ALERT MEMORANDUM

COVID-19: CFIUS Considerations for Distressed M&A and Lending Transactions

May 8, 2020

The COVID-19 pandemic has created market conditions ripe for increased cross border investment as businesses scramble for capital and investors target distressed assets. In response, countries are using existing or new foreign direct investment (**FDI**) review tools to protect sensitive domestic industries and other interests. For example, the European Commission recently called upon its member states to use (or implement) FDI screening tools to protect European strategic assets[1] and Australia's Foreign Investment Review Board lowered the monetary threshold for FDI review to zero, thereby subjecting all foreign investments into Australia to review by the FIRB.[2]

The Committee on Foreign Investment in the United States (**CFIUS**) is no exception. Senior Department of Defense officials have recently and repeatedly stressed the need for the active use of CFIUS reviews to protect against "adversarial capital coming into our markets for nefarious means" [3] during the current economic crisis, stating "we simply cannot afford this period of economic uncertainty to lead to loss of American know-how on critical technologies."[4]

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Against this backdrop, U.S. businesses and foreign investors must be mindful of the CFIUS implications of acquisitions and financing transactions. We summarize below key CFIUS considerations for M&A activity and the exercise of creditors' rights—including under pre-existing agreements—in the current environment and under CFIUS's recently revamped rules.

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[1] For further information, please see our recent alert memo. Cleary Gottlieb, *European Commission Urges Member States to Protect Suppliers of Essential Products from Foreign Takeovers* (Apr. 2, 2020), *available at* https://www.clearygottlieb.com/news-and-insights/publication-listing/european-commission-urges-member-states-to-protect-suppliers. Additional information regarding Cleary Gottlieb's global FDI practice can be found at: https://www.clearygottlieb.com/practice-landing/foreign-investment-review.

[2] The Hon. Josh Frydenberg MP, *Changes to Foreign Investment Framework* (Mar. 29, 2020), *available at* https://ministers.treasury.gov.au/ministers/josh-frydenberg-2018/media-releases/changes-foreign-investment-framework.

[3] U.S. Dep't of Defense, *Transcript: Department of Defense Acquisition and Sustainment Leaders Hold a Press Briefing on the Defense Department's COVID-19 Acquisition Efforts* (Mar. 25, 2020), *available at* https://www.defense.gov/Newsroom/Transcripts/Transcript/Article/2125737/department-of-defense-acquisition-and-sustainment-leaders-hold-a-press-briefing/.

[4] Federal Computer Week, *DOD Hopes Small Business Engagement Will Stave Off 'Adversarial Capital,'* (May 4, 2020), *available at* https://fcw.com/articles/2020/05/04/dod-adversarial-capital-williams.aspx.

I. CFIUS Considerations for Distressed M&A Transactions

A. Potential Mandatory Notifications

The first CFIUS-related question in any transaction is whether a mandatory notification is required, which can affect the overall timing of the investment. Regulations implementing the Foreign Risk Review Modernization Act of 2018 (**FIRRMA**) introduced limited mandatory filings to the historically voluntary CFIUS process.[5] Those include: (i) investments that provide a foreign person with "control" (a standard far short of actual control and encompassing almost any significant governance rights) over or certain types of non-controlling rights in U.S. businesses that produce, design, test, manufacture, fabricate, or develop critical technology (a subset of export-controlled technologies) that is used in or specifically designed for use in specific industries;[6] and (ii) acquisitions by investors at least 49% owned by a foreign government of at least a 25% stake in U.S. critical technology businesses, U.S. critical infrastructure businesses, and U.S. businesses that maintain or possess sensitive personal data (known as **TID U.S. businesses**, for technology, infrastructure, or data).[7]

Parties to any transaction subject to a mandatory notification requirement must notify CFIUS at least 30 days before closing or face potential penalties of up to the value of the transaction. Notifications can take the form of a declaration (which essentially is a short-form CFIUS notice with basic information regarding the transaction) or a traditional full CFIUS notice. Filing a short-form declaration immediately starts a 30-day assessment period (in contrast to full notifications, which are effective only after CFIUS accepts the notice). There is no automatic "safe harbor" at the end of the 30-day review; while CFIUS can provide a clearance resulting in a safe harbor, it can also request a full filing or reach no decision.[8] However, unless CFIUS issues a very rare interim order prohibiting the parties from closing the transaction, the parties are free to close the investment—even in the case of a mandatory filing—30 days after a declaration is filed, taking the risk that CFIUS may later impose mitigation measures or require divestiture of the investment. CFIUS staff have also previously warned that closing a transaction while CFIUS review is still pending may limit the mitigation measures that are practically feasible and increase the risk of more radical measures (the parties may also close the transaction while a full notification is pending.)

