Paul|Weiss

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CFIUS under FIRRMA – Some Key Takeaways for Private Equity Firms

On February 13, 2020, final regulations implementing the Foreign Investment Risk Review Modernization Act of 2018 ("FIRRMA") went into effect. FIRRMA (and these new regulations) significantly expand the jurisdiction of the interagency Committee on Foreign Investment in the U.S. ("CFIUS") — and the related ability of the U.S. President to block or unwind a transaction. While the CFIUS landscape will continue to shift as U.S. government policy evolves and implementation of FIRRMA continues, Richard Elliott, our International Trade Counsel, discusses below some of the important takeaways for private equity firms, including changes in CFIUS filing risks and in the risks associated with non-U.S. limited partner investments and governance rights. Keep in mind that CFIUS regulations are highly technical in nature, so CFIUS risk analysis should be conducted in the context of a specific fund structure or a specific transaction, and with appropriate counsel. We also note that the effects of COVID-19 on CFIUS and other merger review procedures are fluid, and we do not address those topics in this article, but urge you to contact your advisers for additional considerations in that regard.

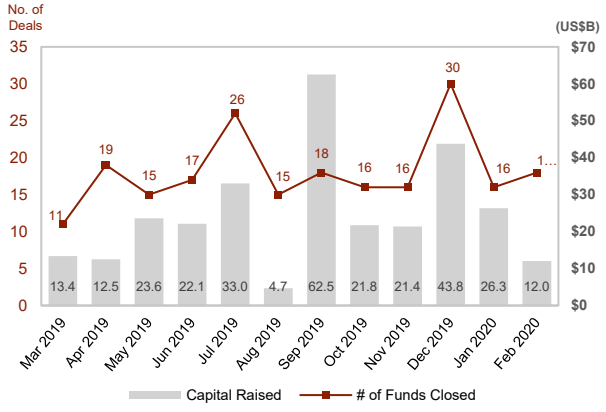
Overview

Before FIRRMA, CFIUS' jurisdiction was limited to acquisitions, investments and joint ventures that could result in foreign control over any U.S. business, direct or indirect (referred to as "covered control transactions"). Subject to implementing regulations, FIRRMA expanded the range of transactions subject to CFIUS jurisdiction to include certain non-controlling, non-passive investments by foreign persons in U.S. businesses that involve critical technology, critical infrastructure or the maintenance or collection of sensitive personal data of U.S. citizens (referred to as "TID U.S. businesses," and such investments referred to as "covered investments").

To implement FIRRMA, CFIUS first issued pilot program regulations, which went into effect on November 10, 2018. Under the pilot program, CFIUS chose to use its new authority under FIRRMA, on a trial basis, (i) to exercise jurisdiction over certain covered investments in U.S. businesses that involve critical technology, but only in certain industry sectors, and (ii) to introduce a mandatory filing requirement for covered control transactions and covered investments related to U.S. businesses that involve critical technology in certain industry sectors.

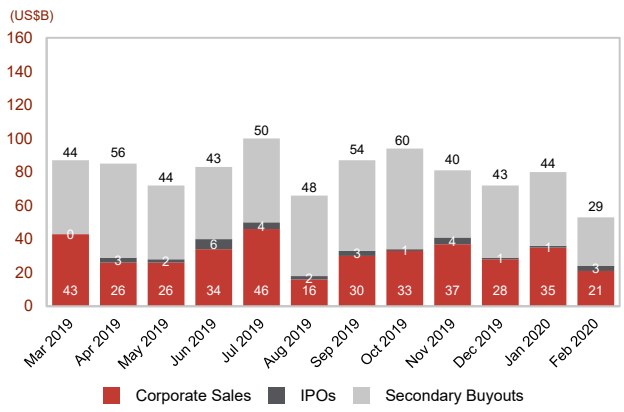
More recently, on September 17, 2019, the Treasury Department released two sets of proposed regulations to implement FIRRMA, with a public comment period that ended on October 17, 2019. On January 13, 2020, the Treasury Department released final regulations to implement FIRRMA, and these regulations went into effect on February 13, 2020. The new regulations expand existing CFIUS regulations – which used to address covered control transactions only – to add covered investments (as revised, the "new investment regulations"). With minor technical changes, the new investment regulations incorporate the pilot program regulations, including

U.S. Private Equity Fundraising



Source: Pitchbook

U.S. Sponsor-Backed Exits by Number



Source: Pitchbook

transactions and covered investments related to U.S. businesses that involve critical technology in certain industry sectors. The new investment regulations also implement the requirement in FIRRMA that a mandatory filing be made for covered control transactions and covered investments that result in the acquisition of a substantial interest in a TID U.S. business by a foreign person in which a foreign government has a substantial interest.

