

CFIUS Rejects Chinese Acquisition in U.S.

April 5, 2011

Background on the Huawei Transaction

In mid-February, the Committee on Foreign Investment in the United States ("CFIUS") informed Huawei Technologies Co. ("Huawei") that it should unwind its recent purchase of certain assets from 3Leaf Systems ("3Leaf"), a California-based company which provides technology for cloud computing. CFIUS conducted a review and a follow-on investigation of the purchase pursuant to the "Exon-Florio" statute, which provides the President with the power to block certain foreign acquisitions, takeovers or mergers that he determines threaten national security. After the investigation, CFIUS informed Huawei that it would have to divest the assets or CFIUS would recommend to the President that he order the parties to unwind the transaction. Although Huawei initially decided to await the President's decision, it ultimately agreed to divest the assets beforehand.

Huawei and 3Leaf did not initially submit the transaction for CFIUS review prior to Huawei purchasing the assets from 3Leaf in May and July 2010, for approximately \$2 million. Reportedly, the parties concluded that the asset purchase was not covered because Huawei did not acquire all of 3Leaf's assets. Furthermore, according to certain reports, after the purchases closed, CFIUS asked Huawei to seek approval for the completed transaction and Huawei voluntarily filed in November.

Huawei has long raised concerns within the U.S. government. Certain members within the U.S. government believe that Huawei is closely connected to China's People's Liberation Army, particularly since, Huawei's founder and current chief executive officer was once a member. Huawei's prior transactions in the U.S. have also failed. In 2008, Huawei's proposed acquisition of 16% of 3Com Corp. was unsuccessful because CFIUS stated that it would recommend that the transaction be rejected. In late 2010, Huawei was also reportedly removed from consideration for a major equipment contract with Sprint Nextel Corp. ("Sprint") after the U.S. Commerce Secretary called Sprint's chief executive officer to express concerns. In August 2010, eight Republican senators had also sent a letter to several U.S. government officials, including the Secretary of the Treasury, expressing national security concerns about the possible supply contract.

The Huawei transaction is the third reported acquisition by a Chinese company that CFIUS has not approved since late 2009. It is important to note that CFIUS proceedings are confidential and, as a result, there could be additional acquisitions by Chinese companies that CFIUS has not approved. In December 2009, CFIUS was poised to block a proposed 51% investment by a Chinese government-controlled company, Northwest Ferrous International Investment Company, in a Nevada gold mining company, Firstgold Corp., allegedly due to the proximity of the target's mining facilities to a naval air station and other nearby sensitive military installations and assets. The parties withdrew the CFIUS notice on the day the transaction was to be referred to the President. In June 2010, New Mexico-based EMCORE Corporation ("EMCORE") and Chinese investment company Tangshan Caofeidian Investment Corporation withdrew their joint CFIUS filing with respect to a proposed sale of an

interest in EMCORE's fiber optics business, because CFIUS expressed certain regulatory concerns.

Background on CFIUS

The U.S. government generally welcomes and encourages foreign investment in U.S. companies, so long as national security and critical infrastructure and technology are not threatened. Huawei is not an indication that the U.S. government is generally closed to Chinese investment. Rather, Huawei is a unique example of the government's longstanding concern over a particular company with strong ties to a foreign government and access to critical U.S. infrastructure. Huawei's persistent difficulties with CFIUS illustrate how not to approach a foreign investment or acquisition in a U.S. company.

Filings with CFIUS are not mandatory. However, parties obtain a safe-harbor for their transaction by voluntarily submitting to CFIUS' confidential vetting process. CFIUS performs a 30-day national security review of foreign acquisitions of U.S. businesses for any national security implications and if red flags are raised, CFIUS conducts a second-stage, 45-day investigation. If concerns are still not relieved, the President has an additional 15 days to review or block the transaction.

A U.S. President has ordered divestiture pursuant to the "Exon-Florio" statute only once before. In 1990, President George H.W. Bush ordered China National Aero-Technology Import & Export Corporation to divest itself of a U.S. aircraft parts manufacturer, Mamco Manufacturing Co. Typically, if CFIUS advises a potential foreign acquirer that it will recommend that the President prohibit the consummation of a transaction, the acquirer will voluntarily abandon the transaction or divest the U.S. business or assets.

Conclusion

The Huawei transaction confirms CFIUS' longstanding assertion that there are no bright-line standards applied in determining whether a transaction raises foreign control or national security concerns. Such cases are determined on a case-by-case basis and U.S. companies and foreign investors should undertake a pre-acquisition internal analysis to determine whether CFIUS review is warranted, or if one is desired to provide a safe harbor from post closing review and challenge.

Kelley Drye Experience with CFIUS Reviews

Kelley Drye is frequently called upon by both domestic and international clients to provide advice on the regulatory issues associated with foreign investment, including corporate mergers, acquisitions, divestments or other commercial investments requiring CFIUS review and filings. Companies and their counsel should consider notifying CFIUS of a transaction if it will allow a foreign entity to control a U.S. company and the transaction could potentially raise political or national security related concerns. For example, investors from countries such as China, Russia and certain Middle East countries may likely receive heightened scrutiny. Moreover, companies should consider notifying CFIUS of proposed transactions involving "critical infrastructure" which is defined as certain systems and assets so vital to the United States that the degradation or destruction of such systems or assets would have a debilitating impact on national security, including national economic security and national public health or safety.