

INCREASING US REGULATORY SCRUTINY OVER M&A DEALS BETWEEN NON-AMERICAN COMPANIES

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Legal Briefings - By **Joseph G. Falcone**

SUMMARY

- The Committee on Foreign Investment in the United States (**CFIUS**) may review M&A deals in which non-US parties look to acquire non-US companies, particularly where those transactions involve the indirect sale of US subsidiaries.
- The key considerations in determining whether CFIUS approval may be required concern whether the transaction will result in 'control' of a US business by a non-US entity and whether the transaction raises national security concerns.
- It is likely that an investment will have US national security implications where the US business is involved in the provision of critical infrastructure or technologies.
- If CFIUS approval is not forthcoming, parties may be forced to abandon the proposed deal, as occurred in the recent Philips/GO Scale transaction.
- Australian companies considering participating in cross-border transactions, even where both parties are non-US entities, should consider whether CFIUS approval may be required and adopt a proactive approach to potential CFIUS issues.

Recent developments concerning the Committee on Foreign Investment in the United States (**CFIUS**), a body tasked with reviewing transactions that could result in control of a US business by a foreign person, highlight the US government's increasing scrutiny of deals in which non-US parties look to acquire non-US based businesses, particularly where such transactions include the sale of US subsidiaries with significant technology portfolios.

Although it did not involve an Australian party, the recent abandonment by Royal Philips N.V. (**Philips**) of its plan to sell one of its business units to Chinese investor GO Scale Capital (**GO Scale**) highlights the wide reach of CFIUS review to the acquisition of non-US based businesses and the potential implications for Australian companies.

THE PROPOSED ROYAL PHILIPS DEAL

In March 2015, Philips, a Dutch multi-national with a focus in healthcare, electronics, and lighting, announced an agreement with GO Scale, an investment fund led by China-based venture capital firm GSR Ventures, in which GO Scale would acquire an 80.1% interest in Phillips' light-emitting diode (**LED**) components and lighting business unit, Lumileds, in a deal then valued at US\$2.8b. Lumileds is a supplier of lighting components to, among other sectors, the automotive and consumer electronics markets, with operations and offices in various countries, including the United States. As part of the transaction, GO Scale would acquire a 34% interest in Lumileds' US operations, which included various US technology patents and Lumileds' California-based product development and LED manufacturing facilities. In announcing the transaction, Philips noted that it was subject to certain closing conditions, including 'customary regulatory approvals'.

US GOVERNMENT REVIEW OF 'FOREIGN INVESTMENT'

One of the required approvals was from CFIUS, an arm of the US government that reviews certain corporate transactions to determine if the acquisition constitutes a threat to US "national security" (a term that CFIUS regulations leave largely, and intentionally, undefined). Nevertheless, it is likely that an investment will have US national security implications where the US entity is involved in the provision of critical infrastructure or technologies (e.g. major energy assets, communications or IT services, transportation, mining, manufacturing, chemicals, ports, food and agriculture etc.).

CFIUS itself is comprised of various US departments and agencies charged with national security, foreign policy and economic responsibilities, including the Departments of Defense, Homeland Security, State, Energy and Commerce, among others. While CFIUS review was traditionally seen in the defense and aerospace industries, its jurisdiction is broad, and in recent years CFIUS review has also focused on acquisitions in the manufacturing sector, including computers and electronics, along with the finance, information (including telecommunications), mining, utilities, and retail sectors. CFIUS has paid particular attention to transactions in the computer and data arenas, given the recent and well-publicised cybersecurity threats and intrusions by private as well as alleged state actors.

THE APPLICABLE THRESHOLD TEST

The threshold for determining whether an acquisition is a 'covered transaction' subject to CFIUS jurisdiction is whether the deal could result in 'control' of a US business by a 'foreign person' (meaning any non-US national, government or entity, or any entity controlled by such non-US persons). Not surprisingly, control can arise from majority or dominant minority share ownership. That said, CFIUS regulations do not define control in terms of a specified percentage of shares or number of board seats held (though these factors are usually relevant). Rather, CFIUS assesses control in functional terms, and a deal structure that enables a non-US person to determine, direct or decide important matters of the US business will constitute control for CFIUS purposes.

Notably, a non-US person will not be deemed to control a US entity if it holds ten percent or less of the voting interest in that entity, and holds it solely as a passive investment (meaning having no operational management role or other indicia of control). The regulations, however, do not provide an automatic exemption from CFIUS jurisdiction simply because an investment is at or under ten percent, and a non-US person with such minimal holdings can still have control if, as one example, it is still able to negotiate the right to appoint a board member of the acquired entity.

