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Investments in the U.S. Energy Sector: CFIUS and the Role of the CFIUS Process

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Mergers, acquisitions, joint ventures, and other forms of investment by foreign persons in the United States continue to increase in the current global economy.

Oil and gas prices have declined considerably since July 2014, and with them the market value of traditional and unconventional oil and gas assets and related service providers. Where will prices be one, five, ten or twenty years from now? Many investors view economically recoverable resources as scarce assets whose value will increase over time. Others believe that the discovery of unconventional assets, the development of enhanced recovery technologies, and the greater use of renewable technologies has changed the game forever. Whoever is right, and whenever there is a difference in view as to value, there is an arbitrage play and buyers and sellers will naturally emerge to create a market. Some of the buyers will focus on the U.S. market. While the figures vary from month to month, the United States is effectively tied with Russia for first place in gas production and tied for second place with Saudi Arabia in oil production, though the United States ranks somewhat lower in proven reserves of both resources. Foreign acquisitions of U.S. energy businesses raise potential U.S. national security and/or critical infrastructure concerns that merit careful planning and consideration.

CFIUS and its Increased Scrutiny of the Energy Sector

The Committee on Foreign Investment in the United States ("CFIUS" or the "Committee") advises the Executive Branch on the impact of investment in U.S. businesses by non-U.S. persons on U.S. national security interests. The creation of CFIUS illustrates the interconnection between national security and economic security. CFIUS is chaired by the U.S. Department of the Treasury. Fifteen Executive Branch agencies are formal members of the Committee, and they are empowered to consult with other agencies to review transactions in appropriate circumstances. The CFIUS review process is voluntary. If a non-U.S. person intends to acquire control of a U.S. business, the parties may seek clearance from the Committee for the proposed transaction to avoid the possibility that the President may require the foreign buyer to divest the business.

CFIUS originally focused on investments in companies whose technology had or could have military applications, particularly if the technology was such that its use by a potential adversary could place the United States or its allies at a military disadvantage. Investments in the energy sector were not originally of interest to CFIUS. However, following adoption of the Foreign Investment & National Security Act of 2007 ("FINSA") in 2007, which broadened the Committee's authority and expanded the list of areas where it considered "national security" issues to be potentially implicated to include critical infrastructure, including major energy assets, CFIUS has expanded its focus to include foreign investments in the U.S. energy sector. For transactions that lead to a non-U.S. entity gaining control of a U.S. business in the energy space, CFIUS now actively reviews and occasionally imposes conditions on the transactions.

Three recent examples discussed in further detail below illustrate this trend. In the CNOOC/Nexen case, rather than block the acquisition of a business involved in the oil and gas sector outright, CFIUS imposed conditions on the transaction. In the Ralls/Terna case, the President required divesture of the seemingly innocuous acquisition of wind farm projects in Oregon, even though CFIUS had taken no action in relation to prior wind project acquisitions by the same company. Finally, though CFIUS approved the acquisition of a sophisticated tech battery manufacturer in the Wanxiang/A123 case, CFIUS did so only after the government contracting business was excluded from the transaction.

- *CNOOC/NEXEN*. In 2012, CNOOC sought to purchase Canadian oil and gas company Nexen for US$15.1 billion. As with many Canadian energy companies, in addition to oil sands plays in Alberta, Nexen has substantial U.S. operations. The Canadian Ministry of Industry and other regulators were concerned about a Chinese state-owned enterprise owning such a large oil and gas player, and expressed the view that it was the last such large transaction that would be approved, in particular in relation to oil sands. For the U.S. portion of the business, even though the acquisition did not involve the acquisition of critical infrastructure per se, CFIUS' apparent concern was Nexen's exploration and production assets in the Gulf of Mexico. Specifically, some of Nexen's assets were located close to the Belle Chasse, Louisiana Naval Air Station, which is used extensively for training and transport, and various subsea telecommunications cables. The original CFIUS notice was withdrawn and resubmitted, which likely indicated that negotiations were underway, and provided CFIUS a face-saving way to conduct a more detailed investigation. While the conditions imposed by CFIUS were not disclosed, the conditions did not rise to the level of divestiture, and some believe that the CFIUS clearance may have been driven in part by a desire to show more openness than was shown when CFIUS rejected CNOOC's bid for UNOCAL several years earlier.

- *Ralls/Terna*. Ralls was an Oregon corporation owned by two PRC nationals. The owners also served as managers in the Sany Group, a Chinese manufacturer. In March 2012, Ralls purchased interests in four Oregon wind farm projects from Terna Energy USA Holding Corporation. Ralls wished to install

