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M&A ACADEMY

Making the Most of Cross-Border Deals in an Era of Heightened Regulatory Risk

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Introduction

1. Conducting Risk-Based International Compliance Due Diligence in M & A Transactions

2. Submitting M & A Transactions for review by CFIUS under the Foreign Investment Risk Review Modernization Act of 2018 (“FIRRMA”)

Conducting Risk-Based International Compliance Due Diligence in M&A Transactions

1. Key International Compliance Risk Areas and Associated Liabilities
2. Guidance and Case Law on Successor Liability
3. Practical Approaches to Conducting Risk-Based International Compliance Due Diligence
4. Key Diligence Questions
5. Use of International Compliance Due Diligence
6. Need for Specialized Contractual Provisions
7. Considerations for Sellers
8. Considerations for Buyers

Key International Compliance Risk Areas and Associated Liabilities: Overview

1. <u>National Security</u>: CFIUS/FIRRMA/FOCI/NISPOM – liabilities can include blocked transactions, forced divestiture or restructuring, loss of government contracts privileges, debarment, suspension of exporting and other and other privileges, criminal and civil fines as well as intangible penalties, such as mitigation agreements, reputational harm or other proscriptions.
2. <u>Sanctions Laws: US and EU– Iran, Syria, North Korea, Cuba, Venezuela, Crimea, Ukraine-related Russian sanctions, blocked persons or SDNs and other OFAC programs</u> – liabilities can include criminal and civil fines, jail time for individuals, debarment, deferred prosecution agreements or consent decrees.
3. <u>Export and Re-Export Laws (US and EU):</u> liabilities can include criminal and civil fines, jail time for individuals, denial of export privileges, deferred prosecution agreements or consent decrees.

Key International Compliance Risk Areas and Associated Liabilities

4. Anti-Corruption: FCPA and UK Bribery Act, as well as applicable local anti-corruption laws – liabilities can include criminal and civil fines, jail time for individuals, debarment, deferred prosecution agreements or consent decrees, follow-up on civil litigation.
5. Anti-Boycott Laws (US): liabilities can include criminal and civil fines and loss of tax benefit.
6. Customs/Import Compliance and Trade Actions/Remedies: liabilities can include increased duties, penalties and forfeitures, exclusion of products from the United States, follow on civil litigation, including False Claims Act claims.
7. Personal liability: A number of these laws and regulations include personal as well as enterprise exposure

Recent DOJ Guidance on Corporate Compliance in M & A Transactions

In March 2019, DOJ updated guidance, originally released in 2017, on how it evaluates corporate compliance and noted these questions that it will ask specifically in the M & A context.

- **Due Diligence Process** – Was the misconduct or the risk of misconduct identified during due diligence? Who conducted the risk review for the acquired/merged entities and how was it done? What has been the M&A due diligence process generally?
- **Integration in the M&A Process** – Has the compliance function been integrated into the merger, acquisition, and integration process?
- **Process Connecting Due Diligence to Implementation** – Does the company take measures to identify and remediate misconduct and misconduct risks identified during the due diligence process? How (if at all) does the company implement compliance policies and procedures at acquired entities?

Recent DOJ Guidance on Corporate Compliance in M & A Transactions

DOJ Guidance now states:

- Where a company uncovers misconduct by the merged or acquired entity
- Did it conduct "thorough and timely due diligence?"
- Did it employ "post-acquisition audits or compliance integration efforts?"
- Did it timely and completely voluntarily self-disclose the misconduct?
- Did it take remedial actions consistent with DOJ Policy
  - Primarily, did it timely implement an "effective compliance program at the merged or acquired entity?"
- Where all of these conditions are met "there will be a presumption of a declination in accordance with and subject to the other requirements of th[e DOJ] Policy"

Recent DOJ Guidance on Export and Sanctions Enforcement

DOJ issued its Export Control and Sanctions Enforcement Policy for Business Organizations

- Includes language (fn7) mirroring the general enforcement policy
  - Same criteria apply
  - If followed, presumption of *non-prosecution agreement*
- Policies must be addressed to ***Export and Sanctions***
- Garden variety ethics, “social”, conflicts, or similarly general policy statements will not be sufficient

