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What Chinese Companies Need to Know about Exon-Florio Review in the Clean Technology and Other Business Sectors

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China's investments in the United States have increased rapidly and will continue to grow in order to acquire market channels, advanced technology and other related assets. The clean technology business sector has become very important to China's economy. Large R&D investments are being made in China on new technology for this sector and in the deployment of proven technology, but U.S. technology and businesses are still important strategic targets. Buyers with cash will have the upper hand in most cases and there is a substantial amount of cash in China.

Solar and wind renewable energy generation products have received the most attention, but China is also progressing rapidly in other markets such as smart grid and energy storage, building integrated photovoltaic (PV), electric vehicles, LED lighting and other energy efficiency products. China has demonstrated low cost manufacturing capability and is quickly increasing its products and services offerings in energy storage, grid management and in the deployment of wind and solar generation projects.

The global consolidation of solar module companies will continue in 2012 because of their weakened financial positions and product commoditization. The trend of acquisitions in the smart grid sector will also continue. There is intense competition and an oversupply of solar module inventory and production capability which creates economic problems in the supply chain all the way back to basic materials and manufacturing equipment. There is a growing list of bankruptcies of both public and private companies in the solar module industry in the U.S. and globally. There is no marketplace demand factor for 2012 such as a Section 1603 cash grant or feed-in-tariff that will solve these problems. While the China domestic demand for modules will increase, it is unlikely to be enough to materially improve financial conditions. These weakened companies will look for investors or buyers and there will be more restructurings, consolidations and bankruptcies.

The U.S. is still a leader in clean technology innovation and is an important market for the deployment of Chinese products. The result of the sector shakeout and weakened financial positions is that there are many potential strategic business or asset targets in the U.S. The types of targets will include assets such as:

- Individual solar projects and solar project pipelines
- Patented and unpatented technologies
- Product distribution channels
- Relationships with utilities, and with engineering, procurement and construction contractors; etc.
- Manufacturing facilities

- Vertically integrated businesses from supply chain to product deployment

Controlling interests in a number of U.S. solar project developers with project pipelines have already been acquired by foreign solar module companies in order to provide capital for projects and to help create demand for the acquirer's modules. Examples are the controlling investment of LDK Solar of China in Solar Power, Inc.; the controlling investment of Walsin Lihwa of Taiwan in Borrego Solar and the controlling investment of Sharp Corporation of Japan in Recurrent Energy. Projects in the pipelines have a higher price than projects sourced today particularly from utilities. Other foreign module companies have acquired or invested in projects as a U.S. market entry strategy to demonstrate the bankability of their modules.

The Exon-Florio review process is a significant planning consideration for transactions in the U.S. as illustrated by the denial of several well-known proposed transactions such as China National Offshore Oil Corporation's (CNOOC) attempted acquisition of Unocal in 2005 and Huawei's proposed acquisition of telecom equipment manufacturer 3Com in 2008 and certain assets of 3Leaf Systems in 2011. On the other hand, the acquisition in June, 2011 of U.S. aircraft manufacturer Cirrus Industries by China Aviation Industry General Aircraft (CAIGA), a Chinese government controlled supplier of civil aircraft, was cleared.

This article provides an overview of the Exon-Florio review process, the timeframe for decision-making and practical guidance for Chinese companies considering transactions in the U.S. While the focus is on the clean technology sector, the guidance is applicable to other business sectors as well.

Legislative Background

Congress enacted the Exon-Florio Amendment as part of the Omnibus Trade and Competitiveness Act of 1988. The law grants the President authority to block or suspend a transaction that would provide a foreign person with control over a U.S. business when there is "credible evidence" that it may "impair the national security."

The Exon-Florio review process was amended in 2007 by the Foreign Investment and National Security Act of 2007 (FINSA), which significantly expanded the scope of transactions to be reviewed and intensified the review process. It imposes new planning concerns on industries previously believed to be unaffected by the Exon-Florio process. FINSA established new requirements for screening, including, among other things:

- A requirement that transactions involving state-owned or controlled foreign entities or critical infrastructure be subject to a mandatory 45-day investigation;
- Mandatory assessment of a transaction's impact on U.S. critical infrastructure, energy assets and critical technologies;
- Emphasis on the use of mitigation agreements between the government and transaction parties to resolve national security concerns.

The Committee on Foreign Investment in the United States (CFIUS), an inter-agency cabinet level committee chaired by the Secretary of the Treasury, conducts the Exon-Florio review. Its statutory members include the Secretaries of the Treasury, Commerce, Energy, Defense, State, Homeland Security, the Attorney General, etc. One agency generally takes the lead on a CFIUS review. The Secretary of Treasury chairs the Committee, but, under FINSA, other agencies may be designated as "lead agencies." For example, the Department of Homeland Security is usually appointed the lead agency on transactions involving telecommunications companies.

