MACDONALD WEISS PLLC

Client Alert

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CFIUS and FINSA: Analyzing "foreign control", "national security risk" and other factors

My recent CFIUS post explained the basic legislative scheme and review process of the Foreign Investment in National Security Act ("FINSA"), which gives the President of the United States, acting upon the recommendation of the Committee on Foreign Investment in the United States ("CFIUS"), the power to block or unwind any transaction which could result in foreign control of any person engaged in interstate commerce in the United States if CFIUS and the President deem the transaction to pose a national security risk. This post describes the analysis of foreign control and whether a transaction poses a national security risk.

Due to the broad scope of the foreign control and national security triggers, it is prudent for non-US parties involved in a US acquisition to consider initiating a voluntary CFIUS review process to proactively manage the process.

Who is "foreign"

A foreign person is defined as any foreign national, foreign government, or foreign entity, or any entity over which control is exercised by a foreign national, government or foreign entity. "Foreign entity" is broadly defined to include any branch, partnership, group or subgroup, association, estate, trust, corporation or division of a corporation, or organization organized under the laws of a foreign state if either its principal place of business is outside the US or its equity securities are primarily traded on one or more foreign exchanges, unless it can be shown that a majority of the equity interest in such entity is ultimately owned by US nationals. "Foreign government" is defined as "any government or body exercising governmental functions, other than the United States government or sub-national government of United States". Consequently, the definition includes not only the government itself but also its respective departments, agencies and instrumentalities. CFIUS has become sensitive to commentary and the positions of members of Congress to apply more stringent controls to foreign state owned enterprises (SOE) and sovereign wealth funds (SWF), due to the possibility that the SWF or SOE could use its interest in the US as a basis for political rather than market-based decisions. The statute does not specifically indicate which investors should be scrutinized, but regulatory guidance gives some insight.

What constitutes "control"

CFIUS jurisdiction attaches to a transaction only if it could result in foreign control over the US business --- control is key, but the law provides CFIUS with relatively broad discretion to determine whether an investment involves a change of control. Control can be found even with a minority investment because CFIUS has the power to look at a number of factors that can affect control, not just ownership percentage -- for example, whether the interest is voting or nonvoting, board representation, formal or informal

arrangements to act in concert with other investors, and any other means by which investors can influence key corporate decisions such as:

- sale of assets, or the reorganization of the US business
- closing or moving the business facilities
- major expenditures or investments, or entering or terminating significant contracts
- hiring or firing senior management
- amending the organizational documents of the US business with respect to these types of matters.

A minority shareholder that has veto rights over key corporate decisions could be considered as a controlling investor by CFIUS because such an investor would exert negative control over the US business. CFIUS regulations, however, include a limited safe harbor for certain minority investments, such as transactions that result in "foreign person holding 10% or less of the outstanding voting interest in the US business" if "the transaction is solely for the purposes of passive investment". "Passive investment is a situation in which the investor "does not intend to exercise control, does not possess or develop any purpose other than passive investment, and does not take any action inconsistent with passive investment." CFIUS also excludes certain shareholder protections that are standard in the marketplace from triggering the "control" issue, for example the power to prevent the sale of all or substantially all of the assets, and a voluntary filing for bankruptcy relief.

What is a "national security risk"

Whether the transaction poses a "national security risk" is a function of the perceived threat -- whether the foreign person has the capability or intent to cause harm -- and vulnerability -- whether the nature of the US business or some other weakness in the system creates a susceptibility to harm -- and the consequences of the interaction of those two factors on national security.

CFIUS applies eleven factors[i] prescribed by the Act, and those given most weight in the analysis include whether the transaction concerns US defense production, critical technologies and critical infrastructure, international technological leadership in areas affecting national security, US energy requirements, and the potential control of the US business by foreign government. The identity of the foreign country and its relationship with the US is a factor, for example a foreign country's potential for diverting military technology, and whether it cooperates with US counterterrorism efforts, are relevant.

CFIUS review covers sales of both shares and assets that constitute a US business, and joint ventures to the extent that the US business is contributed as part of the joint venture and the foreign person gains control over the US business as part of that transaction.

CFIUS has a long arm for extraterritorial application. CFIUS will also assert jurisdiction over the acquisition of one foreign company by another foreign company if US assets are involved, but only to the extent that the target has assets considered to be a US business.

