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Huawei – CFIUS Redux: Now It Gets Interesting

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This is Part I of a series of Paul Hastings Client Alerts focused on the growing impact of cross-border investments on foreign takeover "national security" review laws. Next week: a discussion of China's new "Security Review Mechanisms for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors."

Huawei Technologies Inc., the world's second largest maker of telecom equipment and one of China's leading global companies, is no stranger to the scrutiny applied by the U.S. Government to foreign investments in U.S. technology companies. In 2008, Huawei's proposed investment in U.S. network security company 3Com was thwarted when objections were raised by the Committee on Foreign Investment in the United States ("CFIUS"), an interagency body that reviews foreign takeovers of U.S. businesses for national security reasons. In mid-2010, CFIUS scuttled another proposed investment by Huawei, this time in mobile communications companies 2Wire and Motorola. In each case, reports cited suspected ongoing ties between Huawei's founder and CEO Ren Zhengfei and Chinese military and intelligence agencies, charges that Huawei strongly denies.

It was no surprise, given these prior experiences, that Huawei elected not to notify CFIUS before consummating a $2 million acquisition of technology and employees from 3Leaf Systems, a small server technology firm located in Santa Clara, California. Huawei and its advisors reasoned that the purchase of discrete technology (including patents) and the assumption of less than a third of 3Leaf's employees did not constitute the acquisition of an ongoing "U.S. business," and, therefore, the acquisition fell outside CFIUS's jurisdiction under the Defense Production Act.[1] The small size of the deal almost certainly played a role as well.

The Department of Defense, one of the primary CFIUS members, had a different view, directing the CFIUS staff to take the unusual (though not unprecedented) step of "inviting" Huawei to file a notice of the transaction after the fact.[2] CFIUS determined that it did have jurisdiction, and, following its review, CFIUS informed Huawei that it must divest the 3Leaf assets and employees. After initially indicating it would reject CFIUS's findings and press its case with President Obama (who had 15 days under the statute to review CFIUS's recommendation), Huawei withdrew its objection and agreed to divest.

Many aspects of this matter are notable and should give pause to parties to transactions presenting similar facts:

First, this case starkly demonstrates that CFIUS member agencies (and the staff itself) scour the business pages for reports of deals that might raise national security/critical infrastructure concerns and will not hesitate to reach out to the companies involved when no filing has been made.

Experienced practitioners have learned that certain types of deals are of particular interest to CFIUS, particularly if the buyer is Chinese and the target owns unique or specialized computer technology.

Second, CFIUS will define its jurisdiction broadly in favor of finding a covered transaction if the deal carries any indicia of concern (in this case, a buyer well-known to CFIUS but with a problematic track record), even if the merits argue against jurisdiction. Here, Huawei argued (with some justification) that it did not acquire an ongoing "business" from 3Leaf, but rather only purchased assets (patents) and hired some 3Leaf employees. (3Leaf did, however, cease to exist as a going concern after the deal.) Moreover, to the extent that what Huawei bought was embodied in 3Leaf's patents, that technology can hardly be characterized as sensitive from the standpoint of national security or critical infrastructure. Once the U.S. Patent Office permits information in a patent application to be published, it is not even subject to U.S. export control laws and can be circulated widely without restriction. Huawei's decision not to file under these circumstances could be justified as a matter of plain regulatory interpretation. However, CFIUS proved that context can trump cold legal analysis in some cases.

Third, though its action transpired with relatively little fanfare, the fact that CFIUS chose to intervene in this transaction after it had closed, and then recommended that it be unwound, should be a matter of significant concern to foreign firms looking to invest in the United States. Post-closing divestments under Exon-Florio are extremely rare, the most prominent example dating back to 1990, when President George H.W. Bush ordered the China National Aero-Technology Import and Export Corp. ("CATIC") to divest its control of MAMCO, Inc., a U.S. aircraft parts manufacturer. Only by voluntarily filing a notice and getting clearance from CFIUS prior to closing can parties to a transaction gain assurance that the same thing will not happen to them.

Fourth, as noted, Hauwei initially decided to fight CFIUS's recommendation, issuing statements that it intended to take the matter to presidential review. This was not an illogical strategy. It would have presented a thorny political problem for the White House, which would likely have gone to great lengths to avoid offending the Chinese government. This is reminiscent of the outcomes of several presidential reviews in the China "safeguards" cases in the early 2000s, when the George W. Bush administration refused to impose, against Chinese goods, tariffs recommended by the International Trade Commission at the request of U.S. industries that claimed harm from "surging" imports. Larger political and bilateral issues were at play then, as well. In this case, Huawei may have decided that the size of the transaction was not worth the cost (in terms of legal fees and political capital) of fighting CFIUS's recommendation, or it might even have been ordered by the Chinese government to stand down.

This time, then, the confrontation was avoided. But one is surely coming. China's Ministry of Commerce has repeatedly complained that the U.S. government is using the CFIUS process as a pretext for damping Chinese investment in the United States. And China has recently unveiled, to significant press and industry attention, its own foreign investment review process, part of a new wave of such measures also recently proposed or enacted in other countries, including France and Italy. While the individual EU members' measures seem largely aimed at each other's investments, China's law must be seen as a direct response to prominent failures of proposed Chinese acquisitions in the face of the CFIUS process, including not only the serial Huawei deals, but also the decision by the China National Overseas Oil Company to withdraw its 2005 bid for Unocal (which was ultimately bought by Chevron). Observers await the early results of the new Chinese review process. Now it gets interesting.

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[1] 50 U.S.C. App. § 2170. Transactions potentially subject to CFIUS review are referred to as "covered transactions," and include any proposed or pending transaction "which could result in control of a U.S. business by a foreign person." 31 C.F.R. § 800.207 (emphasis added).

[2] "If [CFIUS] determines that a transaction for which no voluntary notice has been filed . . . may be a covered transaction and may raise national security considerations, the Staff Chairperson, acting on the recommendation of the Committee, may request the parties to the transaction to provide to the Committee the information necessary to determine whether the transaction is a covered transaction, and if the Committee determines that the transaction is a covered transaction, to file a notice . . . of such covered transaction." 31 C.F.R. § 800.401(b).