Recent DOJ Guidance on Export and Sanctions Enforcement

Diligence challenges

- Knowing what to look for and ask
  - And ***actually asking***
- Knowing when the policies are adequate for the purpose ("We have a general conflicts and ethics policy" will never be the right answer
- Risk assessment based on the businesses involved
  - Acquirer and acquired
- Knowing what questions to ask

Successor Liability

- In certain areas of international compliance, including the FCPA, sanctions and export and import controls, substantial precedents establish purchaser/investor liability for misconduct of the target company occurring before the closing under the theory of successor liability.
- In the FCPA area, DOJ/SEC have provided specific guidance in the joint 2012 FCPA Guide how to minimize successor liability.
- In the trade area, the Department of Commerce began asserting successor liability in 2002 in the *Sigma Aldrich* case.
- The Department of State has a long history of imposing strict successor liability on companies who purchase entities that committed violations prior to the acquisition. *See Consent Agreement with L-3/Goodrich; Consent Agreement with General Motors/General Dynamics; Consent Agreement with L-3/Titan; Consent Agreement with Meggitt USA, Inc.; Consent Agreement with Multi-Gen Paradigm*
- In the customs areas, successor liability has been found in numerous cases, including: *Shields Rubber Corp* (1989), *Ataka America* (1993), *Adaptive Microsystems* (2013) and *CTS Holding* (2015).

Risk-Based Due Diligence

- Little guidance exists on what level of risk-based international compliance due diligence is required for a particular target and the scope of due diligence depends upon the particular international compliance risks associated with the target and the amount of time and resources you have available.
- There is a fundamental difference between responding to a governmental enforcement action or pursuing an internal investigation, on the one hand, and performing M&A due diligence on the other.
- While the client or deal team will ask you to estimate potential exposure it is very difficult to do that accurately because of the wide range of potential monetary and non-monetary liabilities and the lengthy 5 year-statute of limitations. It is particularly challenging when the target has limited compliance programs in place and may have unknown violations.

Risk-Based Due Diligence

- Government enforcement cases and internal investigations focus on discovered conduct that may be a violation. Internal investigations may require intensive document review and analysis, electronic mail collection, and witness interviews. Depending upon the subject matter, this process may take many months and even years, especially if the Government is concerned that the conduct at issue has jeopardized an important national security or foreign policy interest.
- In contrast, risk-based international compliance due diligence attempts to identify the international compliance risk areas of a target in a relatively short period of time – often with limited access to critical documents and personnel.

Risk-Based Due Diligence

The risk assessment should focus on the following:

1. The nature of the target's business and reputation in the market.
2. The industry and the countries in which the target operates.
3. The extent to which the target is exposed to certain international compliance risk areas and how it approaches compliance in these areas.
4. The extent to which the target utilizes third parties in dealing with customers and regulators.
5. The extent to which the target interacts with government officials or has government customers.
6. The strength of the target's existing compliance program and internal controls.

Practical Approaches

1. Choose your team wisely: The international compliance due diligence team should include those subject matter experts (SMEs) best suited to address the specific issues involved in a transaction. These include regulatory and compliance, in addition to transaction counsel with experience in the field, and in-house personnel. Each team varies somewhat and a cookie cutter approach generally increases the costs of the transaction.
2. Understand what you need to investigate and review and the timeline: Determine the amount of time, scope of international compliance due diligence based on your risk profile, and allocation of responsibilities. Regulatory counsel is uniquely positioned to advise on these areas, especially where risk exists; the in-house compliance department can supplement the assessment provided by outside counsel SMEs; and the finance department focuses on books and records and accounting controls, including any material weaknesses in internal controls.

Practical Approaches

3. Understand what can be obtained through the data room: Because information concerning international compliance issues is rarely included in publicly available materials or in a data room, it is critical to create a separate work stream to conduct international compliance due diligence. Often a supplemental international compliance questionnaire is submitted, followed by one or more interviews of the target's compliance and business personnel to understand the international compliance risks and to focus on areas for further inquiry.
4. Address violations or noncompliance up front and provide protection in the deal documents: If enforcement cases or internal investigations are discovered or disclosed, having regulatory counsel already involved allows for timely assessment of the risks and exposure arising from these regulatory minefields.