wind turbines manufactured by Sany as a test marketing effort in the United States. The site, however, fell within restricted airspace associated with the Whidbey Island Naval Air Station. No voluntary CFIUS notification was filed; the filing was made only in response to a CFIUS request. The U.S. Department of the Treasury also recommended that Ralls suspend construction, but Ralls proceeded. CFIUS extended the review period in light of national security concerns, and issued a mitigation order to cease construction and to limit site access to CFIUS-approved U.S. nationals. CFIUS then issued an amended order prohibiting the sale or transfer of items manufactured by Sany for use at the site and prohibiting the sale of the project companies without first providing CFIUS the opportunity to object to the buyer (and also requiring the removal of installed equipment before any sale). In response to a CFIUS recommendation, the President issued a Presidential Order prohibiting the parties from directly or indirectly owning or acquiring the project companies. The Order cited "credible evidence" that the parties, by "exercising control of the [project companies,] might take action that threatens to impair the national security of the United States." Ralls was ordered to remove structures within 14 days and to divest within 90 days. In September 2012, Ralls filed suit in U.S. District Court for the District of Columbia, asserting that both Orders violated the Administrative Procedures Act (APA) and the Exon-Florio amendment. The suit further claimed that requiring divestiture was an unconstitutional "taking" of property without due process of law. In October 2013, the District Court dismissed Ralls' remaining claims. The October ruling confirmed that the President holds broad authority under FINSA to take action when the President (acting through the Committee) determines that control of a U.S. business by a foreign person might "cause harm to U.S. national security." Judge Jackson rejected the assertion by Ralls that it had property rights that were subject to constitutional protections -- "Ralls undertook the transaction and voluntarily acquired [the] state property rights subject to the known risk of a Presidential veto." Further, the judge stated that Ralls had "waived the opportunity . . . to obtain a determination from CFIUS and the President before it entered into the transaction." Ralls was forced to divest itself of the wind farm projects.

- *Wanxiang-A123*. Wanxiang America, a subsidiary of China's largest automotive component manufacturer, sought to purchase the assets of A123 Systems Inc. from A123's bankruptcy estate in late 2012, after a prior deal with Wanxiang failed, triggering the bankruptcy. Members of Congress raised national security concerns because the deal would result in a non-U.S. competitor owning technology that they believed had been developed with U.S. government support. A123's business lines include electric-car batteries, energy generation, transmission and distribution products for the electrical grid, as well as products in telecommunications, industrial robotics, power tools, portable power solutions, unmanned aerial vehicles, pulsed power weapons and small energy cells for remote devices. In response to the national security concerns, A123 sold its government business to a U.S.-controlled company, and following CFIUS approval, Wanxiang America purchased the remaining automotive, commercial and grid assets for $256.6 million.

The recent, increasing scrutiny of energy sector transactions can be explained by the intersection of several factors.

1. First, with advances in unconventional recovery technologies and increasing non-U.S. interest in energy investments in the United States, the U.S. government is conscious that infrastructure can be vulnerable. U.S. networked systems, including energy grids and other assets, are potential targets for foreign-based cyber-attacks, and damage to upstream energy assets could lead to supply chain issues and environmental impacts.

2. Second, there appears to be considerable focus by CFIUS on the role of China. The three cases described above all involve China investing in U.S. domestic energy projects. The U.S. government has an interest in bolstering its position as China becomes an increasingly important economic player. At the same time, there are security concerns in some quarters arising from China's increasing prominence and assertiveness globally and China's presence in the U.S. energy market.

3. Third, CFIUS' internal structural dynamics have resulted in CFIUS focusing on the energy sector. In that regard, while trade-focused agencies try to minimize friction in energy investments by important trade and investment partners, their views appear to be accorded less weight in recent CFIUS deliberations. The Department of Defense, on the other hand, has aggressively opposed foreign influence on U.S. security facilities and has made use of CFIUS authority to pursue this objective. This is particularly apparent in the Ralls matter, where the concerns focused on the strategic importance of land with the energy aspects of the deal being more incidental.

Key Points for Energy Investors

CFIUS' scope of authority has broadened and the Committee has taken a more expansive approach to reviewing transactions over the last several years. Non-U.S. investors in energy businesses or assets in the United States should keep a number of points in mind when considering the CFIUS review process.

1. Industry Focus – Not Just Military and High-Technology. Many investors believe that the determination of whether to file a CFIUS notification is based entirely on whether the U.S. business manufactures or is otherwise involved in business related to weapons, aircraft, military products, or products involving classified material in some way. "National security," however, has a much broader meaning since the adoption of FINSA, which expanded the areas with a possible impact on

national security to include "critical infrastructure." Critical infrastructure extends to physical infrastructure, such as ports, airports, bridges and rail systems, as well as telecommunications, the energy sector, the electrical grid and the gas pipeline system, key financial services, and other widely-used systems upon which the smooth functioning of the U.S. economy depends. The broad definition means that an investment by a non-U.S. person in gas transport, electrical transmission, or even the U.S. financial industry that would or may in the future result in foreign control of those assets could be of concern to CFIUS.

2. Asset Purchases May be Subject to CFIUS Jurisdiction. A consideration of whether to make a CFIUS filing should not turn on whether the purchase is an asset transaction. First of all, many asset deals involve transfer of the control of a business. Such a deal can give rise to CFIUS concerns, for example, if the assets have access or proximity to sensitive U.S. facilities, which is particularly likely in the case of large-scale exploration or production assets. Second, even if the foreign party is not acquiring a U.S. "business" or believes that it is acquiring something less than a "business," that does not mean that the transaction does not fall under CFIUS' jurisdiction. Assets can constitute a "business" when the transaction involves other elements as well. For example, if non-military manufacturing equipment (e.g., a downstream petroleum products processing facility) and the structure that housed it were located next to a U.S. military facility, a transfer of those assets together with a lease of the site could give rise to concerns about access and control. Though an asset purchase structure may minimize successor liability concerns, and may also be desirable for tax structuring or other reasons, CFIUS could still be interested in the transaction and notification may be advisable.