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Information submitted to CFIUS is confidential. CFIUS does not issue public reports on its actions. There is little publicly available information about CFIUS review except for what the parties to a transaction voluntarily disclose.

Covered Transaction

In general, any acquisition by a "foreign person" of a United States business that involves a "change of control" and impairs "national security" will be a "covered transaction" that is subject to CFIUS jurisdiction. Thus, there are three threshold questions:

- Does the transaction involve a "foreign person" acquiring a United States business?
- Does the transaction involve a "change of control"?
- Does the transaction impair U.S. "national security" interests?

The first question seems straightforward, but definitions of "foreign" and "United States persons" can be overlapping for CFIUS purposes. The same entity can be "foreign" or "United States" depending on whether it is the target or the acquirer. Any business entity is a U.S. business to the extent of its business activities in the United States. A company listed on a U.S. stock exchange is a U.S. person, which would include a number of the large "Chinese" solar companies, even through incorporated outside the U.S.

A U.S. branch office or subsidiary of a foreign-owned company is deemed a U.S. business, and CFIUS review could be triggered if a different foreign parent seeks to acquire the branch office or subsidiary. At the same time, if the U.S. branch office or subsidiary of a foreign-owned company acquires a U.S. company, it may also be subject to CFIUS review as it is under foreign control. But if a foreign person buys a branch office located entirely outside of the United States of a U.S. company, the branch office business is not deemed to be a U.S. business and the acquisition is not subject to Exon-Florio process.[1]

On the second question, only transactions that involve a change of control are covered transactions but change of control is broadly construed. The Exon-Florio statute and CFIUS regulations specify that an acquisition will be deemed as "solely for investment purposes" if the acquirer will hold 10 percent or less of the outstanding voting securities, does not take any seats on the U.S. corporation's board of directors and the purpose of the transaction is passive investment. Other excluded transactions include:[2]

- Greenfield investments and start-up investments.[3] Establishing a start-up may involve activities such as financing and construction of a new manufacturing facility, and acquiring needed technology. This is not deemed as "acquiring the business of a U.S. person" unless the transaction is, in essence, the acquisition of a U.S. business.
- Formation of a joint venture (JV) by a foreign person and a U.S. person, if it does not involve a change of control of "an existing identifiable U.S. business" from the U.S person to foreign person.[4] For example, if the U.S. person has contributed an identifiable business to the JV and the foreign person is entitled to elect a majority of the Board of Directors of the JV, it is subject to Exon-Florio screening.

[1] 31 C.F.R. 800.301(c) example 2
[2] 31 C.F.R. 800.302(b)
[3] 31 C.F.R. 800.301(c) example 3
[4] 31 C.F.R. 800.301(d)

- Long-term leases involving a U.S. business where the foreign lessee does not make substantially all business decisions, as if it were the owner, for the operation of the leased U.S. business.
- Underwriting, commercial loans, or insurance-related transactions (a) that the foreign person makes in the ordinary course of business; and (b) that do not result in financing or governance rights characteristic of an equity investment, rather than a loan.
- Acquisition of assets, as opposed to a business. [5] The acquisition of products held in inventory, land, or machinery for export from different U.S. businesses is not subject to CFIUS review. However, as evidenced by Huawei's proposed acquisition of enterprise virtualization technology and intellectual property and certain other assets of 3Leaf in 2011, the definition of "business" will be broadly construed. CFIUS will examine an asset transaction to determine if it is, in essence, the acquisition of a U.S. business. The parties in the 3Leaf transaction reportedly concluded that CFIUS review was not required because not all of 3Leaf's assets were being acquired, but CFIUS disagreed.
- Incremental purchases will not be considered covered transactions when the non-U.S. person is acquiring an additional interest in a U.S. business if the foreign acquiring party had previously obtained CFIUS clearance for its prior controlling investment.

The third question is very open-ended. While the term "national security" is not defined, FINSA explicitly interpreted it to include issues related to critical infrastructure and critical technology. In addition to the traditional concerns about defense technologies, experience since enactment of FINSA suggests that transactions involving major energy production assets, telecommunications infrastructure, and cutting-edge information technologies are more likely than others to be denied. As demonstrated by the Huawei situation, the extent of a proposed acquirer's relationship with the Chinese military and its record of dealing with the targets of U.S. embargos will be considered. CFIUS's decision is based on a multifactor balancing test, rather than a bright-line rule. It is susceptible to changing political and public policy concerns.