B. Discretionary CFIUS Reviews

It is perhaps easier to think of reviews outside the mandatory filing provisions as "discretionary" rather than "voluntary." If parties do not submit a notification to CFIUS, CFIUS can still decide to review and impose mitigation measures on a transaction, before or after it closes. The challenge for the investor, then, is to identify and assess the risk of transactions that may be of interest to CFIUS, and then to weigh that risk against the cost and delay of a CFIUS filing.

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[5] For a summary of the final regulations implementing FIRRMA, please see our client alert. Cleary Gottlieb, *CFIUS Releases Final FIRRMA Regulations* (Jan. 22, 2020), *available at* https://www.clearygottlieb.com/-/media/files/alert-memos-2020/cfius-releases-final-firrma-regulations.pdf (the **FIRRMA Memo**).

[6] The list of industries and related NAICS Codes is included as an appendix to the final FIRRMA regulations. 31 C.F.R. Part 800, Appendix B. For more information, see the FIRRMA Memo at 3, 6, 16.

[7] This mandatory notification requirement applies to virtually all state-owned or controlled investment entities other than a narrow range of entities linked to Australia, Canada, and the United Kingdom. *See* 31 C.F.R. § 800.401(e)(1).

[8] Declarations are now available for all transactions within CFIUS's jurisdiction but are subject to the noted limitations.

Transactions CFIUS can review. CFIUS generally has jurisdiction over investments giving rise to "control." However, CFIUS has long interpreted "control" as something more akin to "substantial influence." CFIUS's regulations provide a presumptive (not absolute) safe harbor from review when an investor acquires less than 10% of a target and is solely passive—voting its shares, but with no rights to board representation, consent rights over significant decisions, etc.[9] Although the regulations do not say that anything outside of that safe harbor is reviewable, we are aware of public examples in which CFIUS has asserted jurisdiction over acquisitions of as little as 15% of a public company with appointment of a single director, and no other substantial governance rights. Any investment accompanied by governance rights, especially if the investment is not purely financial and substantive cooperation with a strategic acquirer is expected, should be evaluated for potential CFIUS concerns. Moreover, following FIRRMA, investments in TID U.S. businesses are subject to an even lower standard for review that can be triggered by consultation on any substantive business decision or access to material non-public technical data.[10] Following FIRRMA, CFIUS has been enlarged and reorganized to significantly increase resources devoted to identifying and looking into non-notified transactions of interest, and such inquiries are much more common than in the past (particularly for acquisitions of startup and early-stage companies).

Foreign investors should also bear in mind that follow-on investments in a U.S. business where the original investment was within CFIUS's jurisdiction, but was not reviewed and cleared as an acquisition of "control," can result in CFIUS review. This is particularly relevant for investors contemplating providing liquidity to distressed U.S. businesses in exchange for additional rights or equity. Although CFIUS scrutiny of a follow-on investment would be relatively unusual, CFIUS could review both the increase in rights resulting from the new investment, and, if the original investment was not notified, the original investment as well.[11] A follow-on investment may draw CFIUS's attention to a previously unreviewed transaction.

Cost and timing of reviews. CFIUS has recently introduced filing fees of up to $300,000,[12] but the real cost of CFIUS review is the time required. As a practical matter, completing a CFIUS review can take four to eight months or longer.[13] Although CFIUS is operating and accepting new filings while government operations are restricted, inevitably remote work has had an unpredictable impact on the length of reviews. As noted, parties may choose to close over CFIUS review, particularly in cases of minimal sensitivity, but buyers are often reluctant to do so when the restrictions that may be placed on the investor's operation and integration of the U.S. business

[9] *See* 31 C.F.R. § 800.302(b). Only transactions that are "solely for the purpose of passive investment" qualify for this presumptive safe harbor.

[10] *See* the FIRRMA Memo at 9-10.

[11] There is a presumption that investments older than three years will not be reviewed, although the Secretary of the Treasury has the power to approve a review even in that case. *See* 31 C.F.R. § 800.501(d).