Sectors that raise the red flag

CFIUS regulations do not specify the sectors for which filing a notice is expected, but the regulations do give special consideration to sectors that could be considered "critical infrastructure" which is "a system or assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of the particular system or asset of the entity over which control is required pursuant to that covered transaction would have a debilitating impact on national security". These sectors definitely include energy, telecommunications, transportation, information technology, any product or service related to defense or subject to the requirements of the International Traffic in Arms Regulations.

Due to (i) the broad nature of the types of businesses that can fall within the triggering factors for a CFIUS review, (ii) what constitutes "foreign" when analyzing private, governmental and quasi-governmental entities, (iii) how "control" reaches past mere voting control and can include minority interests, and (iv) the trend in recent years for CFIUS to review transactions that have nothing to do with sensitive industries but merely involve businesses that have assets located near military installations or government facilities, non-US parties involved in a US acquisition should consider their transaction in light of the CFIUS review parameters and consider carefully whether to initiate a voluntary review process. The recent US Court of Appeals for the DC Circuit opinion in the Ralls Corporation vs. CFIUS and President Obama,[ii] discussed in my prior post, requires that supplicants are entitled to due process in the review process.

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[i] Pursuant to §2170(b)(1)(D) of the Defense Production Act of 1950 (50 U.S.C. app. §2170(b)(1)(D)), the President or the President's designee may, taking into account the requirements of national security, consider—

(1) domestic production needed for projected national defense requirements,
(2) the capability and capacity of domestic industries to meet national defense requirements, including the availability of human resources, products, technology, materials, and other supplies and services,
(3) the control of domestic industries and commercial activity by foreign citizens as it affects the capability and capacity of the United States to meet the requirements of national security,
(4) the potential effects of the proposed or pending transaction on sales of military goods, equipment, or technology to any country—
(A) identified by the Secretary of State—
(i) under section 6(j) of the Export Administration Act of 1979 [section2405 (j) of this Appendix], as a country that supports terrorism;
(ii) under section 6(l) of the Export Administration Act of 1979 [section2405 (l) of this Appendix], as a country of concern regarding missile proliferation; or
(iii) under section 6(m) of the Export Administration Act of 1979 [section 2405 (m) of this Appendix], as a country of concern regarding the proliferation of chemical and biological weapons;
(B) identified by the Secretary of Defense as posing a potential regional military threat to the interests of the United States; or
(C) listed under section 309(c) of the Nuclear Non-Proliferation Act of 1978 [42 U.S.C. 2139a (c)] on the "Nuclear Non-Proliferation-Special Country List" (15 C.F.R. Part 778, Supplement No. 4) or any successor list;
(5) the potential effects of the proposed or pending transaction on United States international technological leadership in areas affecting United States national security;
(6) the potential national security-related effects on United States critical infrastructure, including major energy assets;
(7) the potential national security-related effects on United States critical technologies;
(8) whether the covered transaction is a foreign government-controlled transaction, as determined under subsection (b)(1)(B);
(9) as appropriate, and particularly with respect to transactions requiring an investigation under subsection (b)(1)(B), a review of the current assessment of—
(A) the adherence of the subject country to nonproliferation control regimes, including treaties and multilateral supply guidelines, which shall draw on, but not be limited to, the annual report on "Adherence to and Compliance with Arms Control, Nonproliferation and Disarmament Agreements and Commitments" required by section 403 of the Arms Control and Disarmament Act [22 U.S.C. 2593a];
(B) the relationship of such country with the United States, specifically on its record on cooperating in counter-terrorism efforts, which shall draw on, but not be limited to, the report of the President to Congress under section 7120 of the Intelligence Reform and Terrorism Prevention Act of 2004; and
(C) the potential for transshipment or diversion of technologies with military applications, including an analysis of national export control laws and regulations;

(10) the long-term projection of United States requirements for sources of energy and other critical resources and material; and
(11) such other factors as the President or the Committee may determine to be appropriate, generally or in connection with a specific review or investigation.

[ii] Ralls Corp. v. Committee on Foreign Investment in the United States, NO. 13-5315, 2014 U.S. App. LEXIS 13389 (D.C. Cir. July 15, 2014).

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