

# Report from Washington

## Navigating Inbound Chinese Investment Through CFIUS

October 17, 2014

### Introduction

There are numerous macroeconomic and commercial reasons for the large amount of Chinese investment in the United States over recent years, yet the prevailing suspicion within some Washington circles and among Americans more broadly is that Chinese investment in U.S. companies is either unfair—considering that U.S. companies may not have the same opportunities in China—or even threatening. Over the past several years, the growth of Chinese investment in the United States has been controversial, which is reflected in the critical attention being paid to Chinese investment by Congress and the media, as well as by scrutiny from the Committee on Foreign Investment in the United States (“CFIUS” or the “Committee”), which reviews inbound foreign investment that may pose a risk to national security. As shown by a number of recent examples discussed below, including the Smithfield/Shuanghui,<sup>1</sup> Nexen/CNOOC, and IBM/Lenovo transactions, the parties successfully navigated the CFIUS review process by adopting proactive and transparent approaches with the Committee.

As part of its review of Chinese investments in U.S. businesses, CFIUS will consider a number of factors in determining whether the investment poses a risk to national security, including:

- Whether the U.S. target’s business is considered “critical infrastructure”;
- Physical proximity of assets of the U.S. business to U.S. government and military facilities and restricted airspace;
- High technology controlled by the U.S. business that may have military uses;
- Access through the U.S. business to sensitive and personal data of U.S. citizens,

<sup>1</sup> Simpson Thacher represented Smithfield in the acquisition, including for CFIUS purposes.

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particularly U.S. government employees;

- Sensitive U.S. government contracts, particularly classified contracts, with the U.S. business;
- Involvement of state-owned enterprises with the Chinese acquirer.

It is prudent for parties to potential transactions that will be subject to CFIUS review to frontload the identification and analysis of possible hot button issues that could cause delays or impediments to realizing the full expected benefits of proposed investments.

### The CFIUS Process

CFIUS is an inter-agency committee within the Executive Branch of the U.S. Government tasked with reviewing transactions—including minority investments and other transactions falling short of complete acquisitions—that could result in “control”<sup>2</sup> of a U.S. business by a foreign person and that could pose a risk to “national security”<sup>3</sup> (i.e., a “covered transaction”). Where serious national security concerns are implicated, CFIUS will negotiate mitigation agreements or insist on assurances from the parties to address those concerns. However, CFIUS can also recommend to the President that he or she block (or unwind) a transaction.

Working with experienced CFIUS counsel early in the process, especially prior to signing a transaction agreement, will help the parties evaluate potential CFIUS risks and appropriately structure the transaction to assign the risk of unfavorable outcomes, minimize the impact of a potential CFIUS review, and pro-actively engage in work-streams to facilitate an expeditious review process.

Filing a notice to initiate CFIUS review is, technically, a voluntary process. However, for any

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<sup>2</sup> As defined in 31 C.F.R. 800.204, “[t]he term control means the 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; in particular, but without limitation, to determine, direct, take, reach, or cause decisions regarding the following matters, or any other similarly important matters affecting an entity.”

<sup>3</sup> The regulations do not define “national security,” but CFIUS will review each covered transaction on a case by case basis to evaluation whether any national security concerns may be present by the transaction based on factors such as “where the transaction results in foreign control over critical infrastructure that . . . could impair national security” or “where the transaction is a foreign government controlled transaction.” Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons, 73 Fed. Reg. 70,702 (Nov. 21, 2008).

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transaction “which could result in control of a U.S. business by a foreign person,”<sup>4</sup> CFIUS can initiate an investigation on its own, even when a notice is not filed. In practice, this means that CFIUS can effectively require parties to submit a notification for its review when it learns of a transaction that could adversely affect national security, as it did to Huawei and Ralls Corp. described in further detail below. For this reason, it is prudent to engage with CFIUS whenever there is a “close call” as to whether CFIUS would initiate its own investigation of a transaction. Parties following this strategy will also avoid reputational risks down the road.