[12] 85 Fed. Reg. 23736 (Apr. 29, 2020). For further information on the filing fee rules, please see our client alert. Cleary Gottlieb, *CFIUS Imposes Filing Fees* (Apr. 29, 2020), *available at* https://client.clearygottlieb.com/36/1658/uploads/2020-04-29-cfius-imposes-filing-fees.pdf.

[13] Preparation of the filing itself can take some time. Once a draft is complete, the parties typically submit the draft to CFIUS for review, which can take two weeks or more. Even after the revised draft is submitted, the formal review does not begin until CFIUS accepts the filing, which can take some time. CFIUS then has 45 days for an initial review, at the end of which CFIUS can either clear the transaction or initiate a second-stage investigation lasting an additional 45 days, extendible to 60 in "extraordinary circumstances." Even then, CFIUS can pressure parties to "voluntarily" withdraw and resubmit a filing if the review is not complete, which restarts the statutory clock back to the initial 45-day review. *See* 31 C.F.R. § 800.509. At the conclusion of the investigation, CFIUS will either issue a letter clearing the transaction or refer the transaction to the President, who then has 15 days to rule on the transaction. *See* 31 C.F.R. § 800.501, 503, 505-508.

remain unclear, or even whether the buyer may be forced to divest the asset (under time pressure and for an uncertain price).[14]

Areas of interest. While CFIUS's mission is not economic protectionism, and this has remained true during the Trump Administration, the COVID-19 crisis is likely to lead to additional scrutiny in a number of areas:

- ***Healthcare***. Targets involved in pharmaceuticals, biotechnology, medical equipment, and other sectors directly relevant to the pandemic are likely to receive additional scrutiny.

- ***Supply chains***. CFIUS has long been concerned about supply chain vulnerabilities for the government contracting sector. The COVID-19 crisis has underscored the dependency of key U.S. industries on overseas supply chains for goods such as ventilators.

- ***Recipients of government contracts and funding***. CFIUS gathers information about (and has jurisdiction over) recipients of priority orders and funding under the Defense Production Act, which has been invoked a number of times for pandemic-related goods.[15]

- ***Food security***. There have been a number of proposals over the past several years to formally expand CFIUS's jurisdiction to include food security. While these have been unsuccessful, disruptions of the food supply chain (which falls within CFIUS's broader "critical infrastructure" remit) may lead to increased focus on transactions in this sector.

On top of these areas, CFIUS already had a very broad conception of "national security." Particularly relevant here is CFIUS's recent focus on access to sensitive personal data and biotechnology, but CFIUS retains its broad range of concerns regarding potential technology transfer, espionage, and sabotage vulnerabilities in a wide range of sectors including government and defense contracting, high technology, and "critical infrastructure," very broadly defined.[16]

[14] Typically when a divestiture is ordered, the foreign investor is required to hold the asset separate, its control rights are limited, and it is required to divest the asset to an approved buyer within a specified period of time. The transaction is not rescinded; the seller is under no obligation to return the purchase price.

[15] CFIUS requires parties to disclose in both short-form declarations and full notifications whether the U.S. business has received or placed priority rated contracts or orders under the Defense Priorities and Allocations System within the past three years. 31 C.F.R. § 800.404(c)(14); 31 C.F.R. § 800.502(c)(3)(vii). Receiving certain priority-rated orders or Defense Production Act funding makes a U.S. business "covered investment critical infrastructure," which only has a formal impact on a narrow range of foreign government-linked transactions but is indicative of CFIUS's focus on the issue. *See* 31 C.F.R. Part 800, Appendix A.

[16] The National Infrastructure Protection Plan, based on a definition of "critical infrastructure" paralleling that used by CFIUS (systems and assets so vital that their incapacity or destruction would have a debilitating impact on national security) focuses on sixteen critical infrastructure sectors: chemical; commercial facilities; communications; critical manufacturing; dams; defense industrial base; emergency services; energy; financial services; food and agriculture; government facilities; healthcare and public health; information technology; nuclear reactors, materials, and waste; transportation systems; and water and wastewater systems. *See* Cybersecurity and Infrastructure Security Agency, *Critical Infrastructure Sectors* (Mar. 24, 2020), *available at* https://www.cisa.gov/critical-infrastructure-sectors; Presidential Policy Directive 21 (Feb. 12, 2013). While not every transaction relating to any of these sectors in any way will raise CFIUS issues, the list gives a sense of the range of possible national security concerns.

