

Export Controls Claim Spotlight as CFIUS Shifts Its Approach

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When the coronavirus pandemic hit and a corresponding economic downturn followed, many dealmakers temporarily abandoned their M&A plans for greener post-recovery pastures. Still others opted to seize the unprecedented opportunity to capitalize upon distressed businesses and are now doubling down on their investment strategy.

With experts predicting a surge of M&A activity on the horizon, recently proposed changes to the approach of the Committee on Foreign Investment in the United States (CFIUS) may make it easier for foreign dealmakers looking to invest in U.S. businesses to anticipate CFIUS reviews and best-position their transactions for success with a proactive look at their targets' export controls classification.

Additional CFIUS Scrutiny Now In Place

Congress significantly expanded CFIUS's jurisdiction in several ways in 2018 and final implementing regulations went into full effect earlier this year. The Foreign Investment Risk Review Modernization Act (FIRRMA) has significantly added to the type, and number, of transactions that will be subject to review.

Since its inception in 1975, CFIUS has worked as an inter-agency committee of the U.S. government to review the national security implications of foreign investments in American companies or operations. Before February 2020, CFIUS reviewed only those transactions in which a foreign entity intended to buy a controlling interest in a U.S. business.



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Now, CFIUS is responsible for reviewing non-controlling investments by foreign entities, where the investment gives those entities access to material, non-public technical information or provides management control such as veto rights or a board seat. Second, CFIUS also is empowered to review real estate transactions near sensitive government facilities. Third, FIRRMA requires mandatory filings for investments in U.S. businesses that involve “critical technologies,” and CFIUS has identified technologies in 27 categories as defined by North American Industry Classification System (NAICS) codes as “critical.”

As a result, many more investors in and sellers of U.S. businesses, technology, and real estate need to be concerned about a CFIUS review of their transactions.

NAICS to be Replaced by Export Controls

The breadth and timing of these changes caused challenges almost immediately upon implementation. The NAICS codes were vague and subject to interpretation, resulting in significant uncertainty and possible risk for businesses and investors. These deficiencies quickly became apparent.

The Committee will soon utilize the U.S. export control classification, rather than NAICs, for services or products to determine if export-controlled critical technology is in play and, therefore, a review is required. This change recognizes that export classifications already consider variables such as national security, foreign policy, limited supply, and other national policies.

How Dealmakers and Their Counsel Can Prepare

Now more than ever, foreign investors and their deal teams must take a proactive look at export classifications, and licensing and authorization

requirements under the International Traffic in Arms Regulations (ITAR); the Export Administration Regulations (EAR); and export, import, and assistance regulations covered by the U.S. Department of Energy and the U.S. Nuclear Regulatory Commission that apply to a subject business. This assessment will help determine whether the transaction involves “critical technologies” and, therefore, triggers the mandatory CFIUS filing obligation.

It is important to note that certain license exceptions will eliminate the need for a mandatory CFIUS filing, particularly if the products pose a lower risk of unauthorized or impermissible end uses. Third-party experts, especially those with firsthand global trade controls and CFIUS expertise, are invaluable in this evaluation and can offer recommendations to help prevent future transaction failures.

Further, while CFIUS’ new export control classification criteria are more transparent, dealmakers should also expect confidential scrutiny by the U.S. government of business partners and investors, and reviews of the entity’s prior export controls compliance track record. Investigation into past compliance behavior, along with intelligence-gathering on individuals’ backgrounds and relationships is not uncommon.

Experts in compliance and investigations can be helpful in pre-deal review risk evaluation, in considering the likely scope and timing of a review, and in positioning if under review. Businesses might consider a third party to conduct an independent “mock audit,” holistic compliance program review, or both to determine if any ongoing relationships or past transgressions present a potential national security risk from the Committee’s perspective. These experts can also be tapped to provide objective insight on potential supply chain and third-party risks that could affect deal ROI.

Export Controls and Mitigation

Historically, CFIUS has approved most transactions.

In many cases, however, CFIUS approval comes with an agreement requiring processes and procedures to mitigate any perceived threat to national security. The percentage of cleared transactions which include mitigation agreements has been increasing in each of the past three years.

Experience to date shows us that companies with significant export controls are likely to have some form of mitigation. These agreements can have significant operational and competitive impact and, thus, should be carefully and completely evaluated to set-up the business for success post-CFIUS approval. For example, mitigation agreements often have provisions requiring specified operational

procedures. These provisions are negotiable and can also provide a company with the opportunity for innovation and competitive advantage, if framed correctly.

What's Next for Foreign Investors

The 2020 global pandemic has disrupted industries and economies across the world, and yet the pace of transactions continues; foreign investors and their counsel must keep pace with CFIUS' evolving scope and approach to avoid transaction failures. While the change to export classification provides more clarity, the Committee will be watching closely in deals involving cutting-edge technology, sensitive data, critical infrastructure, and investments in real estate near sensitive government facilities.

About the Authors

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