction (or to seek divestment in the case of a post-facto review of a completed acquisition). Approval at any stage of the process means that the transaction is cleared for Exon-Florio purposes.

Although the CFIUS review process is normally initiated by a voluntary notice filed by the parties, an investigation may also be opened by CFIUS itself, even long after a deal is concluded. Dealmakers therefore proceed at their own risk if they incorrectly determine that their transaction does not need to be reviewed.

When should notice be given? A transaction may be voided if (1) a "foreign" person is to acquire a "United States" person; and (2) there is the potential for the acquisition to harm U.S. "national security." Where these circumstances may be present, the question of CFIUS review must be considered.

One would think that determining whether a "foreign" person is acquiring a "U.S." person should be fairly straightforward, but it is not. Any entity that conducts business activities in the United States is a U.S. person. So, even a U.S. branch office or subsidiary of a foreign-owned and organized company is considered a U.S. person, triggering review if acquired by another foreign firm. At the same time, that U.S. branch or subsidiary is under foreign control, so it is also considered a foreign person if it attempts to acquire a U.S. company.

The second condition – whether the transaction could threaten U.S. national security – is inherently ambiguous and getting more so every day. "National security" is not defined by Exon-Florio, with the statute leaving its scope "within the President's discretion." The list of some of the factors reflecting whether a transaction has the potential to harm national security includes:

• Domestic production of a given product needed for national defense.

• The capability of domestic industry to meet these requirements.

• The effect foreign control over production might have on meeting national defense needs.

• Whether foreign control will lead to increased risk of proliferation of weapons of mass destruction or missile technology.

• The impact on U.S. technological leadership in defense areas.

While the transactions subject to CFIUS review extend well beyond those involving traditional "defense" concerns, scrutiny is heightened when the targeted company has technologies that cannot lawfully be exported or those that would be critical to national defense. The same is true if the company has classified contracts with the U.S. government. The motives of the foreign purchaser or its plans for the U.S. company once acquired can also cause CFIUS to pause over a transaction.

Because of these types of concerns, both parties to such a transaction have to disclose a great deal of information to the Committee, including detailed background on those with ownership interests or management responsibilities in the purchasing company and descriptions of all sensitive technologies and information held by the company to be acquired.

Compromises are often struck before formal filing of these materials or in the initial 30-day review period. In 2000, for example, CFIUS required a Japanese telecommunications firm to agree to bar involvement in the firm by the Japanese government as a condition for approving its acquisition of a U.S. Internet service provider. Similarly, a Dutch firm's 2001 acquisition of a U.S. company was approved when it agreed to divest itself of the acquired company's optics and semiconductor businesses, which produced manufacturing technologies for U.S. military satellites.

At the end of the 30-day review, CFIUS is generally required to either approve the transaction or begin a far more detailed and intrusive 45-day investigation, culminating in the Committee's formal recommendation to the President. CFIUS has discretion to decide whether to conduct a 45-day investigation, but if the acquiring entity is controlled by or acting on behalf of a foreign government, it must do so. In practice, the parties often will decide to withdraw the notice to give the Committee more time for review or to structure a set of conditions that would allow it to approve the transaction. To avoid rejection of the transaction, it is important to have explored what those conditions might be well in advance of formal filing.

At the end of the formal 45-day investigation, CFIUS is to issue findings and a recommendation to the President about whether the transaction should be blocked or rescinded. On rare occasions there are "dissenting opinions" for the President to consider. The President has 15 days to act. He then submits a report to Congress explaining his decision.

CAREFUL PLANNING NEEDED

Each transaction that comes before CFIUS is unique. No two are likely to present the same national security issues or business objectives, and the policy environment in which CFIUS is making its decisions changes constantly. Therefore careful planning is required.

• Understand the particular concerns of each stakeholder at the CFIUS table. Perhaps the most important step that merger or acquisition proponents can take is to plan an approach to CFIUS well in advance of the conclusion of the transaction, assessing how each CFIUS participant would view the transaction and whether to notify CFIUS of the impending deal.

CFIUS often makes rapid-fire requests for information and demands short-fused decision-making regarding possible alterations to the deal.