C. Transaction Planning and Structuring

In light of the above, parties planning potentially sensitive M&A transactions would be wise to consider potential CFIUS issues (and not to assume that, "in these times," all investments will be welcome).

Impact of CFIUS on contested transactions. CFIUS issues may have a significant impact on both auctions and hostile transactions. In auction situations, sellers have often effectively discounted bids by foreign acquirers because of perceived CFIUS risk, and rival U.S. bidders have in the past sometimes attempted to generate national security-related concerns with respect to a foreign bidder. While competitors or other bidders have no direct role in the CFIUS process and CFIUS maintains a healthy skepticism of and hostility toward attempts to use its process as a competitive lever, if there are legitimate potential national security concerns, parties must take into account the possibility that others will spotlight them. The risks are heightened in the case of hostile transactions, where there are two issues for prospective acquirers to consider. First, the target company knows its own business and the issues its activities may raise best, and unlike competitors it does have standing to make a unilateral filing seeking CFIUS review of a transaction. Second, if the acquirer attempts to make a CFIUS filing (either of its own accord or at the government's request), it may well not receive full cooperation from the target, and CFIUS has at times been reluctant to proceed on the basis of incomplete information (even though a unilateral filing is contemplated by its rules).

Structural approaches to limiting CFIUS risk. If a transaction involving a foreign investor is potentially sensitive, the parties may wish to consider alternative transaction structures to eliminate the possibility that a foreign investor would exercise control. Restructuring can take place before the transaction, to eliminate the need for CFIUS review or at least make it easier, or as mitigation during a CFIUS review (although negotiated mitigation generally results in a long CFIUS review and greater uncertainty of outcome). Note that these mechanisms should be structural; merely appointing a board of retired U.S. generals and admirals is unlikely to be effective if there are no constraints on their replacements:

- **Limitations on governance rights**. Non-voting shares, structuring supermajority rights so that no single investor can block a decision, restrictions on information rights, and other measures are all possible means by which CFIUS issues arising from a foreign investment can be mitigated (assuming that the foreign investor is willing to be a passive investor as a business matter). The U.S. investment could, if the global integration of the business allows it, be treated separately from other businesses.

- **Preferred or debt investments**. To the extent the investment is purely financial and governance rights are not significant to the investors, economically senior investments without significant influence over governance are less likely to attract CFIUS scrutiny. In particular, as discussed below, typical debt covenants have not historically been treated as control rights.

- **Strategic divestiture**. The sensitive portions of the U.S. business, or the U.S. business generally, could be excluded from the transaction or sold separately to U.S. or low-risk foreign buyers.

- **Consortia and investment funds**. CFIUS views traditional private equity funds as not being controlled by their limited partners, so long as the individual limited partners are truly passive with respect to portfolio companies and do not have the ability to make or block major decisions of the fund.[17] It is also possible to create an ad hoc consortium vehicle in which non-U.S. investors are passive or have limited

[17] *See* 31 C.F.R. § 800.208(e)(7)-(8); 31 C.F.R. § 800.307.

governance rights (although, for higher risk investors, strategic links such as joint R&D will also be sensitive).

In addition, there are a number of techniques that have been used to allow an immediate injection of capital while deferring CFIUS review of the acquisition of governance rights (though these structures must take into account the possibility that CFIUS approval cannot be obtained on commercially acceptable terms):

- **Two-step closing**. Parties could consider two-step transactions with a first step including a financial, completely passive investment and a second step, which would only close after receipt of CFIUS clearance, including acquisition of governance rights over the U.S. business. Although a two-step closing may be useful in a distressed environment, investors risk holding only a passive stake if CFIUS does not clear the transaction.[18]

- **Convertible debt**. Investors could receive secured debt in exchange for capital. These investments could be structured to convert to an equity instrument with governance rights post-CFIUS clearance. Again, any such vehicle must ensure that the initial note does not provide the lender with control or the types of non-controlling rights that could trigger CFIUS jurisdiction.