#### The Source of CFIUS Authority

CFIUS derives its authority from Section 721 of the Defense Production Act of 1950, as amended, which gives the U.S. President authority to investigate the impact on U.S. national security of mergers, acquisitions and takeovers by or with foreign persons that could result in foreign control over persons engaged in interstate commerce in the United States. Pursuant to this authority, the President can suspend or prohibit a transaction—or in the case of a completed transaction, order mitigation measures, divestiture or unwinding—if he or she concludes that (1) there is credible evidence that the foreign interest exercising control might take action that threatens U.S. national security; and (2) the provisions of law, other than the International Emergency Economic Powers Act, do not provide adequate and appropriate authority to protect U.S. national security. The President delegated his investigative authority to CFIUS.<sup>5</sup>

#### The CFIUS Notice

In addition to describing the transaction and identifying the parties, the initial CFIUS filing must also include, *inter alia*:

- The nature and purpose of the transaction as well as relevant deal documents;
- The names, addresses, and other information for each parent entity of the buyer or buyers, up through the ultimate parent entity.

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<sup>4</sup> 31 C.F.R. 800.207.

<sup>5</sup> CFIUS is chaired and staffed by the Department of Treasury. Its members are the heads of the Departments of Treasury, Justice, Homeland Security, Commerce, Defense, State, Energy and the Offices of the U.S. Trade Representative and Science and Technology Policy. The following offices also observe and participate as appropriate: the Office of Management and Budget, the Council of Economic Advisors, the National Security Council, the National Economic Council and the Homeland Security Council. The Director of National Intelligence and the Secretary of Labor are non-voting, ex-officio members of CFIUS with roles as defined by statute and regulation.

*“Often the most time-consuming and burdensome requirement is gathering and separately submitting the personal identifier information (‘PII’) for the officers and directors of each foreign person that is a party to the transaction and its immediate, intermediate, and ultimate parents. In addition, PII must be gathered for each individual that owns five percent or more of the equity of the foreign party to the transaction and its ultimate parent.”*

- Business information about the parties to the transaction which helps the Committee to evaluate the sensitivity of the target U.S. business;
- Personal information about officers, directors, and shareholders of the buyer;
- Buyer disclosures regarding whether it has any plans to shut down or move outside of the United States any of the target’s facilities, consolidate or divest product lines or technologies, modify or terminate government contracts, or eliminate the domestic supply of any product.
- Several items in the filing are aimed at determining the extent of potential foreign government control in the target post-transaction, including whether any foreign government entity has or will have any contingent rights, “golden shares”, appointment rights, or convertible voting instruments in the target, the buyer, or the buyer’s parents.

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If the parties to a transaction decide to file a notice with CFIUS, the process of preparing the draft notice can take around two weeks and requires a significant investment of time by in-house counsel and employees from each party.

#### Timing of CFIUS Review

After a draft notice is submitted, the Committee staff will review and provide comments, normally within a week of submission of the draft. After revising the notice to address such comments, the parties submit the final notice, which is typically accepted within a day or two, thereby commencing a 30-day review period for the transaction. During this initial period, the Committee may conclude the proposed investment is not a “covered transaction” or that the deal presents no unresolved national security concerns. However, CFIUS may also decide to initiate a 45-day investigation.<sup>6</sup> CFIUS will initiate a 45-day investigation if a CFIUS member agency advises the CFIUS Staff Chair that it believes the transaction could

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<sup>6</sup> Parties should be sensitive to specific circumstances that could lead CFIUS to reject a notice (thus tolling the 30-day clock and potentially delaying consummation of the transaction). These include: non-compliance with the filing requirements, a mid-review material change in the transaction, the revelation of information contradicting the notice, failure to provide supplemental information within three business days of a request, and failure to include a final certification under the regulations.

threaten national security or if the agency (or one of several agencies) tasked with taking lead on the 30-day review recommends that an investigation should be undertaken.

Notably, there is a presumption in favor of a 45-day investigation when the acquiring entity represents or is controlled by a foreign government or when the transaction involves so-called “critical infrastructure.”<sup>7</sup> This presumption is rebuttable and does not ensure that a 45-day investigation will be initiated. During the investigation, CFIUS may also ask follow up questions, in which case the parties have only three business days to respond.