3. Transaction Size Doesn't Matter. There is no dollar threshold for a CFIUS notification -- neither the purchase price nor the investment amount has regulatory meaning. Instead, CFIUS scrutinizes the nature of any national security or critical infrastructure concerns that an investment in a U.S. business may raise, as well as the nature and extent of the control that the investor would hold in relation to the business after the transaction closes. While investment approvals in some countries and antitrust clearances in other countries that have a notification system are tied to the value of the transaction, that is not the case with the CFIUS notification process.

4. When is the Deal "on the Radar?" Non-U.S. investors often assume that their deal will not be "on the radar" of CFIUS either because the deal is small, the sector does not seem to be especially sensitive, or the investor is from a friendly country (e.g., a G-7 member). Others believe that because they have not notified CFIUS of prior transactions and CFIUS has not contacted the investor to request a filing, that CFIUS is unlikely to believe that a filing is required in that particular case.

Although CFIUS does review Securities and Exchange Commission filings, press releases and other official and public filings and notifications in order to monitor transactions that have closed or are underway, much of the information that could suggest to CFIUS that the parties should submit a notice is not always publicly available. For example, an investment or transaction between two private parties may not come to CFIUS' attention if the parties have not announced it publicly. Further, as a practical matter, not all U.S. government agencies supply information to CFIUS. In that regard, although a CFIUS-member agency may flag a transaction to CFIUS if it appears to be particularly noteworthy, they may not do so in all cases.

Even if CFIUS has not acted in the past, that does not mean that the new transaction will not be of interest to CFIUS or that the transaction does not implicate U.S. national security or critical infrastructure concerns. It may be that the prior transaction did not come to the attention of the Committee because of its limited resources. CFIUS relies on the parties to a transaction to file notices when appropriate, but that does not mean that a party which somehow slips through the "honor system" is off the hook even though no filing was made, a point made clearly by the Ralls-Terna transaction. In situations where CFIUS review is not sought, the parties must accept the uncertainty that CFIUS may later take action.

5. Companies with No Classified Information Can Still be Subject to Scrutiny. Though CFIUS filings only require the inclusion of classified contracts or subcontracts completed or handled within five years prior to the notification, a company, including one in the energy sector, connected with such classified contracts at any time may very well be scrutinized by CFIUS. While it was not clear whether the information A123 used in connection with the government contracts was classified, several representatives zeroed in on the possible transfer of sensitive technological information. The U.S. government is intensely concerned about improper access to classified information. The high risk to U.S. national security interests in the event of such improper access is what necessitates the security classification in the first place. As a result, a company that has needed classified access in the past, even beyond the required five years, is likely of interest to CFIUS, and therefore those companies should consider making a CFIUS filing regardless of the fact that the classified work has ended.

6. Impact of Activities by a Non-U.S. Investor Outside the United States. CFIUS is concerned about the possibility that a foreign investor, after completing a transaction with a U.S. energy sector company, could transfer assets or technologies that it acquired through the transaction to certain countries of concern to the U.S. government, or that the activities of the non-U.S. investor may influence the way in which it deals with U.S. counterparties in the U.S. market. Because of this, CFIUS

will take into consideration the fact that a foreign party has done business with such countries in the past. In addition to the foreign party's transaction history, CFIUS will look to restrictions in the purchase or investment documents, as well as other self-implementing restrictions created by law or regulation. In an effort to determine the extent of potential harm to U.S. national security interests, CFIUS will not limit itself to conduct by the foreign party in the United States. CFIUS will look to conduct abroad as well, now and in the company's past. Notably, a number of non-U.S. energy companies have had dealings with National Oil Companies and private sector oil and gas companies in countries that are or have been the subject of U.S. sanctions.

Investors in the U.S. energy market need to consider the following takeaways:

1. CFIUS' focus on energy and infrastructure is becoming increasingly broad. Transactions that may have been under the radar before FINSA was enacted in 2007 may now be the subject of intense scrutiny.
2. The location of the project matters. CFIUS is more likely to scrutinize a project located near sensitive infrastructure or military facilities. Such facilities are located throughout the United States, in almost every state., Production and exploration assets are more likely to encounter such issues given their size.
3. Investments by companies headquartered in countries that are not traditional allies arouse more suspicion than others, as do investments by companies that do even legal business with countries that are the subject of U.S. sanctions.
4. While an energy investor may make a reasonable good faith decision not to make a CFIUS filing, the failure to do so may give rise to greater scrutiny or to political backlash.
5. It is better to seek guidance early. Some investors are familiar with the CFIUS process, others are surprised by it. The "bad news early" adage certainly applies in the case of CFIUS reviews.

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