Practical Approaches

5. Understand the risks and where additional diligence is needed: One of the biggest challenges in conducting due diligence is determining when a desk-top review or interview of target personnel may be insufficient and when certain potentially high-risk transactions should be analyzed in more detail. This kind of analysis can be time consuming and international compliance issues are often difficult to detect without an opportunity to interview the right people or conduct a more thorough investigation.

Practical Approaches

6. Prepare to deal with foreign affiliates or subsidiaries: Most transactions involve international activities or parties. Your transaction may involve a target's foreign subsidiaries, foreign suppliers or vendors or foreign consultants and customers. Uncovering potential violations in any of these situations where foreign parties may be involved presents an additional challenge. Privacy requirements, the extraterritorial effect of US laws and regulations as well as interpretative consistency may hamper the diligence process.

– To the extent there is not an opportunity to conduct pre-acquisition international compliance due diligence, be prepared to conduct more in-depth post-acquisition international compliance due diligence to eliminate ongoing compliance problems. Among the many topics to address, for example, is the integration of the acquired company into the acquiring company's international compliance program.

Important Diligence Questions

Key risk areas to focus on include the following:

1. **Is the target in a high-risk industry?**
   - For example, the target or its competitors are in an industry of particular focus for US governmental authorities and there have been enforcement cases involving the target or its competitors.
   - Industry examples: Oil and Gas, Telecommunications, Medical Devices, Pharmaceuticals, critical technology, infrastructure
   - **Diligence Goal:** Understand the regulatory environment and enforcement patterns to plan diligence resources and effort.

Important Diligence Questions

2. Does the target operate in any high-risk country?

- For example, if the target is located in or operates in a country that has a reputation for corruption, additional diligence is advisable.
- Locations of concern, for example, for export controls, FCPA and AML issues can include countries such as China, Brazil, Argentina, India, Indonesia, The Philippines, and other countries with poor scores on the Transparency International Corruption Perceptions Index.
- Locations of concern can also vary depending on the target's industry.
- **Diligence Goal:** Understand the target's business model, including its ethics culture, compliance structure, and methods for operating in challenging ethical environments.

Important Diligence Questions

3. **Does the target have extensive international sales, foreign subsidiaries or many points of contact with foreign government officials (or politically exposed persons)?**

   – For example:
     – The target has an Asian subsidiary focusing on a market consisting of many government customers.
     – The Asian subsidiary is managed by a foreign national who has significant family contacts in the government.
     – The target has multiple business-related licenses issued by various levels of government.

   – **Diligence Goal:** Understand and apply the level of diligence effort necessary to reasonably assess risk.

Important Diligence Questions

4. **Does the target rely on the use of third-party intermediaries to make sales or to handle government relations? Are you able to easily identify the target's third parties in its records and accounting systems?**
   - For example:
     - The target relies heavily on third-party intermediaries with success fees or other incentive compensation.
     - The target has third parties involved in handling government relations activities, including obtaining critical permits/regulatory approvals.
     - Contracts with third parties do not have FCPA clauses, or they have limited provisions, and there is little evidence that third parties have been trained in the FCPA.
   - **Diligence Goal:** Identify and evaluate high-risk intermediary activities and the target's pre-engagement diligence on and continuing oversight of third parties.

Important Diligence Questions

5. **Does the target's sales force rely, explicitly orimplicitly, on business gifts and entertainment, including travel, as well as charitable and political contributions as part of its sales and marketing?**
   - For example:
     - The target's sales representatives have a history of being reimbursed for significant sales and marketing expenses without appropriate documentation.
     - Many customers have been reimbursed for travel.
     - Significant charitable or political contributions have been made in other countries (potentially for purposes of market access).
   - **Diligence Goal:** Assess (i) whether the business has been built on a foundation of corrupt activities, (ii) the strength of the target's accounting controls, and (iii) the cultural risks inherent in the business.

Important Diligence Questions

6. Does the target export products, technical data or services that are subject to the export control jurisdiction of the US Department of State?