The new regulations also implement FIRRMA's expansion of CFIUS' jurisdiction to cover the purchase or lease by a foreign person of real estate located either (i) at an airport or maritime port or (ii) in close proximity to a U.S. military base or other U.S. government facility that is sensitive from a national security perspective. Before FIRRMA, CFIUS could only review an acquisition of real estate if it was part of a transaction that could result in control by a foreign person of a U.S. business. Rather than add this new authority to existing regulations, CFIUS chose to release a separate set of new regulations focused just on real estate transactions (the "new real estate regulations").[1]

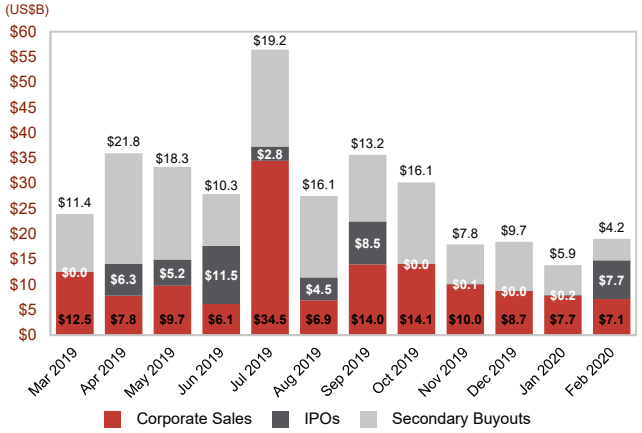
Although the new regulations implement almost all elements of FIRRMA, they do not implement the provisions in FIRRMA that allow CFIUS to impose fees for filing notices with CFIUS. Instead, on March 4, 2020, the Treasury Department released proposed regulations to impose fees for filing notices with CFIUS, with public comments requested through April 8, 2020.

Mandatory Filing Requirements Have Fundamentally Changed the Risks for Private Equity Firms

Before FIRRMA, no CFIUS filings were mandatory. As a consequence, U.S. private equity firms with offshore fund structures could take the position that they would not file with CFIUS because the U.S. control over their offshore funds, together with their principal place of business being in the U.S., made those funds U.S. persons for CFIUS purposes. While foreign private equity firms could not take the same position, they could still choose not to file, based on an assessment of their profile and that of their U.S. target.

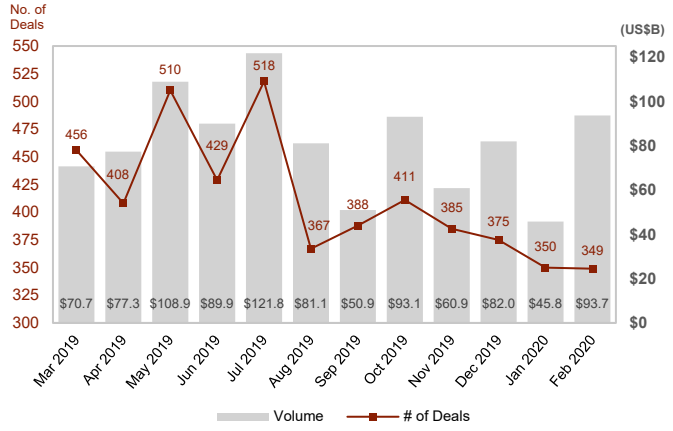
With the introduction of mandatory filing requirements, this landscape has shifted dramatically, particularly given a potential fine for failing to file up to the greater of $250,000 or the value of the transaction. Under the new investment regulations, a mandatory filing requirement is triggered by any transaction whereby a foreign person acquires control over, or makes a covered investment in, a U.S. business that is using critical technology (generally export-controlled items) in certain industry sectors.[2] In addition, under the new investment regulations, a foreign person that acquires a 25% or greater voting interest in a TID U.S. business will trigger a mandatory CFIUS filing

