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M&A in the United States: What Chinese Cleantech Companies Need to Know about CFIUS Review in 2013

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China's investments in the U.S. have increased rapidly and will continue to grow in order to acquire advanced technology, real estate, market channels and other assets. With solar module oversupply continuing through 2013 and the balance sheets of many solar module, energy storage and other cleantech companies under severe stress, more industry consolidation is occurring. With Chinese companies making large R&D investments in new clean technology, as well as in the deployment of proven technology, U.S. technology and businesses are strategic targets. In most cases, those proposed investments by Chinese companies are subject to national security review by the Committee on Foreign Investment in the United States (CFIUS), which has shown a willingness to question a number of China-related M&A transactions and to require a range of national security protections in some deals..

The recent annual report from CFIUS provides insight into the committee's national security review (Exon-Florio review) considerations and the potential challenges foreign companies may face when considering M&A transactions and other investments in the U.S. 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. in 2013. While many of the examples are from the clean technology sector because of the large number of distressed companies and assets looking for buyers, the guidance is applicable to other sectors as well.

The 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." To help the president make that determination, he relies on CFIUS, an inter-agency cabinet level committee chaired by the Secretary of the Treasury, to conduct the Exon-Florio review.

CFIUS' statutory members include the Secretaries of the Treasury, Commerce, Energy, Defense, State, Homeland Security, and the Attorney General. One agency generally takes the lead on a CFIUS review. The Secretary of Treasury chairs the Committee, but other agencies may be designated as "lead agencies." Information submitted to CFIUS is confidential and CFIUS does not issue public reports on its individual actions and determinations. There is little publicly available information about CFIUS review except for what the parties to a transaction voluntarily disclose.

The Exon-Florio review process was amended in 2007 by the Foreign Investment and National Security Act of 2007 (FINSAs), 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. FINSAs established new requirements for screening, including, among other things:

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- 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.

Covered Transactions

In general, any acquisition by a "foreign person" of a U.S. 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 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 review.¹

On the second question, only transactions that involve a change of control are covered transactions but change of control is broadly construed. The CFIUS regulations specify that an acquisition will be deemed "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 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.

As recent example of this is President Obama's denial of Ralls' acquisition of four wind farm project companies in Oregon on September 28, 2012. Ralls is a Delaware corporation owned by executives of China's Sany Group Co., one of China's largest construction equipment manufacturers. Sany/Ralls filed a lawsuit against the President and CFIUS, with a number of

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.

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claims, including that CFIUS and the President unconstitutionally deprived Ralls of its property without due process and “by unfairly and unjustly singling out Ralls for differential treatment compared to similarly situated parties, CFIUS and the President have violated Ralls’s right to equal protection of the law”.⁴

In the Sany/Ralls case, if the project companies were formed as greenfield projects on the leased land, CFIUS might not have had jurisdiction over the transaction. However, greenfield investments are still subject to other U.S. laws and regulations, including export controls.

- **Joint Ventures.** 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 is excluded.⁵ 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 review.
- **Underwriting, Commercial Loans, or Insurance-Related Transactions.** Other exclusions include underwriting, commercial lending 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.**⁶ The acquisition of products held in inventory, land, or machinery for export from different U.S. businesses is not subject to CFIUS review. The definition of “business” will be broadly construed, however, as evidenced by Huawei’s proposed acquisition of enterprise virtualization technology and intellectual property and certain other assets of 3Leaf in 2011. 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.
- **Technology Licensing.** In the case of technology, a non-exclusive technology license, with or without a non-controlling, minority interest investment, which may accomplish the business purpose if an acquisition is not feasible, subject to any required compliance with export controls is also excluded.
- **Incremental Purchases.** 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 and subject to the changing political climate. While “national security” is not defined, FINSAs 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 FINSAs suggests that transactions involving major energy production assets, telecommunications infrastructure, and cutting-edge information technologies receive high levels of scrutiny. CFIUS is not only attentive to directly relevant factors such as the industry of the transaction, but also the ownership background.

⁴ Ralls Corporation’s Complaint against the President and CFIUS: available at <http://online.wsj.com/public/resources/documents/RallsFiledAmendedComplaint.pdf>.

⁵ 31 C.F.R. 800.301(d).

⁶ 31 C.F.R. 800.302(c).