- The US State Department controls the permanent and temporary export and temporary import of defense articles, defense services and related technical data (items). The items subject to State Department jurisdiction are included in the US Munitions List (USML) found in the International Traffic in Arms Regulations (ITAR).
- Exports of USML products, technical data and services require licenses from the State Department's Directorate of Defense Trade Controls (DDTC) unless an ITAR exemption applies. The ITAR also includes lists of countries for whom exports or temporary imports are prohibited or otherwise subject to a presumption of denial.
- If the target exports, designs, develops, modifies, adapts, uses or manufactures USML items, the target is required to:
  - register with DDTC and
  - provide certain notifications to DDTC before the closing (in the case of non-US acquirers) or after closing (in the case of US acquirers).
- **Diligence Goal**: Determine the target's ITAR obligations to assess target's ITAR compliance.

Important Diligence Questions

7. Does the target export products or technology that are subject to US export control jurisdiction of the US Department of Commerce?

- The US Department of Commerce has export licensing jurisdiction for dual use products and technology – items that have a civil and military application - that are included in the Commerce Control List (CCL) included in the Export Administration Regulations (EAR).
- Exports of products or technology <u>may</u> require product-specific licenses from the Commerce Department's Bureau of Industry & Security (BIS) unless an EAR license exception applies.
- Exports destined to certain countries, certain end users and certain end uses <u>may also</u> separately require BIS export licenses.
- **<u>Diligence Goal:</u>** Determine the target's EAR obligations to assess target's EAR compliance.

Important Diligence Questions

8. Has the target been granted any export licenses from DDTC or BIS or used any DDTC or BIS export exemptions / exceptions?

- Target is required to comply with:
  - all export license provisos and any other license conditions.
  - the terms of all relevant export license exemptions / exceptions
- How does the target monitor compliance with license provisos, license conditions and license exemptions / exceptions?
- Have any of the target's export license applications been denied?
- Have any of the target's export licenses been denied, revoked or suspended?
- Did target obtain any Commodity Jurisdiction determinationss (CJs) from DDTC or any Commodity Classification Rulings (CCATs) from BIS in support of the proper jurisdiction for the export licenses that target secured?
- Are target's export licenses transferrable with minimum interruption to the business?
- **<u>Diligece Goal:</u> Assess target's compliance with export license and export exemption / exception requirements under ITAR and EAR.**

Important Diligence Questions

9. Does the target conduct business in or engage in any business dealings involving <u>countries</u> subject to OFAC sanctions without the requisite OFAC authorization (specific license or general license)?

- It is critical to determine whether the target conducts business in, facilitates business in or engages in any unauthorized activities involving OFAC sanctioned countries.
- OFAC country sanctions apply primarily to "US Persons" but in certain instances apply extraterritorially.
- In addition to primary country sanctions, OFAC also maintains secondary sanctions which may require no US nexus.
- OFAC country sanctions are subject to implementation or modification with little or no notice.
- The Statute of limitations for OFAC violations is five (5) years.
- **<u>Diligence Goal:</u>** Assess the target's potential exposure to OFAC violations incurred via current or past dealings in or with OFAC sanctioned countries.

Important Diligence Questions

10. Does the target conduct business with or engage in any business dealings involving OFAC <u>sanctioned parties</u>?

- It is critical to determine if the target conducts business with, facilitates business with or engages in any business dealings involving OFAC sanctioned parties.
- OFAC considers sanctioned parties to include those parties that are 50% or more owned by a sanctioned party. These parties will not necessarily appear on OFAC's SDN list.
- To the extent that the target comes into possession of a sanctioned party's assets, the target is required by OFAC to block such assets and file a report with OFAC regarding the asset blocking.
- OFAC sanctions are subject to implementation or modification with little or no notice.
- <u>**Diligence Goal:**</u> Assess the target's potential exposure to OFAC violations incurred via current or past dealings with OFAC sanctioned parties.

Important Diligence Questions

11. Does the target conduct business in or with any "boycotting" countries?

- The US has laws and regulations that prohibit compliance with the Arab boycott of Israel (and all other unsanctioned boycotts) and imposes both substantive prohibitions and reporting obligations. To complicate matters there are two sets of boycott regulations – the Treasury and Department of Commerce Regulations – and they are not entirely consistent.
- **Diligence Goals:** Determine if the target does business in any "boycotting" countries and assess the target's exposure to anti-boycott violations.