CFIUS may terminate a 45-day investigation at its own initiative without referring the matter to the President for action. CFIUS will refer the matter to the President only if it decides the transaction should be suspended or blocked, cannot decide on a recommendation, or requests that the President make the determination. Upon referral, the President has 15 days to make a decision, which is final and cannot be appealed. As such, the CFIUS process may take up to 90 days from initial filing to final determination. As a practical matter, parties will usually withdraw a notice and abandon the transaction when CFIUS signals its intent to oppose a deal.

In connection with its review and eventual recommendation, CFIUS may ask the parties to agree to certain mitigation measures to address and alleviate national security concerns. For instance, CFIUS may ask the parties to ensure that certain customer information is not disclosed to unauthorized parties or to agree that U.S. government agencies will have continued access to certain information in the possession of the target or certain of the target’s systems. CFIUS’ regulations permit mitigation agreements to include actual or liquidated damages for breach.

## The Role of CFIUS Counsel

As noted above, given the increasing prevalence of thorough CFIUS review, involving CFIUS counsel early on has several advantages.

### Evaluating the Need to File

First, experienced CFIUS counsel can help a potential acquirer review the probable substantive outcome of CFIUS’ consideration of a proposed transaction. This may provide early comfort that the parties will *not* need to make a CFIUS filing.

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<sup>7</sup> Critical infrastructure is defined as “a system or asset, whether physical or virtual, so vital to the United States that the incapacity or destruction of the particular system . . . would have a debilitating impact on national security.” 31 C.F.R. § 800.208.

*“When appropriate, CFIUS counsel can facilitate a confidential briefing with CFIUS about a transaction to explain to the Committee why the parties believe a filing is not necessary. Although CFIUS does not issue advisory opinions, such briefings can provide further insight into the advisability of making a filing as well as demonstrate the parties’ commitment to transparency with CFIUS.”*

*“[A]n issue that Chinese acquirers must consider is the impact of the U.S. arms control regime. Pursuant to the [ITAR], U.S. exports to China of items that are on the United States Munitions List...are prohibited and it is the policy of the United States to deny licenses for such exports.”*

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#### Structuring the Transaction

In the event the parties decide to make a CFIUS filing, CFIUS counsel's early involvement can help to structure transactions to reduce CFIUS risk and to assign risk of unfavorable outcomes. For instance, CFIUS counsel can assist a corporate deal team with drafting closing conditions and cooperation clauses similar to what commercial parties often include with respect to antitrust review. Another benefit of early involvement of CFIUS counsel during the deal negotiation is that it helps frontload the work of gathering the extensive information needed for a draft filing and thereby prevents unnecessary delays in getting to closing.

In connection with proposed minority investments, CFIUS counsel can assist in carving out certain rights the absence of which will allow CFIUS to conclude that control is not being acquired. In some cases CFIUS counsel may recommend limiting the size of the investment in order to avoid any claim of "control" as a result of a dominant minority shareholding.<sup>8</sup> Further, CFIUS counsel can help the parties in some deals get comfortable with an early closing by recommending that they structure certain rights as "springing rights" which become effective only upon CFIUS clearance of a transaction.

#### Issue-Spotting Other Regulatory Issues

CFIUS analysis often identifies other foreign-investment related regulatory issues.

For instance, an issue that Chinese acquirers must consider is the impact of the U.S. arms control regime. Pursuant to the International Traffic in Arms Regulations ("ITAR"), U.S. exports to China of items that are on the United States Munitions List ("U.S.M.L.") are prohibited and it is the policy of the United States to deny licenses for such exports. The mere acquisition of a controlling equity stake in a business that possesses items on the U.S.M.L. is likely to raise ITAR issues. These prohibitions can raise challenges in transactions involving targets possessing or doing business related to U.S.M.L. items, because such items or business must be divested prior to the closing of a transaction.

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<sup>8</sup> The CFIUS regulations do provide a safe harbor for investments that result in a foreign person holding ten percent or less of the outstanding voting interest in the U.S. business "but only if the transaction is solely for the purpose of passive investment." 31 C.F.R. § 800.302(b).

Likewise, to the extent that a Chinese acquirer is pursuing a U.S. business that engages in classified activities that require it to have a facility clearance with the Department of Defense, CFIUS counsel will be able to provide advice on the parallel regulatory regime run by the Defense Security Service of the Department of Defense.

