

CFIUS challenges for China companies investing in the US

By Dara A. Panahy and Li Chen¹

China companies have become increasingly active in outbound mergers & acquisitions transactions, capitalizing on China's robust economy to address their growth and developmental needs. As a result of the global financial crisis and related economic developments, the US has been a key target market for such outbound activity. However certain China companies involved in the aviation, defense, IT and telecoms sectors have faced challenges in obtaining approval from the Committee on Foreign Investment in the United States (CFIUS) for their proposed investments in, or acquisitions of, US companies.

As an example, Huawei Technologies Co., Ltd. (Huawei), a leading Chinese global telecoms company, has had to abort several prospective transactions in the US given perceived technology transfer or national security concerns associated with the acquisitions. In 2008, following input from CFIUS, Huawei withdrew a proposed acquisition of US-based network security company 3Com, and last year, Huawei's bid for Motorola's wireless-equipment businesses was aborted on similar grounds. In February of this year, at the request of CFIUS, Huawei unwound its completed purchase of certain assets from a bankrupt US server technology company called 3Leaf.

What is CFIUS and how can CFIUS affect China companies investing in the US?

CFIUS is an inter-agency committee of the US government and is made up of representatives from nine federal agencies such as the Department of Defense, Department of State and Department of Homeland Security, and chaired by the Secretary of the Treasury. The US President is authorized to investigate the impact on national security of "mergers, acquisitions, and takeovers" by foreign persons that result in foreign control over a US company or its assets. CFIUS has been delegated the authority to review and investigate such transactions. As such, inbound investment or acquisition deals that are subject to CFIUS' authority include US businesses with assets, products, services or technology that are deemed to raise national security concerns, or involve critical US infrastructure of the US. As a general matter, any investment

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exceeding 10% of the equity, voting control or equity of a US company could trigger a CFIUS review, and the characterization of what may implicate national security concerns or be deemed to constitute critical infrastructure may be broadly defined and is determined on a case-by-case basis.

In any proposed transaction that is subject to CFIUS authority, the domicile of the proposed foreign investor or purchaser is an important consideration. Noting that CFIUS has the task of safeguarding US national security and critical infrastructure, its review process must withstand scrutiny from both the US Congress and the President. As such, CFIUS may be less concerned by a proposed investment or acquisition involving a foreign company based in country that is a strategic ally of the US, as compared to transactions involving certain countries such as China. Generally, any proposed investor or acquirer that is a state-owned enterprise or sovereign wealth or investment fund will also receive additional scrutiny by CFIUS, irrespective of its domicile.

General CFIUS guidance for China companies investing in the US

Consider voluntary filing and early communication with CFIUS

Filing a notice for review by CFIUS is voluntary and does not involve any filing fee. Unlike the antitrust-related Hart-Scott-Rodino premerger notification process, companies are not required to file a CFIUS notice merely because a transaction meets a predetermined size threshold. Instead, the need to file is determined purely by the potential effects of the transaction on US national security or critical infrastructure. The benefit of filing a CFIUS notification is two-fold. First, the US President and CFIUS have the authority to initiate a transaction review even if the reviewing parties have not filed a CFIUS notice. Voluntarily filing avoids the appearance of impropriety, particularly if the US government would be likely to investigate a transaction in any case. Second, if a notification is not submitted and CFIUS later determines that the transaction adversely affects US national security considerations or critical infrastructure, the transaction parties may be directed to unwind the investment or acquisition. Filing a CFIUS notification may also reduce ancillary execution risk for the transaction, as it may limit competitors or other third parties from lobbying Congressional members or US executive branch officials to urge CFIUS to initiate an investigation after a transaction has closed.

Involve Professional Advisors at Early Stage

Weighing the pros and cons of filing a CFIUS notification can be particularly challenging and requires significant consultation with experienced legal

counsel. Engagement of reputable professional advisors, in particular CFIUS counsel, and the early involvement of such advisors in the assessment of CFIUS-related matters, can be extremely helpful in avoiding unnecessary costs or delays in the execution of an investment or acquisition transaction.