Important Diligence Questions

12. How much of the target's business includes imports, of what types and from what countries?

The target's imports should be assessed for compliance because of the potential for unpaid duty obligations and penalties. In addition, the following types of imports might raise additional issues:

- products produced using prohibited or forced labor such as slave labor, convict labor, indentured child labor, and labor by North Korean nationals and citizens without regard to country of residency
- products subject to extraordinary trade remedies or actions, such as antidumping or countervailing duties, section 301, 232, or 201 duties, quotas arising from trade actions and other remedies
- products made as preferential duty entries (Free Trade Agreements), duty deferral or duty exemption entries
- products that are subject to US Customs and Border Protection audits / enforcement / seizure cases for misclassification or duty underpayment

Compliance Goals: Determine if the target's import program is subject to potential disruption by events beyond target's control.

Important Diligence Questions

13. Does the target have a strong culture of compliance, and/or strong compliance policies and procedures?

- Be alert for issues such as:
  - The target has an underfunded compliance program which appears to be an "off-the-shelf" document taken off the shelf program.
  - The target has a newly adopted compliance program.
  - Training and auditing are infrequent and the tone at the top is focused on the achievement of sales objectives.
  - There is little or no use of a company reporting "hotline" or other reporting mechanisms.
  - There are no compliance cases or sanctions imposed on anyone for violating the company's code of conduct.
- **Diligence Goal:** Understand the target's compliance culture and assess the nature of the target's compliance policies and procedures

Important Diligence Questions

14. How cooperative is the target with the diligence process and does a lack of cooperation signal hidden issues?

- For example:
  - The target is slow to produce compliance related documents – whether licenses, exception/exemption records, license proviso implementation records, voluntary disclosures or copies of audit reports.
  - The target has numerous documents produced in the local language only.
  - Internal experts are uniformly concerning key diligence areas.
- **Diligence Goals:** Determine whether a lack of cooperation reflects compliance weaknesses that require enhanced diligence inquiries in one or more areas. Consider engaging diligence specialists for targeted diligence efforts.

Important Diligence Questions

15. Does the target have any ongoing internal or government investigations or has the target voluntarily disclosed any international compliance concerns that are currently pending government review?

- For example:
  - The target has disclosed the existence of a government investigation or subpoena.
  - The target has produced compliance hotline reports reflecting international compliance allegations.

- **Diligence Goal:** Understand the nature of the allegations, exposure, employee and third-party involvement, affected business units, and current control environment.

Use Of Due Diligence

Once the risk-based international compliance due diligence is concluded, assess the effect of what has been found in the overall transaction diligence. Options include:

(a) proceeding as planned or renegotiating to account for risks,

(b) delaying closing until further due diligence is done or active cases/investigations are resolved and then reassessing or renegotiating, or

(c) walking away.

Use Of Due Diligence

Questions to consider include:

1. How much of the target's revenue stream/business model could be affected?
2. How many key employees, intermediaries, or customers may be affected or need to be retrained or terminated?
3. Is the target's business model/culture so different that it will be difficult to integrate it into your compliance program without the business being materially affected?
4. How much uncertainty is there concerning whether you have had sufficient time to assess compliance risks or to resolve known compliance issues and quantify associated costs and liability?
5. Can identified risks be addressed through contractual provisions or revaluation? Or are they so serious that they should be resolved prior to closing?

Need for Specialized Agreement Provisions

- It is market practice to include specialized FCPA and other international compliance representations and warranties in transactional documents and not to rely on general compliance with laws representations and warranties, which are often qualified with no material adverse effect language.
- These specialized representations and warranties serve two purposes; first, to force disclosure of compliance issues and, second, in private company transactions where representations and warranties survive the closing, to set up special indemnities, which may be secured by special escrows.