No single solar project in any of the project pipelines mentioned above is large enough to materially impact the U.S. electricity grid infrastructure as a national security matter. As projects scale, however, a single project or the cumulative effect of multiple projects could have such an impact. On the other hand, any current Chinese involvement in the operations of the U.S. grid (as in the Philippines) or the acquisition of a business with critical smart grid technology would clearly raise CFIUS issues.

Review Timeline

The CFIUS review process has four steps:

1. A voluntary filing,
2. A 30-day preliminary review of the transaction,
3. A potential additional 45-day full investigation, and
4. A potential 15-day period during which the President decides to clear, suspend or deny the transaction.

[5] 31 C.F.R. 800.302(c)

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Step One: Voluntary Filing

Formal review of a transaction is normally triggered by the filing of a notice with CFIUS by both parties to the transaction. The CFIUS notification process is voluntary, unlike the Hart-Scott-Rodino Act antitrust review. CFIUS, however, has the authority to review a transaction even when the parties have not filed a voluntary notice if (a) it believes that a transaction may raise national security considerations; or (b) a member of CFIUS has reason to believe a transaction is a covered transaction and may raise national security considerations.

A voluntary notice that results in CFIUS clearance, either after the 30-day preliminary review, or the 45-day full investigation or by presidential decision after the 45-day investigation, provides the transaction a safe harbor from post-closing review and challenge unless a party submitted false or misleading material information or omitted material information in its communications with CFIUS.

In contrast, if there is no formal clearance, there is continuing uncertainty that the President might intervene and unwind the deal after closing. For example, in Huawei's proposed acquisition of 3Leaf assets, neither Huawei nor 3Leaf had notified CFIUS. Huawei argued that it believed the $2M purchase of enterprise virtualization technology and intellectual property used in cloud computing and certain other assets did not require a review. Reports are the Pentagon raised Exon-Florio concerns after the close of the deal in May 2010, and the parties retroactively filed notice with CFIUS. In mid-February 2011, CFIUS apparently determined that the asset acquisition, in essence, was the acquisition of a U.S. business and reportedly informed Huawei that it would have to divest the assets or CFIUS would recommend to the President that the acquisition be unwound. In late February, Huawei announced that it would not await the President's determination and abandoned the deal.

Such a post-closing request is a clear reminder that a CFIUS filing should occur before the deal is closed if there is any possibility that it could raise national security concerns, as CFIUS has the authority to challenge a transaction after its completion. By filing the notice, parties can seek formal clearance of a transaction and obtain certainty that the transaction is final. This means that parties need to file even more often than before.

Among other things, an Exon-Florio notice must include the following[6]:

- The basic information about the transaction, including the timelines and assets or businesses to be acquired and plans the acquiring party has for the target;
- Sensitive technologies or information that the target possesses and U.S. government contracts to which the target is a party;
- Detailed information about the ownership structure of the acquiring party, especially with respect to any ownership by a foreign government;
- Biographical information concerning key management and other personnel so U.S. security officials can conduct background checks of the foreign individuals involved in the transaction.

In practice, parties are generally encouraged by CFIUS to engage in consultations and negotiations before filing the formal notice. While these discussions are not part of the formal review process, they can help CFIUS understand the transaction and provide it an opportunity to request additional information to be included in the actual notice. It is not uncommon for parties to modify their transaction (with CFIUS approval) after this informal pre-file consultation to expedite clearance. In

[6] 31 C.F.R. 800.402 (c)

some cases, parties have abandoned transactions after it became clear from informal discussions that they were unlikely to be approved.

Step Two: 30-day Preliminary Review of the Transaction

The 30-day preliminary review period commences once CFIUS gives notice that the filing contains all of the required information. Within 30 days, CFIUS should review the notice and make a determination. During the 30 days, the parties may be invited, or they may request, to meet with CFIUS staff to discuss the transaction. Most transactions are concluded within the preliminary 30-day period.

In making the determination, CFIUS has three options:

- If it determines the transaction is not a covered transaction, or if it is a covered transaction but does not threaten to impair the national security of the U.S., CFIUS can issue a letter concluding the review.
- If it determines the transaction is a covered transaction and does have national security risk, but the risk can be adequately mitigated, CFIUS and the lead agency can enter into a mitigation agreement with the parties and modify the transaction.
- It is required to launch a 45-day full investigation if it determines that:
    1. The acquirer is controlled by or acting on behalf of a foreign government; or
    2. The proposed transaction threatens to impair U.S. national security and has not been mitigated before or during the 30-day review process; or
    3. The lead agency recommends an investigation and CFIUS concurs that an investigation be undertaken; or
    4. The transaction would result in foreign government control of a U.S. business or critical infrastructure, and could impair U.S. national security.