While a party is not *required* to notify CFIUS before concluding the transaction – even if it appears likely that it will implicate national security concerns – parties must carefully consider whether it makes sense to submit a preemptive alert. Any CFIUS member may, on its own initiative, provide "notice of a transaction" at any time within three years of the transaction's completion, and the President may void the transaction. Although the resulting CFIUS inquiry may be burdensome and time-consuming, especially in the busy period

immediately prior to concluding a transaction, a lingering, long-term threat of potential divestiture can inject crippling uncertainty into a deal.

Advisers who understand the relevant national security issues and how they will be viewed, especially in the political and business context, are critical to evaluating the risks and rewards of notification and the mitigating measures that may permit a transaction to pass muster. Because of the compressed time frame of the CFIUS process (a maximum of 90 days from notice to decision), the parties will need advice on the interests and perspectives of each department and agency likely to be concerned with a given transaction. Knowledge of related regulatory schemes applicable to transnational business with national security implications – such as antitrust, export controls, personnel security clearances, and the Foreign Corrupt Practices Act – is also important.

• Do not file a notification until a favorable outcome is assured. Most of the material work before CFIUS should be addressed before filing with CFIUS. This includes vetting potentially problematic aspects of a transaction with each relevant stakeholder and working to resolve its concerns, either by addressing them on the merits or accommodating them with measures that mitigate national security concerns. Similar planning and consultation can immunize a transaction from Congressional or media criticism, especially if CFIUS members can assure policy makers that they have considered and addressed potential problems.

Just as experienced trial lawyers adhere to the adage, "never ask a witness a question unless you know what the answer will be," parties to a transaction with national security implications should not file a CFIUS notification until they have developed a high degree of confidence that the transaction will be quickly cleared.

• Do not underestimate the demands of the CFIUS process. Of the 470 notifications filed with CFIUS, only eight have resulted in formal investigations. These numbers should not, however, be read to suggest that CFIUS is a paper tiger. The relatively low number of formal, 45-day investigations does not reflect the dialogue and negotiation that occur between the parties and CFIUS before the filing of a notice or during the initial 30-day preliminary review period. In practice, the vast majority of filings are settled during the initial 30 days, either by approval of the acquisition – often after the parties agree to mitigate concerns raised during the review – or voluntary withdrawal of the filing.

During this compressed period, CFIUS often makes rapid-fire requests for information and demands short-fused decision-making regarding possible alterations to the deal. As a result, parties must stand ready to respond quickly, and to evaluate costs and benefits of proposed changes rapidly. Parties should not be lulled into thinking the process is a formality merely because few formal 45-day investigations occur. When the notice is filed, parties should expect high-tempo action.

A SENSITIVE FORUM

Most business executives have never heard of the Committee on Foreign Investment in the United States, but with the increased pace of foreign acquisitions and the growing number of technologies, resources and infrastructures that can be considered to be part of our national security, the CFIUS process will become a more common venue for competitive battles. Remote national security implications can be exploited by opponents, who may be able to generate public and political pressures that could drive the CFIUS process in unexpected and potentially disadvantageous directions.

Remote national security implications can be exploited by opponents, who may be able to generate public and political pressures.

It has never been easy to anticipate which transactions will trigger scrutiny and concern. In a changing business and national security climate, this little understood process is likely to present many more traps for the unwary, fraught with peril for the unsuspecting or the unprepared. Those carefully armed with a well-designed and informed strategy will successfully navigate the shoals.

Jamie S. Gorelick, is a partner at WilmerHale, in Washington, DC. She previously served as deputy attorney general of the United States and general counsel of the Department of Defense, and most recently as a member of the National Commission on Terrorist Attacks Upon the United States. She serves on the boards of United Technologies Corp. and Schlumberger, Ltd.

Stephen W. Preston is a partner at WilmerHale, in Washington, DC. He was previously general counsel of the Department of the Navy and acting general counsel of the Department of Defense, as well as deputy assistant attorney general at the Department of Justice. He is currently vice chair of the Defense, National Security and Government Contracts Department at WilmerHale.

Reprinted with permission from Executive Counsel, January/February 2006.
© EXECUTIVE COUNSEL. All Rights Reserved. On the Web at www.executivecounsel.info.