U.S. Sponsor-Backed Exits by Dollar Volume



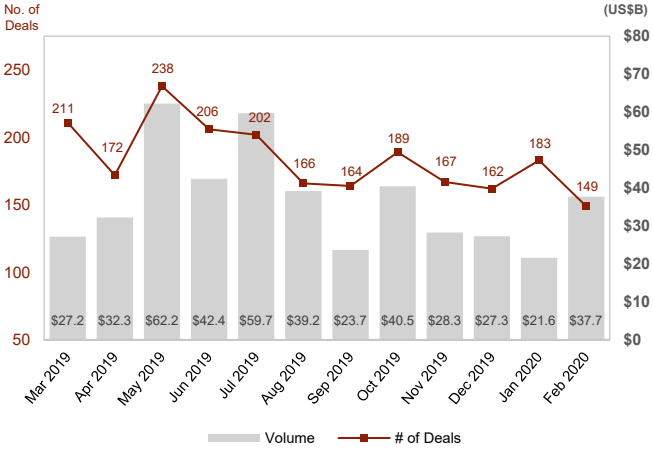
Source: Pitchbook

Global Sponsor-Related M&A Activity



Source: Cortex

U.S. Sponsor-Related M&A Activity



Source: Cortex

Each metric in this publication that references deal volume by dollar value is calculated from the subset of the total number of deals that includes a disclosed deal value

requirement if the national or subnational governments of a single foreign state have an interest in that foreign person, direct or indirect, of 49% or more. Fortunately, CFIUS largely removed concerns related to this second mandatory filing requirement in the context of investment funds by providing in the final version of the new investment regulations (unlike in the proposed version) that the 49% threshold will not be met unless the national or subnational governments of a single foreign state hold a 49% or greater interest in the fund's general partner or equivalent. But, for investment funds that are or may be foreign persons for CFIUS purposes, the critical technologies mandatory filing requirement remains highly relevant – and the private equity firms affiliated with these funds will need to be sensitive to the export control status of the equipment, materials, products, software and technology of targets that are U.S. businesses or have subsidiaries that are U.S. businesses. This task will be complicated by the fact that (i) many small or start-up U.S. companies do not have a good understanding of the export control status of their equipment, materials, products, software or technology and (ii) the U.S. government, under the leadership of the Commerce Department, is in the process of identifying and placing export controls on emerging and foundational technologies, which could substantially expand the range of U.S. businesses captured by this mandatory filing requirement.

For foreign private equity firms, these mandatory filing requirements are likely to apply, regardless of what country a given firm is based in. But U.S. private equity firms with offshore fund structures will not be caught by the critical technologies mandatory filing requirement if they can demonstrate that the offshore funds are not foreign persons for CFIUS purposes – which they can do by demonstrating that (i) the funds are under the control of U.S. persons and (ii) the principal place of business of each offshore fund and any offshore general partner is inside the U.S.

Unfortunately, the new investment regulations complicate the second prong of this test by adding a definition of "principal place of business" that could create problems for some offshore funds. Although this new definition is helpful in that it essentially uses a "nerve center" approach to "principal place of business," the new definition contains a potentially important proviso – namely, if the entity in question has represented in its most recent filing with any government (U.S. or non-U.S.) that its principal place of business, headquarters, or the equivalent is outside the U.S., such representation will be controlling for CFIUS purposes unless the entity can demonstrate that such location has changed to the U.S. since the filing occurred. Consequently, it has now become important for U.S.-based private equity firms that use offshore funds for U.S. investments to ensure that their filings with governmental entities (whether for tax or other reasons) avoid identifying the principal place of business, principal office, or headquarters of the fund or any non-U.S. general partner as outside the U.S.