NATURE OF THE CFIUS REVIEW PROCESS

Review by CFIUS arises in two ways. The parties to the transaction (which can take various forms, including an acquisition, merger, consolidation, or joint venture) may undertake a voluntary submission to CFIUS, generally before closing, and provide the substantial information that CFIUS regulations require (e.g., information regarding the scope, purpose and value of the transaction, the identity of the parties and their significant shareholders, etc.). The submission is 'voluntary' in that failing to make a submission to CFIUS does not violate US law. That said, CFIUS is authorised to initiate its own review of acquisitions of US businesses, and can do so even after closing.

While the contours of the national security review are transaction-specific, CFIUS generally will examine various factors, including whether the US business being acquired has classified or sensitive information, deals in technology or information subject to export controls or else is part of critical technologies or infrastructure, has contracts with US agencies, or owns real estate proximate to sensitive US government facilities. Most CFIUS reviews are concluded, and cleared, at the end of the initial (30 day) review period. Such clearance provides a 'safe harbour' protection that generally insulates the deal from subsequent review. If the transaction still presents national security concerns, CFIUS will withhold clearance and initiate a 45 day investigation. The investigation is mandatory for transactions involving critical infrastructure, including major energy transactions, as well as for acquisitions that will result in control by a non-US government (unless waived).

CFIUS can then approve the transaction outright, or else require the parties to adopt so-called 'mitigation' measures that may reduce non-US ownership, control, or influence over potentially sensitive technologies (a common example is conditioning approval upon the pre-closing disposal of US assets). However, should the investigation or mitigation efforts still not resolve CFIUS's security concerns, CFIUS will recommend to the US President that the acquisition be blocked or that a consummated transaction be unwound. Presidential action, however, is quite rare, since in most cases, including the Philips-GO Scale deal, the parties will withdraw from transactions that do not receive CFIUS approval.

CFIUS AND THE PHILIPS DEAL

Although the fact of CFIUS review is generally public (indeed, deal parties frequently advise the markets of CFIUS and related regulatory reviews in statements regarding pending transactions), review of a particular transaction is confidential.

In separate statements, both Philips and GO Scale advised that despite their 'extensive' and 'persistent' efforts to secure clearance and mitigate issues raised by CFIUS, ultimately CFIUS refused to approve the transaction due to 'unexplained' national security concerns. Presumably, the parties could not overcome CFIUS concerns that currently surround Chinese acquisitions of US companies in the technology sector, given the perception by some in the US government that the transfer of such technologies to Chinese entities may result in US security vulnerabilities, and that US intellectual property will be used to shortcut the development of China's own expanding tech industry. Moreover, while Lumileds' provision of LED components for cars and consumer electronics wouldn't seem to implicate US national security, CFIUS may have focused on the fact that certain semiconductor technology used in LED production can also have military applications.

Finally, although investment by private Chinese investors has surpassed investment by state-owned entities, CFIUS may still give stricter scrutiny to deals involving private Chinese investors based on a lingering perception that such investors are subject to significant state influence.

COMMENTARY - THE AFTERMATH AND ITS IMPACT ON CFIUS BEST PRACTICES

After it cancelled its planned sale to GO Scale, Philips noted that other parties had shown interest in a Lumileds acquisition, though the value realisation in any new deal could be lower than what the company expected via the original transaction. Beyond Philips' immediate business concerns, however, the case broadly emphasises that dealmakers need to be mindful of the potential for CFIUS scrutiny in any acquisition that would transfer control of US assets to a non-US entity, even where such acquisitions seemingly have little nexus to US national security. This is the case even where the deal parties are not US companies or where the US business is already owned by a non-US entity.

The increasing scrutiny of such acquisitions, however, does not mean that CFIUS approval cannot be secured. Indeed, the majority of transactions reviewed by CFIUS are cleared, including those involving Chinese investors, who have secured CFIUS approval of several high-profile acquisitions in recent years. Thus, deal parties should consider, as early as practical, whether the transaction reasonably implicates US national security concerns as currently interpreted by CFIUS, and, if so, whether those concerns can be addressed, perhaps through a restructuring of the deal terms or otherwise. Parties may also need to be flexible regarding deal terms should CFIUS require mitigation as a condition for approval. Ultimately, parties should take a proactive approach to CFIUS issues, and where appropriate engage with CFIUS early on to maximise the chances for approval of their cross-border transactions.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



JOSEPH FALCONE
PARTNER, NEW YORK

+1 917 542 7805
Joseph.Falcone@hsf.com

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