Considerations for Sellers

Sellers should consider the following with respect to international compliance issues:

1. Prepare due diligence for buyers by doing a self-assessment of ongoing compliance issues, including hotline complaints, internal investigations, or external enforcement cases.
2. Prepare any required disclosure information and determine at what time and in what manner to disclose it to buyers.
3. Be prepared for a discussion with buyers concerning the potential materiality of international compliance issues in terms of purchase price adjustments in public deals where representations, warranties and indemnities do not survive the closing or special escrows in private deals where they do.
4. Be prepared for a request/requirement by buyers to disclose the international compliance issues to enforcement authorities as a condition of closing.

Considerations for Buyers

Buyers should consider the following with respect to international compliance issues:

1. Prepare due diligence plan and allow for adequate time where possible; do not let the sellers delay disclosure until the 11th hour.
2. Adjust the due diligence plan and resources depending upon what is learned.
3. Discuss with sellers and buyers' own counsel potential materiality of international compliance issues and level of uncertainty.
4. Consider international compliance representation and warranty insurance products.
5. Consider adequacy of proposed special escrows in private deals where issues have been identified.
6. Consider whether forcing disclosure to enforcement authorities will lead to timely resolution of international compliance issues before closing.
7. Prepare pre-acquisition the post-acquisition international compliance integration plan.
8. If the target is a public company, consider SEC disclosure obligations and potential issues relating to material weaknesses in internal controls.

Clearing Transactions with CFIUS under the Defense Production Act

The US maintains an “open door” policy regarding FDI and that policy is generally managed by Treasury, the US Trade Representative and Commerce

- This “open door” policy is counterbalanced by the impact of FDI on US military and critical technology advantages, cyber capabilities, intellectual property, and supply chain integrity – equities generally managed by the Departments of Defense, Justice (to include the Federal Bureau of Investigation) and Homeland Security
- National security agencies embrace commercial technologies outside of the Government R&D or procurement process as a way to cut costs and take advantage of cutting edge technologies developed by the private sector

Clearing Transactions with CFIUS under the Defense Production

The challenges within the Committee, and to transactions in general, increased with more frequent Chinese attempts (and some successes) to purchase, for example, semiconductor or related businesses in alignment with China's policy to match and overtake US primacy in this field

- This resulted in changes in the way:
  - Parties structured their transactions
  - CFIUS reviewed the transactions
  - Parties were asked to pull and refile CFIUS notices; and
  - Mitigation agreements designed to limit the national security impact of a particular transaction were drafted and implemented
- Some of these changes were shared publicly in the required Annual Report on CFIUS activity and others came to light through public statements issued by the parties to a transaction

Clearing Transactions with CFIUS under the Defense Production Act

- In 2016 - 2018, CFIUS increased the number of transactions to which it objected and either recommended that the President block, or that fell through under the threat of such action, including, for example:
  - 2016:
    - Philips NV’s proposed sale of Lumileds to a Chinese Consortium (including GSR Ventures and Nanchang Industrial Group) (January 2016)
    - Fairchild Seminconductor International proposed sale to China Resources Microelectronics Ltd and Hua Capital Management Co Ltd. (February 2016)
    - AIXTRON SE proposed sale to Grand Chip Investment GmbH (a Chinese company) (December 2016)
  - 2017:
    - Wolfspeed proposed sale to Infineon Technologies (February 2017)
    - Inseego Corporation proposed sale of MiFi business to TCL Industries Holdings (June 2017)
    - Global Eagle Entertainment, Inc. proposed sale to HNA Co Ltd (July 2017)
  - 2018:
    - Moneygram proposed sale to Ant Financial (January 2018)

Clearing Transactions with CFIUS under the Defense Production Act

- Based on this background, Congress heightened its interest in modernizing and changing the CFIUS process, leading to the enactment of FIRRMA in August 2018
  - FIRRMA introduced a number of changes, and a new focus on areas perceived to require more and closer scrutiny for national security reasons
  - Examples include big data, personal information, access to technology, access to R&D that can be used to leapfrog existing development, cyber capabilities, software development, artificial intelligence, biotechnology, civil nuclear applications, robotics, commercial technologies with national security applications, and industrial base issues have become key factors in any CFIUS