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Even geographical proximity to sensitive facilities may trigger CFIUS concerns. In 2009, Northwest Non-ferrous International Investment Company, a subsidiary of China's largest aluminum producer, Aluminum Corp of China Co., abandoned its proposed \$26.5 million acquisition of 51% ownership of Firstgold, a Nevada-based mining company, after complaints that the four ore fields were located too close to the Fallon Naval Air Station and other sensitive security and military facilities. Another example is the denial of Sany/Ralls's wind farm projects. CFIUS determined that one of the construction sites was in restricted airspace used by the U.S. Navy while the other three sites were within 5 miles of it.

CFIUS' decisions are based on a multifactor balancing test, rather than a bright-line rule. It is susceptible to changing political and public policy concerns and is more stringent towards acquirers from countries that historically are at odds with U.S. national security interests, such as China. In the Sany/Ralls's complaint, it argued that "numerous other wind farms using foreign-made turbines and with foreign ownership are located in or near the Navy's restricted airspace. At least seven foreign-made turbines are located within the restricted airspace, like one of Ralls' planned wind farms. At least thirty foreign-made turbines are located near the restricted airspace, the same distance from the restricted airspace (if not closer) than Ralls' three other planned wind farms.... The federal government has not imposed on these similarly situated turbines or wind farms, or their owners or developers—including foreign-made turbines and foreign owners or developers—any prohibitions or restrictions similar to those imposed on Ralls....."⁷

Acquisitions in sensitive security-related sectors have been cleared in the past. The June 2011 acquisition of U.S. aircraft manufacturer Cirrus Industries by China Aviation Industry General Aircraft (CAIGA), a Chinese government controlled supplier of civil aircraft, was cleared. In addition to Lenovo's purchase of IBM's PC business, there have been several high-profile U.S. investments by Chinese companies that received CFIUS clearance such as Zhengjiang Geely Holding Group's purchase of Ford Motor's Volvo unit. In the cleantech industry, other Chinese companies' wind farm projects have been completed such as Goldwind's 109.5MW wind farm in Shady Oaks, Illinois in 2011, and even a 10MW wind farm in Texas for Sany/Ralls.

CFIUS, however, has shown caution about some China-related transactions, as illustrated by the denial of the Sany/Ralls wind farm projects. This indicates that Chinese companies must plan their U.S. M&A strategies very carefully, paying particular attention to the potential political context of each proposed acquisition and carefully anticipating and framing mitigation arrangements.

Special Considerations When Acquiring Real Estate

Even though no single solar or wind project in any of the project pipelines is likely to be large enough to materially impact the U.S. electricity grid infrastructure as a national security matter, multiple projects owned by one company could be perceived to have such an impact. Further, any current Chinese involvement in the operations of the U.S. grid or the acquisition of a business with critical smart grid technology would raise CFIUS issues.

Even though a large number of Chinese investments in real estate have been completed without Exon-Florio challenge, FINSAs has provided guidance on how transactions could be subject to such review:

- If the assets to be acquired consist in whole or part of "critical infrastructure" or house the manufacture or storage of "critical technologies," they can be subject to CFIUS.

⁷ Ralls Corporation's Complaint against the President and CFIUS, see supra note 1.

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- Unimproved land, if acquired solely with no other assets, assuming there is no other “relevant facts” such as proximity of the property to critical infrastructure, is excluded from characterization as a “covered transaction,” because such land alone is not a “U.S. business.”⁸
- An acquisition of a currently unused building, such as an empty warehouse, not including customer lists, intellectual property, or other proprietary information or transfer of personnel, assuming there are no other “relevant facts”, is not a covered transaction. If personnel, customer lists and inventory management software to operate the facility are also purchased, however, the transaction can be covered under CFIUS.⁹
- Long-term land leases are likely to be treated as an investment in real estate and subject to review if the foreign lessee makes substantially all business decisions for the operation of the land.¹⁰

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, condition, or deny the transaction.

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 \$2 million 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 filed post-closing 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

⁸ 31 C.F.R. 800.302(C) example 1.

⁹ 31 C.F.R. 800.301(c) example 6 and 7.

¹⁰ 31 C.F.R. 800.224 (f).

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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.

Another example is the Sany/Ralls wind farm projects. Sany/Ralls did not notify CFIUS when it acquired the four project companies but CFIUS learned of the transaction and requested that Ralls submit formal notification. Ralls filed in June 2012 and the purchase was denied for the reasons stated above.

