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China and CFIUS: a double-edged sword

As far back as 2008, when China introduced its first comprehensive merger control clearance process under the PRC Anti-Monopoly Law, the concept of a parallel national security review process for inbound investment was floated. Article 31 of the Anti-Monopoly Law specifically states:

> "*Where the acquisition of domestic enterprises or the participation in concentrations by foreign investors via other means involve national security, it shall, apart from being subject to a review of the concentration in accordance with the Anti-Monopoly Law, also be subject to national security scrutiny in accordance with relevant national laws and regulations.*"

However, no further steps were taken to put in place the agency or procedural rules to conduct a national security review. That is, until just recently.

National security reviews launched in China

On 12 February 2011, China's State Council (the highest executive organ of State power) finally issued the Notice on Establishing a Security Review System for Mergers and Acquisitions of Chinese Enterprises by Foreign Investors, under which acquisitions involving Chinese assets can be reviewed by a ministerial-level review committee on national security grounds. Sectors as broad-ranging as military-related activities, key agricultural products, key energy or natural resources, key infrastructure and transportation services, key technologies and key equipment manufacturing activities could all trigger a review, and if deemed to raise national security concerns, can be rejected. Any deal that proceeds without the relevant Chinese government approval may be unwound on national security grounds.

CFIUS' rejection of 3Leaf – coincidental timing?

As many commentators have noted, similar national security regimes already exist in other countries, in particular the well-known national security clearance process of the Committee on Foreign Investment in the US (CFIUS) . What has been less debated is the timing of China's new national security review rules and what this might say about how China will apply its new powers. Why now?

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Here it is interesting to look at the hardly coincidental timing of yet another CFIUS rejection of a Chinese company's bid for assets. On 11 February 2011, just one day before China's national security rules were published, CFIUS advised Huawei to withdraw its already completed acquisition of the cloud computing assets of 3Leaf Systems or face a divestiture order from President Obama. On 21 February 2011, the Ministry of Commerce of the People's Republic of China (MOFCOM) took the highly unusual additional step of criticising the CFIUS decision, saying "the acquisition of 3Leaf's technology assets is a normal business activity of Huawei based on the principles of market economy and its own development needs, and we regret the case result."

In this note, we consider the possible reasons for CFIUS' action and the potential implications for foreign investors should China's new rules be applied in some form of political tit-for-tat between the Chinese and US governments.

How does CFIUS work?

The CFIUS process differs from other US clearance procedures (such as the Hart-Scott-Rodino antitrust regime) because it is voluntary. Specifically, the clearance process enables transaction parties to obtain comfort pre-closing that CFIUS will not later object to a foreign acquisition on national security grounds. Parties can decide for themselves, however, whether to contact CFIUS or proceed on the basis that CFIUS would be unlikely to assert jurisdiction or concerns over their transaction in any event.

Despite the words in the statute, however, CFIUS undoubtedly expects that parties who purport to be good corporate citizens and committed to good relations with the US government will notify transactions that they anticipate might be of interest to CFIUS, and not complete those transactions until CFIUS has cleared them. Failure to observe this unwritten protocol does not violate any laws, but does have the effect of antagonizing CFIUS, as demonstrated by the outcome of the 3Leaf case.

The Huawei / 3Leaf case

Huawei has stated publicly that it did not notify the deal because it concluded that CFIUS had no jurisdiction over the purchase of a collection of assets rather than an entire business. Huawei may also have been influenced by the size of the acquisition, which was priced at only USD2 million. Unfortunately for Huawei, although the CFIUS regulations are not entirely clear on this point, they do provide CFIUS with a basis to assert jurisdiction in such cases. The consequences for Huawei have been serious. CFIUS exercised its authority to self-initiate an investigation of the acquisition post-closing, determined that US national security required a divestiture, and offered CFIUS the choice of a voluntary liquidation of the relevant assets or a Presidential order requiring that outcome. Such post-closing interventions and directives from CFIUS are rare but not unprecedented, as Huawei and Chinese investors generally are now reminded.

Implications

Because Huawei already had months of access to the 3Leaf technology post-closing, it is difficult to see how the divestiture could actually improve US national security in any real sense. Rather, by forcing the asset divestiture, CFIUS appears to have used the opportunity of Huawei's miscalculation to signal to all future investors that: (1) "voluntary" notification is not so voluntary after all; and (2) the standard of review will be very harsh indeed if CFIUS believes that parties may have intentionally closed a deal without notifying CFIUS in cases in which (a) China or another country of concern is involved, and (b) the assets are potentially sensitive.

The CFIUS legislation imposes a two-part test for a decision by the President to block or unwind a transaction, as follows:

The President may exercise the authority to block/unwind only if the President finds that—

(a) there is credible evidence that leads the President to believe that the foreign interest exercising control might take action that threatens to impair national security; and

(b) provisions of law, other than this section and the International Emergency Economic Powers Act, do not, in the judgment of the President, provide adequate and appropriate authority for the President to protect national security in the matter before the President.

The second part of the test is often overlooked in practice but very important in interpreting the rationale for unwinding the 3Leaf acquisition. The United States maintains strict laws against (1) economic espionage and sabotage, (2) tampering with or disrupting communications networks, (3) transferring classified or sensitive technologies to foreign countries without an export license, etc. Thus, the reasons usually assigned to the opposition within CFIUS to acquisitions of US assets by Huawei do not actually justify blocking of such acquisitions under the CFIUS statute. Rather, by reference to the 11 criteria provided under the statute for the President to block acquisitions, the one that appears potentially most relevant to Huawei and that cannot be addressed under other existing laws is as follows:

> "The potential effects of the proposed or pending transaction on United States international technological leadership in areas affecting United States national security."

This criterion may provide an important clue to at least one of the reasons for the extreme opposition to Huawei within CFIUS. CFIUS may potentially regard any commercial advantage to Huawei as a disadvantage to the competing US champions such as CISCO, Motorola, etc, under the theory that technological leadership is a zero sum game. Because leadership in telecoms and internet technologies is considered extremely important to US national security, CFIUS may have felt justified to use its power to restrain Huawei even if the US Government would be reluctant to express such thinking publicly given its traditional doctrine of open markets and free trade.

But even Adam Smith acknowledged that national security is the only legitimate rationale for protectionism (timbers for the British Navy back in those days). The problem, of course, is that national security is not, for the most part, a legal concept but rather a public policy concept and thus can be abused in its application. Here, both the US and Chinese governments need to tread a careful path.