Clearing Transactions with CFIUS under the Defense Production Act
Next Steps

- Some essential FIRRMA changes
- Increased scrutiny of specific transactions involving:
  - Specific countries – China, Russia, or proxy countries
  - A broader range of technologies and/or services
  - Foundational or disruptive technologies – whether civil or defense related
  - Big data and data management
  - Companies or businesses that may be crucial to the supply chain for US national security or critical infrastructure interests
  - AI, robotics, autonomous vehicles (air, underwater, ground)

Clearing Transactions with CFIUS under the Defense Production Act

- Additional factors to consider
  - o Foreign purchaser's history of compliance with US laws and regulations
  - o Protection of personal information
  - o Role in the supply chain
  - o Transaction financing
  - o Candor and accuracy
  - o Consistent representations
  - o Indirect foreign government control or influence

The New "CFIUS Model"

- FIRRMA impacts the due diligence process and whether and when to file a CFIUS notice
- New considerations include
  - o Mandatory declaration analysis
    - Control
    - Investment
    - Critical technology
    - Pilot Program industry
  - o Voluntary notice analysis
  - o Special rules for investment funds (pilot program and non-pilot program)

The New “CFIUS Model”

- Generally, CFIUS reviews ‘covered transactions’ – whether mergers, acquisitions or takeovers – by a foreign person that result in control of a US business
- On February 13, 2020, the Department of Treasury, the chair of CFIUS, final regulations implementing FIRRMA went into effect
- Implement the expansion of CFIUS jurisdiction to non-controlling investments in US businesses that are involved with critical technologies and to real estate/critical infrastructure transactions
- On March 6, 2020, CFIUS issued a proposed rule implementing the filing fees required by FIRRMA
  - Apply to voluntary notices, not mandatory declarations
  - Including voluntary notices that follow mandatory declarations
  - Not clear when it will be effective

CFIUS Filing Fees

- CFIUS filing fees in proposed rule
  - Where the value of the transaction is equal to or greater than $500,000 but less than $5,000,000, a filing fee of $750 is assessed;
  - Where the value of the transaction is equal to or greater than $5,000,000 but less than $50,000,000, a filing fee of $7,500 is assessed;
  - Where the value of the transaction is equal to or greater than $50,000,000 but less than $250,000,000, a filing fee of $75,000 is assessed;
  - Where the value of the transaction is equal to or greater than $250,000,000 but less than $750,000,000, a filing fee of $150,000 is assessed; and
  - Where the value of the transaction is equal to or greater than $750,000,000, a filing fee of $300,000 is assessed.

The New “CFIUS Model”

- Practical effect – changes in due diligence
- Mandatory declaration now an essential review as part of any equity investment
  - Documents to review
    - NAICS codes – the regulations define ‘critical technologies’ industry sectors by primary NAICS codes
    - Export classifications – cover EAR, ITAR, NNSA, NRC, DOE, viruses/toxins and “emerging or foundational technologies”
    - US and foreign government engagements
      - Direct
      - Indirect
      - R&D
      - Commercial-off-the-shelf purchases
      - Government directed export activities

The New "CFIUS Model"

- Practical effect – changes to due diligence
  - Documents to review
    - Industry identification – segment, sector, and classification codes
    - Defense Priorities and Allocations designations
    - Cyber and IT protections – plans, reports on breaches, staffing
    - Suppliers – supply chain documentation (without limitation to tier level)
    - International agreements that may apply – *e.g.*, 123 Agreements
    - Framework agreements regarding IP
    - Lists of joint ventures and other collaborative arrangements entered into by the purchaser and countries of concern or interest to the US – *e.g.*, China, Russia, Hong Kong, Taiwan, Venezuela (and now Turkey, Saudi Arabia)

The New "CFIUS Model"

- Practical effect – changes to due diligence
  - Jurisdictions where the foreign purchaser conducts business
  - Requirements within those jurisdictions that apply to the foreign purchaser's business – *e.g.*, China's security laws that may require access to communications and other data stored, generated or used by the foreign purchaser; similar laws in Russia
  - Lists of internal foreign purchaser committees (and their members) who address IP or trade secret matters for the purchaser
  - All term sheets or LOIs for any investment
  - Financial documents, such as loans or credit facilities—what is the true nature of the transaction
    - When is a loan really an equity investment?
    - Characteristics of an equity investment
      - Board representation
      - Voting agreements, etc.
  - Provenance of investors (without regard to level of investment)