The post-closing requests are a clear reminder that parties should consider making a CFIUS filing before the transaction 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.

Among other things, an Exon-Florio notice must include the following:¹¹

- 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; and
- 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 after this informal pre-file consultation to expedite clearance. In 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 reviews are concluded within the preliminary 30-day period.

In making that 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.

¹¹ 31 C.F.R. 800.402 (c).

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- 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 also 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 investigation of a transaction is more likely to occur in the case of Chinese 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, condition, or impose conditions on the transaction after CFIUS submits its recommendation.

Mitigation Arrangements

Parties sometimes are able to clear the transaction during the preliminary 30-day review or 45-day investigation by agreeing with CFIUS to take mitigation steps in binding agreements. Here are some sample mitigation measures:

- Restriction on the access by non-U.S. citizens to critical infrastructure and classified or export controlled information.
- Requirement that a subsidiary with sensitive technology or classified contracts have a separate and independent board of directors composed of U.S. citizens.

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- 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. Proximity issues are among the most difficult to mitigate, as illustrated by the Ralls case.

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 encryption technology to a Chinese company may require an 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 foreign 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 CFIUS with information and a commodity classification about relevant EAR controlled items that it exports. In addition, through the International Traffic in Arms Regulations (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 and carefully reviews foreign acquisitions of U.S. entities that are registered with DDTC or that export items listed on the USML.

National Security and Jobs Impact

Job retention or losses are not part of CFIUS’s consideration, as its mission is limited to screening national security risks. U.S. job impact should be considered, however, as part of an acquisition strategy. Public support over job impact could influence CFIUS’s decision. When, for example, Borse Dubai merged with NASDAQ in 2009, New York Mayor Michael Bloomberg voiced his support of this transaction, emphasizing its benefits in terms of job creation and U.S. competitiveness. CFIUS approved the merger without requesting any divestiture. The collapse of the negotiations of Superior Aviation Beijing’s acquisition of Hawker Beechcraft, in part because of Exon-Florio review concerns, has put thousands of U.S. jobs at risk.¹²

Chinese companies would be wise to inform CFIUS, potential critics, and the American public when a proposed transaction will have a positive U.S. job impact. According to the Woodrow Wilson International Center for Scholars, a D.C.-based think tank, China’s investment in the clean energy section has directly created approximately 6,000 U.S. jobs.¹³ Furthermore, most jobs created by clean

¹² On October 18, 2012, multiple sources reported that the negotiations had collapsed for reasons including national security concerns as “the company’s defense operations were integrated with its civilian businesses that proved difficult to untangle,” and legal complications, as “advisers in the U.S. had trouble negotiating with Chinese representatives unfamiliar with U.S. finance and bankruptcy law.” See Mike Spector: Hawker Sales Talks Collapse Over Review Worries, Wall Street Journal, October 18, 2012.

¹³ Chinese Investment in Clean Energy, available at <http://www.wilsoncenter.org/article/chinese-investment-clean-energy>

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energy investment are downstream – meaning they are in the installation and maintenance of solar panels and wind turbines, rather than in the manufacturing process which China dominates. For example, a study conducted by Duke Energy estimated that 73% of employment created is in the country of power generation, mitigating or eliminating the perception of outsourcing U.S. jobs.¹⁴ Chinese investors have been responding to increasing concerns over job outsourcing by doing more local hires and local purchases. Xinjiang Goldwind's 109.5MW Shady Oaks project in Illinois, for example, would use 60% locally manufactured materials even when importing the wind turbines from China.

Conclusion

As illustrated by the Huawei-3Leaf transaction and Sany/Ralls's wind farm construction plan, Chinese companies should be prepared for intense scrutiny, particularly if the acquirer is government controlled. Even a relatively small transaction may trigger CFIUS concerns. Chinese companies need to understand the political context in which CFIUS operates and to prove that national security 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. A positive U.S. job impact may also help. Chinese companies should try to anticipate CFIUS concerns early, address potential political criticisms from the beginning, and engage CFIUS in a cooperative and constructive dialogue to find a solution to any security concerns by restructuring acquisitions or proposing a mitigation agreement.

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¹⁴ Duke Energy: U.S.-China Energy Partnership Can Create Jobs In Both Countries, available at <http://news.duke-energy.com/2010/10/06/u-s-china-energy-partnership/>.

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