### Overview of CFIUS and Recent Scrutiny of Chinese Investment

In its most recent annual report, CFIUS reported that it received notices for 23 covered transactions from China in 2012. This is more than double the 10 notices received for covered transactions from China in 2011. While the percentage of all notified deals subject to second-phase 45-day investigations remained relatively constant from 2010 to 2012 (36% to 39%), the absolute number of such investigations per year almost doubled from 2008 to 2012 (from 23 to 45), reflecting greater scrutiny of proposed deals following the CFIUS reforms enacted in the wake of the Dubai Ports controversy in 2006. CFIUS also reported that an increasing number of transactions are being withdrawn after the initiation of an investigation, indicating that the parties may have concluded CFIUS would recommend blocking the transaction or require unacceptably onerous mitigation conditions. In 2012, 20 notices were withdrawn after the commencement of an investigation, compared with only five withdrawn notices in 2011. While new notices were filed in ten of these deals in 2012, at least ten transactions were abandoned. While CFIUS's report does not indicate the nationality of the proposed investors who withdrew these notices, it is distinctly possible that some involved Chinese acquirers.

### Examples of Chinese Investments Blocked or Abandoned After CFIUS Investigation

While the number of deals ultimately blocked by the President remains in single digits, Chinese acquirers have run into several high-profile issues with CFIUS review:

- In March 2012, the Chinese acquirer Ralls Corp. acquired an interest in four wind farm project companies in Oregon without first filing a voluntary notification to CFIUS. In June 2012, CFIUS requested that Ralls file a voluntary notification. After Ralls filed its notice, CFIUS recommended that Ralls cease all construction and operations of the wind farms until CFIUS's investigation could be completed. CFIUS was primarily concerned with objections raised by the U.S. Navy over the placement of wind turbines by Ralls near or within restricted Naval Weapons Systems Training Facility airspace. Among other sensitive operations, the Navy tests drones at that facility. At the conclusion of its investigation, CFIUS recommended that President Obama unwind the investment. On September 28, 2012, President Obama issued an executive order stating that credible evidence existed that the Ralls acquisition threatened to harm U.S. national security and required Ralls to divest the Oregon wind farm project. Pursuant to CFIUS's recommendation, the President also imposed other requirements such as requiring Ralls

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to remove previously installed equipment.

- In 2011, Huawei decided not to notify CFIUS before acquiring \$2 million of technology and employees from 3Leaf Systems, a small server technology firm in Santa Clara, California. Apparently based on concerns about the sensitivity of the underlying technology, CFIUS required Huawei to file a notice of the transaction. Following its review, CFIUS notified Huawei that it would recommend divestment of the 3Leaf acquisition. Huawei initially objected to CFIUS's findings and indicated that it would attempt to press its case with President Obama (who had 15 days under the statute to review CFIUS's recommendation). However, Huawei eventually withdrew its objection and agreed to divest the 3Leaf assets.<sup>9</sup>
- In December 2009, a subsidiary of China's largest aluminum producer, Northwest Non-Ferrous International Company, attempted to acquire U.S.-based Firstgold. The transaction was withdrawn due to CFIUS's concerns about the proximity of Firstgold assets to sensitive military bases. CFIUS could not even inform the parties what military facilities were implicated by the transaction because of national security issues, and the closest known facilities were dozens of miles away from known military installations. It is a difficult challenge for parties to anticipate concerns regarding potentially unknown and highly confidential military activity.

## Examples of Successful Navigation of CFIUS Process by Chinese Investors

### Smithfield

CFIUS's review and clearance of the acquisition of Smithfield by a Chinese pork manufacturer, Shuanghui, is a helpful case study of the CFIUS process involving arguable national security issues. Early on in the Smithfield transaction, the parties recognized that CFIUS might have concerns about the transaction as a result of Smithfield's substantial involvement in the U.S. pork industry and large number of facilities and geographic footprint. Consistent with best practices, described above, the parties proactively engaged CFIUS through CFIUS counsel (Simpson Thacher represented Smithfield), including presenting the parties' perspective on the transaction prior to making a formal filing. Ultimately, the Committee cleared the proposed acquisition without any conditions at the conclusion of a 45-day investigation.