Consider filing in questionable cases

The ultimate determination of whether to submit a notification in marginal or questionable situations will be largely dependent upon the acquiring firm's risk tolerance. Many companies that make frequent investments in the US, or hope to do so, prefer to file a CFIUS notification in virtually all of these marginal or questionable cases. Doing so not only results in the certainty that is obtained following a CFIUS approval for a transaction, it also demonstrates the willingness of a foreign firm to cooperate with the US government and act as a responsible corporate citizen, thereby possibly securing goodwill with, and further trust from, the Committee for future transactions.

A pre-filing notification is highly recommended

A CFIUS notice is filed jointly by the US company and its proposed foreign investor or acquirer, who should coordinate the process in advance and do so in conjunction with CFIUS. This typically includes submitting a draft of the voluntary notice in advance of when the formal notification is expected to be filed. The pre-notification provides CFIUS an early understanding of the transaction, as well as the opportunity to informally consider, on an preliminary basis, whether the proposed transaction may implicate national security considerations or critical US infrastructure. The pre-notification also provides an opportunity for CFIUS staff to suggest additions or modifications to the filing and can help avoid unnecessary and frustrating delays in the review process.

Consider mitigation or remedies early

If CFIUS determines that a proposed transaction creates a risk to US national security, then it may oppose the transaction outright or request that the parties take steps to mitigate the foreign ownership, control or influence (FOCI) concerns CFIUS has. Certain means to alleviate or mitigate FOCI concerns are, for example, through partial divestiture of a sensitive facility or product line. With respect to a potential divestiture, it is important to understand whether there is any technology or intellectual property used by the divested portion of the business that is also used or needed in remaining areas of the business to be acquired. If so, a license from the remaining business to the new owners of the divested portion of the business to use that technology may be a necessary step to ensure that the new owners of the

divested assets have the ability to operate a viable business. Another means of mitigating FOCI concerns involves, where applicable, submission to US government-approved safeguards/security agreements involving physical plant, information systems or network security undertakings, or alternatively, the establishment of a secured subsidiary affiliate company that isolates and limits foreign person access to any sensitive US assets, products, services or technology. It is impossible to predict with any certainty whether CFIUS will request, or accept as effective mitigation, any of these remedies; it is, however, possible to anticipate that CFIUS may object to or intervene in a proposed transaction. Proactively considering possible remedies or mitigation measures will allow the transaction parties, and not CFIUS, to take the initial step in shaping the discussion on such potential remedies or mitigation measures.

Do not assume that CFIUS approval is impossible

Notwithstanding Huawei's challenging CFIUS experiences, numerous other China companies have obtained CFIUS approval for significant investment or acquisition transactions. Examples include Lenovo in its acquisition of IBM's PC business in 2005, and China sovereign wealth fund China Investment Corporation in its investment in AES, a US-based power company in 2010. More recently, AVIC International, the international arm of China Aviation Industry Corporation, the largest aviation company in China, obtained CFIUS clearance within a short timeframe in its acquisition of two subsidiaries of US general aviation engine manufacturer Teledyne Continental. This is a landmark transaction not only because it is the first successful acquisition by a Chinese aviation company of a US aviation industry manufacturer, but also because the predecessor of AVIC International was the only foreign investor that involved the US President exercising its veto right in connection with a CFIUS investigation of a foreign investor's acquisition of a US company.

"Foreign investment in the aviation industry is potentially sensitive for the US government," notes Ed Sun, partner at Milbank, Tweed, Hadley & McCloy LLP, which represented AVIC International. "We were able to draw upon both our deep experience in China outbound transactions, and our extensive experience in the US aviation sector to successfully negotiate a solid transaction and also obtain CFIUS and other regulatory approvals."

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