The New “CFIUS Model”

- Structuring Transactions
  - Analyzing transactions to determine whether a mandatory filing is required
  - Analysis is needed at the front end of the transaction – at the time the investment is contemplated, not at the document drafting stage
  - Transactions are structured to address business and regulatory requirements – *e.g.*, revenue streams, customer requirements, tax benefits, IP issues – but how will this be interpreted in light of the “avoidance” of CFIUS review factor?
  - Recasting a transaction is not uncommon but consideration needs to be given to potential CFIUS review when changing transaction structures, if the changes are designed to:
    - Evade CFIUS review or
    - Avoid CFIUS review

Clearing Transactions with CFIUS under the Defense Production Act

- Preparing for the changes
  - Expand your due diligence – *e.g.,* not only of the business but of the parties involved
  - Research beyond the information provided by the parties – *see, e.g., Ness Technologies SARL v. Pactera Technology International, et al.* (Supreme Court of NY, Filed December 6, 2016)
  - Plan for detailed filings – *e.g.*, parties will likely find little success by taking the approach that “we’ll submit it to CFIUS and see what it says”
  - Carefully consider financial penalties when CFIUS is a closing condition
  - Answer CFIUS questions asked, not ones the parties would like to answer
  - Conduct the mandatory declaration analysis
  - Even if no mandatory declaration, should voluntary notice still be filed?
    - Traditional analysis
    - The Government has identified and is using resources to educate itself on transactions that have occurred or are underway, but have not been notified to the Committee

QUESTIONS?

Biography

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Giovanna M. Cinelli is lead of the International Trade and National Security practice of Morgan Lewis. For more than 30 years, she counseled clients in the defense and high-technology sectors on a broad range of issues affecting national security and export controls, including complex export compliance matters, audits, cross-border due diligence, and export enforcement, both classified and unclassified. She advises on transactional due diligence for regulatory requirements involving foreign direct investments, government contracts, export policy, and compliance, as well as settlement of export enforcement actions before the US departments of State, Commerce, Treasury, and Defense, and related agencies. She advises clients on matters before the Committee of Foreign Investment in the United States (CFIUS), and addresses mitigation requirements that may apply as part of CFIUS clearances for cross-border transactions.

Biography

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Kenneth J. Nunnenkamp represents buyers and sellers in transactions before the Committee on Foreign Investments in the United States (CFIUS), and counsels parties to transactions regarding CFIUS risks, applicability and solutions. His experience includes representation of buyers and sellers in public and private transactions in all value ranges, from small transactions in the millions to large matters in the billions, public and private. Ken's experience with CFIUS includes almost every industry and transactions involving entities from more than 35 countries, including Japan, China, Germany, the United Kingdom, Canada, Switzerland, Norway, Sweden, Indonesia, Australia, South Korea, Luxembourg, France, and many more. Ken chairs the Morgan Lewis CFIUS Working Group, which brings together the Firm's attorneys who practice in the area and who are interested in its developments. Ken's expertise encompasses trade and regulatory fields dealing with or implicating national security issues, including: US economic sanctions; Trade remedies (§§ 201, 232 and 301, and related matters, including exclusion requests, hearing testimony and Congressional involvement); Export controls and compliance/investigations under the ITAR, EAR and other regulations; US Customs regulations governing imports and exports; Customs and Census issues arising under the Foreign Trade Regulations, Endangered Species Act and Lacey Act issues with imports and exports of exotic and controlled items; C-TPAT; and Trade Agreements/Buy American issues. Ken also represents clients in matters relating to classified activities and before the Justice Department's Foreign Agent Registration Act (FARA) division. He brings more than 30 years of litigation and investigation experience, including time as a JAG Officer in the US Marine Crops. As an experienced entrepreneur, Ken applies business acumen to legal solutions, while assessing risk in user-friendly terms. He serves on the Wake Forest University Business School Board of Visitors, and publishes and presents frequently on topics relating to national security law, trade and business.

THANK YOU