II. CFIUS Considerations for Creditors' Rights

The risk that CFIUS poses to non-U.S. secured lenders (whether lending during the COVID-19 crisis or considering execution on collateral of defaulting companies) is often underappreciated and should be evaluated well in advance. CFIUS has discretion to review acquisitions of contingent equity interests, including security interests in equity.[19] However, in the case of lending transactions (or acquisitions of preferred equity), CFIUS generally will review the potential execution on those interests "only at the time that, because of imminent or actual default or other condition, there is a significant possibility that the foreign person may obtain control of a U.S. business."[20] Therefore, foreign lenders and preferred shareholders must plan for CFIUS review as a possible obstacle to assumption of control over a defaulting company. CFIUS's powers to review transactions also extend to sales in bankruptcy, despite the involvement of the courts.[21]

Most importantly, if the acquisition of control over the borrower is subject to a mandatory notification requirement, that requirement and the 30-day waiting period apply to default situations. In the release adopting the final FIRRMA regulations, CFIUS noted that, in its view, efforts to cure any default and execute upon collateral or otherwise exercise rights to assume control generally last longer than 30 days and, therefore, should allow a filing to be completed.[22] While CFIUS also indicated that exigent circumstances would be taken into

[18] Note that there is a technical issue with the definition of "completion" of a transaction that must be taken into account in a two-step structure to which a mandatory notification requirement is applicable. The "completion date" of a transaction is "the earliest date upon which any ownership interest, including a contingent equity interest, is conveyed." 31 C.F.R. § 800.206; *see also* 31 C.F.R. § 800.401(g) (mandatory notification must be submitted 30 days prior to the completion date). The 30 day notification therefore may still be required if the investor has a contractual right to acquire the second-stage investment. However, the two-step structure still should help allay any substantive concerns.

[19] 31 C.F.R. § 800.308.

[20] 31 C.F.R. § 800.306(a)(1).

[21] *See* 31 C.F.R. § 800.213 note 1; 31 C.F.R. § 800.306(d)(2).

[22] U.S. Dep't of the Treasury, *Provisions Pertaining to Certain Investments in the United States by Foreign Persons*, 85 Fed. Reg. 3112, 3120 (Jan. 17, 2020).

account in determining whether to assess a monetary penalty for violating the 30-day notice requirement, creditors of distressed companies would be well advised to assess whether a mandatory CFIUS filing is required, and to plan for it, as early as possible (as preparing a notification also takes meaningful time, especially without full cooperation from management of the distressed borrower). The relevant point for assessment is at the time of exercise, not the time of the loan, so even secured loans extended prior to the creation of notification requirements pursuant to FIRRMA may now be subject to mandatory review.

Aside from the procedural issue of mandatory notifications, there remains the substantive risk of CFIUS review and restrictions on the control rights of, or requirements to divest imposed upon, non-U.S. secured parties. Holders or potential acquirers of interests in distressed companies should evaluate any CFIUS risks, and the advisability of a voluntary filing, as if they were equity buyers well in advance of execution. (To the extent the secured party wishes to dispose of the asset as soon as possible, CFIUS considerations may also affect the market for the asset.)

Secured parties may also want to consider advance arrangements to mitigate CFIUS risks in connection with execution upon interests in sensitive companies. The main additional option available in this context is to attempt to find a U.S. party to manage the asset pending disposition independently of the foreign secured parties, who would nevertheless retain their economic stakes. Options include arrangements to transfer control and management of the U.S. business to a U.S.-national independent trustee upon default or, where there is a lending or investing consortium including U.S. persons, placing operating control solely with those persons to manage in the economic interest of the consortium. Because default mechanisms for past transactions generally cannot be changed, it may be difficult to avoid CFIUS review altogether, but parties can plan in advance to quickly address any issue. To the extent new loans are being made (or loan documents amended), CFIUS's rules explicitly provide for similar mitigation measures, stating that the acquisition of a voting interest in or the assets of a U.S. business by a foreign lender is not reviewable if it is acquired as part of a syndicate of banks and (a) any action by a foreign lender requires the consent of a majority of U.S. lenders, or (b) the loan or financing documents limit the foreign lenders' ability to exercise control over the debtor or exercise any access, governance rights, or substantive involvement in a TID U.S. business.[23]

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For further discussion of CFIUS and other FDI issues in distressed investments, please contact Paul Marquardt, Chase Kaniecki, our Foreign Investment Review team, or any of your regular Firm contacts.

[23] In the context of a syndicated loan made by foreign and U.S. banks, exercise of any default rights may not be subject to CFIUS review so long as the relevant financing documents include advance arrangements barring foreign lenders from exercising control over the debtor (or from exercising any qualifying access or rights over a TID U.S. Business). 31 C.F.R. § 800.306(c).