The Limited Partner Status of Foreign Investors Does Not Necessarily Mean that CFIUS Will Treat Them as Passive

In looking at whether a foreign investor is in a position to exercise control or is otherwise non-passive, the fact that the foreign investor is a limited partner is not dispositive from a CFIUS perspective. Rather, all of the following factors may be relevant and will need to be analyzed:

- How large a stake does the foreign investor or investor group have?
- Note that, for investors from state-directed economies (like China), the investors should all be considered part of the same group. In addition, Hong Kong investors should be considered part of the China group.
- What consent rights does the foreign investor or group of investors have? For example, are there consent rights that go beyond narrow, standard waiver rights with respect to conflicts of interest and investment caps?
- Does the foreign investor sit on a fund advisory board/committee? If so, what are the powers of that board/committee?
- Does the foreign investor have the right to remove the general partner, or even to block removal of the general partner?
- Is there a broader business relationship between the private equity firm and the foreign investor that is likely to give the foreign investor heightened influence?
- Is the foreign investor a key co-investor for a particular transaction?
- Does the foreign investor have consent rights or a board seat (including as an observer) at any U.S. portfolio company?
- Does the foreign investor have access to the non-public technical information of, or sensitive personal data of U.S. citizens maintained or stored by, a U.S. portfolio company?

Careful Consideration Should Be Given to Creating National Security Carveouts for Foreign Investor Rights

Although this is rapidly changing, fund limited partnership agreements, commitment letters and side letters did not traditionally give sufficient consideration to CFIUS and other national security regulatory requirements in setting forth the rights of investors. While investors will obviously not accept unfettered powers on the part of the general partner, these documents should be drafted so that the rights of investors – including most-favored-nation rights, the right to participate on an advisory board/committee, the right to participate in particular investments and ultimately even the right to remain as a limited partner in the fund – are subject to legitimate national security regulatory considerations, certainly including CFIUS.

For U.S. Targets that CFIUS Cares About, You Should Be Prepared for the Possibility that CFIUS Will Come Knocking on Your Door

Based on increased funding and personnel in the wake of FIRRMA, CFIUS has become more active than ever in monitoring U.S. acquisitions and investments that have not been notified to CFIUS. Where a private equity fund has acquired a U.S. target that CFIUS cares about and the transaction has not been notified to CFIUS, CFIUS may reach out to the private equity firm for more information, especially where the firm and its fund structure are not already well-known to CFIUS. In that context, any or all of the following questions may be asked:

- What is the control structure above the fund or funds, all the way to the top?
- If there are relatively large foreign investors, who are they?
- What is the breakdown of investors by country?
- Who sits on the advisory board/committee, and what are the powers of the board/committee?
- What are the rights of the limited partners, including (but not limited to) removal of the general partner?
- Does any foreign investor have any role with respect to the operations of the U.S. portfolio company?
- Does any foreign investor have access to non-public technical information of, or sensitive personal data of U.S. citizens maintained or stored by, the U.S. portfolio company?

Conclusion

The CFIUS landscape will continue to shift in coming months, as CFIUS and transaction parties work with the new regulations and as CFIUS makes changes with respect to filing fees and the critical technologies mandatory filing requirement (and possibly in the definition of "principal place of business"). What is already clear is that private equity firms – both U.S. and foreign – must be attuned to CFIUS risk in connection with acquiring or making investments in U.S. businesses, whether directly or indirectly (for example, by acquiring a foreign company with a U.S. subsidiary). This should include carefully assessing the ownership/control structure of their funds and re-assessing when significant changes occur. This should also include assessing the national security sensitivity of any U.S. target where the relevant fund or group of funds does not qualify (or may not qualify) as a U.S. person – especially where the transaction might trigger a mandatory CFIUS filing requirement. All of this can be complicated in the current environment, but it is manageable with appropriate planning and resourcing.

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[1] For a technical discussion of FIRRMA and the implementing measures taken to date by CFIUS, please see our prior client memoranda addressing FIRRMA developments:

(1) https://www.paulweiss.com/media/3977953/13aug18-cfius-reform.pdf;

(2) https://www.paulweiss.com/media/3978244/26oct18-cfius-pilot.pdf; and

(3) https://www.paulweiss.com/media/3978919/30oct19-cfius.pdf.

[2] In its explanatory materials accompanying the new investment regulations, the Treasury Department indicated that CFIUS expects to replace this mandatory filing requirement that involves a linkage between critical technology and specified industries with a mandatory filing requirement that focuses just on export control licensing requirements. Whether this change will narrow or broaden the range of U.S. businesses that are captured by the mandatory filing requirement remains to be seen.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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