If CFIUS is unable to conclude its preliminary review after 30 days, or if the parties have not agreed to mitigation conditions requested by agencies, parties can withdraw and re-file their application with CFIUS approval to give CFIUS more time to complete its review.

Step Three: Potential 45-day Full Review of the Transaction

Historically, the overwhelming majority of acquisitions have been approved by CFIUS after the 30-day preliminary review. In the case of Chinese companies, however, a full review of a transaction is more likely to occur because of so many Chinese companies being state owned enterprises (SOE) or controlled by SOEs. Even though it is rare for CFIUS to launch the 45-day full review, it is not uncommon for parties to avoid this extended review by modifying their transaction. CFIUS may condition clearance at the end of the 30-day period on mitigation steps. In 2001, for example, CFIUS required a Dutch firm to agree to divest itself of the target U.S. company's optics and semiconductor business as a condition for clearing its proposed acquisition.

If CFIUS proceeds with a full investigation, it must conclude it within 45 days and make either of the two available determinations. If it determines that the threat posed to the national security interest can be mitigated to its satisfaction, CFIUS can advise the parties that the review ends. Otherwise, CFIUS will submit a recommendation for the transaction to the President for a decision. In cases where

members of CFIUS cannot agree on their recommendation, CFIUS will also submit the matter to the President.

Step Four: 15-day Presidential Review Period

The President has 15 days to clear, block or impose conditions on the transaction after CFIUS submits its recommendation.

Sample Mitigation Arrangements

It is common for parties to clear the transaction during the preliminary 30-day review or 45-day investigation by agreeing with CFIUS to take mitigation steps. Here are some sample mitigation measures:

- Restriction on the access by non-U.S. citizens to critical infrastructure and classified information.
- Requirement that a subsidiary with sensitive technology or classified contracts have a separate and independent board of directors composed of U.S. citizens.
- Requirement that several approved outside directors be appointed along with inside/foreign directors, and to establish procedures to regulate communications and visits between the target and the investor.

Some transactions pose national security concerns that cannot be mitigated successfully. Those transactions usually are abandoned before the completion of the CFIUS process.

U.S. Export Controls

There are U.S. export control laws that restrict the disclosure and transfer of sensitive technology and technical information to other countries even when no acquisition is involved. For example, a non-exclusive license of thin-film solar technology to a Chinese company may require some type of export license. These laws need to be reviewed to determine compliance obligations prior to beginning due diligence on an investment or M&A transaction since access to technology and technical information may be deemed an export requiring U.S. government approval. The export controls on energy-related technology and technical information are not as restrictive as in certain other sectors.

The Bureau of Industry and Security (BIS) of the U.S. Department of Commerce regulates the export and re-export of "dual use" items and technologies in accordance with the Export Administration Regulations (EAR). The export of controlled items can require some type of export license from BIS. The U.S. business being acquired must provide information and a commodity classification in a CFIUS notice of any items that it exports under a BIS license. In addition, through the International Traffic in Arms Regulation (ITAR), the Department of State's Directorate of Defense Trade Control (DDTC) restricts the exports of military items, services and technology listed on the U.S. Munitions List (USML). CFIUS requires disclosure of ITAR-controlled articles and services in the CFIUS filing and carefully reviews foreign acquisitions of U.S. entities that are registered with DDTC or that export items listed on the USML.

Conclusion

As illustrated by the Huawei-3Leaf transaction in February 2011, Chinese companies should be prepared for intense scrutiny, particularly if the acquirer is government controlled. Even a relatively small transaction may trigger CFIUS concerns. But Chinese investment will not always be denied. In

addition to Lenovo's purchase of IBM's PC business, there have been several recent high-profile investments by Chinese companies in U.S. targets that received CFIUS clearance, such as the CAIGA acquisition of aircraft manufacturer Cirrus; Zhengjiang Geely Holding Group's purchase of Ford Motor's Volvo unit, CNOOC's purchase of 33 1/3% interests in two of Chesapeake Energy Corporation's oil and natural gas projects and China Chemical Petroleum & Chemicals' purchase of a 33 1/3 % interest in five of Devon Energy's oil and gas projects.

For Chinese companies, the key to clearing the Exon-Florio review is to understand the national security concerns of CFIUS, to plan ahead on how to prove not just to CFIUS but also in the political context in which CFIUS operates that those concerns are not threatened, and, when a threat may be perceived, to determine and explain clearly if there are practical mitigation steps to restructure the transaction while still accomplishing the business goals. In the case of technology, a non-exclusive technology license, with or without a non-controlling, minority interest investment, may accomplish the business purpose if an acquisition is not feasible, subject to any required compliance with export controls. In other cases, structuring the transaction as buying assets may achieve the same business result, again subject to export control compliance.

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