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<sup>9</sup> The unwinding of the Huawei 3Leaf deal is a case study on how not to deal with CFIUS and the potential reputational negative consequences to parties of getting it wrong. After Huawei agreed to divest the 3Leaf assets, it posted a letter to its website to address "misconceptions." The letter ([http://www.huawei.com/ilink/en/about-huawei/newsroom/press-release/HW\\_092875](http://www.huawei.com/ilink/en/about-huawei/newsroom/press-release/HW_092875)) explained the circumstances surrounding the divestiture and explained why the U.S. government was concerned with the transaction. The letter noted that Huawei hoped to pursue future U.S. investments and expressed hope that the transaction would not have any reputational effect.



The Smithfield review was also notable for the focus by the media and Congress on issues that had less obvious implications for national security, but were nevertheless important for the parties and its government relations and media relations advisors to tackle. In the middle of the 30-day first-stage review of the Smithfield transaction, the Senate Agriculture Committee held hearings touching on food scarcity and food security while inviting witnesses hostile to the transaction and generally hostile to Chinese investment in the U.S. Critics went so far as to claim that Chinese management practices might adulterate the U.S. food supply.

While these criticisms were not credible given that no U.S. imports of Chinese pork were likely as a result of the transaction, such seemingly non-security-related issues had to be proactively considered and comprehensively addressed during the course of the CFIUS investigation.

#### Nexen

CNOOC's acquisition of Nexen is illustrative of the importance of proactively reviewing a transaction for potential national security implications. In 2013, CNOOC, a Chinese state-owned petroleum company, received CFIUS approval to complete its \$15.1 billion acquisition of Nexen, a Canada-based petroleum company holding significant exploration rights and production assets in the Gulf of Mexico. The Nexen acquisition, however, was not CNOOC's first attempt to buy an energy company with U.S. assets. In 2005, it attempted to buy U.S. energy producer Unocal for \$18.5 billion, but had to withdraw its bid before even reaching CFIUS review following stiff political opposition in Washington.

In the Nexen acquisition, CNOOC actively courted U.S. and Canadian regulators early in the transaction, making moves to win support from politicians and taking steps to put the regulators at ease even before the transaction was announced. During its bid for Nexen, CNOOC approached CFIUS informally before signing the deal and explained the proposed transaction and what it planned to do with the U.S.-based assets should the transaction be permitted. The early notice gave CFIUS a chance to become comfortable with the deal before any external pressure from the media arose, in sharp contrast to the attempted Unocal transaction in which regulators were first introduced to the deal through critical reports in the newspapers.

In the end, CNOOC received CFIUS approval but was barred from "operating" Gulf of Mexico oilfields. The terms of the agreement allowed CNOOC to own the assets, oversee operations at a high level, and collect revenue from the properties, but it could not control how the facilities operated on a daily basis.

#### IBM/Lenovo

Lenovo's 2014 purchase of IBM's low-end server business also provides a clear example of the importance of being proactive and flexible with CFIUS. That transaction drew the scrutiny of politicians and the press because of recent tension between China and the United States over U.S. allegations of state-sponsored hacking by the Chinese government. Those high-profile stories, coupled with the fact that IBM sold servers to the Defense Department and the Department of Homeland Security, made for a lengthy review process.

The parties notified CFIUS before the transaction was publicly announced, allowing time for the U.S. Government to investigate how widely it used IBM servers. The parties also voluntarily pulled and resubmitted the transaction before the 45-day investigation period expired to allow the Committee more time.

CFIUS reportedly asked many questions during the probe, primarily focusing on maintenance of installed IBM servers and Lenovo's access to them. The investigation revealed the servers were used more extensively in sensitive areas than the parties believed. To allay the regulators' fears, IBM offered to continue performing maintenance on Lenovo's behalf for five years after the sale. In the end, although CFIUS placed some minor, undisclosed conditions on the deal, the transaction was approved no doubt helped by the parties early notification and transparency with CFIUS.

For further information about the CFIUS process, please feel free to contact the following lawyers in our Washington, D.C. office:

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