Portfolio Media. Inc. | 111 West 19th Street, 5th floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

A Close Look At CFIUS' New Critical Tech Reporting Rule

By **Zlatko Hadzismajlovic** (September 22, 2020, 5:45 PM EDT)


Zack Hadzismajlovic

The U.S. Department of the Treasury published a final rule on Sept. 15, revising provisions in the regulations of the Committee on Foreign Investment in the United States that implement Section 721 of the Defense Production Act, as amended by the Foreign Investment Risk Review Modernization Act of 2018.

The rule becomes effective Oct. 15, and once in place, will do away with the critical technology mandatory declaration based on North American Industry Classification System codes, which are applicable to U.S. businesses in one of 27 industries, that were part of a rule published Jan. 17.

In that rule, the Treasury anticipated it would revise the mandatory declaration requirement regarding critical technology in Title 31, Section 800.401(c), of the Code of Federal Regulations from NAICS codes to one based on export control licensing requirements. The NAICS code protocol, nevertheless, will continue to apply to transactions for which specified actions occurred on or after Feb. 13 but prior to Oct.15.

Mandatory Declarations Are Triggered by Export Controls

The rule modifies the mandatory declaration provision for certain foreign investment transactions involving a U.S. business that produces, designs, tests, manufactures, fabricates, or develops one or more critical technologies.

Specifically, the rule mandates declarations in connection with covered transactions where U.S. regulatory authorizations would be required to export, reexport, transfer (in country), or retransfer a U.S. business's critical technology to certain transaction parties or others in the ownership chain.

The term "U.S. regulatory authorization" is defined as licenses or authorizations required by the U.S. Department of State pursuant to the International Traffic in Arms Regulations, the U.S. Department of Commerce pursuant to the Export Administration Regulations (as modified by the Export Control Reform Act), the U.S. Department of Energy pursuant to regulations governing assistance to foreign atomic energy activities,[1] as well as the Nuclear Regulatory Commission pursuant to regulations governing the export or import of nuclear equipment and material at Title 10, Section 110, of the Code of Federal Regulations.

In sum and substance, if one of the aforementioned export control regimes requires licensing or authorization prior to the export of said critical technology to the home country of the foreign investor, a mandatory declaration is required for that particular transaction.

Mandatory Assessment Timelines and Triggers

The parties are required to conduct a critical technology assessment upon the earliest of the execution of a binding agreement by the parties or any change to investors' rights that results in a covered transaction or covered investment.

Both direct and indirect ownership interests must be evaluated to determine whether a U.S. regulatory authorization would be required for the hypothetical export activity of the U.S. business's critical technology to the direct acquirer, or to a person with a 25% or higher voting interest, direct or indirect, in such direct acquirer.

In certain circumstances, this 25% threshold would apply up the ownership chain to the direct acquirer's general partner or its equivalent. The rule clarifies that foreign persons who are related, have formal or informal arrangements to act in concert, or are agencies or instrumentalities of, or controlled by, the national or subnational governments of a single foreign state, are considered part of a group of foreign persons, and their individual holdings are aggregated.

Critical Technology Early-Stage Companies Take Note

Export controls are a cornerstone of national security reviews of foreign inward investment. Those involved in critical, foundational and emerging technologies should understand that the importance of export controls will continue to grow due simply to the inseparability of strictly civil technologies from potentially military and strategic technologies.

Attracting foreign investment in U.S. early-stage companies that develop cutting-edge, dual-use technologies may also assist the foreign investor's home country in augmenting that country's military and strategic capabilities. Some of those countries may be strategic competitors of the U.S.

FIRRMA was enacted to address investments that pose the greatest potential risk to national security, an effort that warrants modernization of the processes and authorities of CFIUS and of the U.S. export control system.

How to Prepare

- Profound and thorough export control due diligence is required, by those with genuine experience with the CFIUS process.
- Buyers must be aware of any potential successor liability from the unmitigated export control violations of sellers.
- In addition to the standard CFIUS representations and warranties, buyers should also consider asking for export control representations and warranties.
- In addition to CFIUS requirements, buyers and sellers should determine whether they are subject to mandatory notice requirements under the International Traffic in Arms Regulations that will determine whether work may continue on existing licenses or agreements post-acquisition.
- Buyers will need to determine whether they conduct business in countries subject to U.S. or multilateral sanctions, and whether they conduct business with entities that are denied, debarred or listed by one of several U.S. government agencies.
- Sellers must be sure to conduct thorough export control classification of their products, technologies or services prior to the CFIUS filing.
- Sellers must ensure that an export control compliance assessment has been performed and that no export control violations are identified. If violations are identified, sellers must determine whether a voluntary self-disclosure is appropriate.
- Sellers should be extraordinarily careful not to release export controlled technical data to foreign investors during due diligence, negotiations or any time until all appropriate authorizations are in place from the cognizant government agency.

Fines

Recently, CFIUS received over $24 million in funding to hire 39 additional full-time employees before the end of the next fiscal year. This signals that CFIUS anticipates growth in its caseload.

Those transactions that are subject to mandatory declaration but are not declared are subject to monetary penalties of $250,000 or the value of the transaction, whichever is greater.

Not only does CFIUS have the authority to seek out undeclared transactions, but its increased budget and staffing signal that this may be a priority.

It is crucial, therefore, that both the seller and the buyer understand the export control classification requirements of the technology that is the subject of the transaction. Specifically, the parties must be able to accurately determine licensing requirements or exceptions thereto.

Zlatko "Zack" Hadzismajlovic, a partner and head of the global trade, CFIUS and export controls practice at McCarter & English LLP.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] Specifically, regulations governing assistance to foreign atomic energy activities at 10 C.F.R. Section 810, other than the general authorization described in 10 C.F.R. Section 810.6(a).

All Content © 2003-2020, Portfolio Media, Inc.