



Maneuvering the Traps of CFIUS to Enable Chinese Investment of U.S. Energy Assets



By David G. Drumm

214.855.3032 | ddrumm@ccsb.com

It was only six years ago that the U.S. was focused on increasing imports to meet its demand for oil and natural gas, as U.S. oil production had been falling for decades.¹ Since then, with the development and refinement of technologies used in oil and gas exploration, drilling, and production activities, the tables have turned. The U.S. Energy Information Administration reports that natural gas production from new wells is outpacing declines in existing wells and that the gap between domestic oil production and consumption is beginning to narrow, and that U.S. production of oil and gas has surpassed that of traditional power players like Russia and Saudi Arabia.²

This growth in U.S. reserves and production has led to foreign investors trying to get a collective foot in the door of the U.S. industry.³ The capital inflow is coming from several sources, but a significant amount is from Asian countries, and China, in particular, has been one of the most active investors in the U.S. energy industry.⁴ Key factors driving Chinese investment include that China has surpassed the U.S. as the largest energy consumer, crude oil imports account for over half of total Chinese demand, and its domestic hydrocarbon production is declining.⁵ For U.S. oil and gas companies, the foreign investment provides the money required to fund capital improvements, infrastructure build-out, and new projects.⁶

Most foreign investment has taken the form of acquiring a non-controlling interest in a U.S. company, rather than buying an existing company or creating a foreign-owned startup company. This strategy allows the investor to learn alongside the U.S. partner and rely on it to maneuver the complex regulatory framework, but avoid assuming all of the risk associated the venture. Generally speaking, the U.S. government is receptive to foreign investment, but there have been well-reported objections resulting from transactions that were blocked by the Committee on Foreign Investment in the United States ("CFIUS"). As a result, CFIUS was developed a reputation for being a deal killer.⁷

Regulatory Review

Prospective investors are naturally concerned with the need for U.S. regulatory approval for any acquisitions and in particular the approval of CFIUS. CFIUS is an inter-agency committee that is authorized to review transactions that could result in control of a U.S. business by a foreign person ("covered transactions"), in

order to determine the effect of such transactions on the national security of the United States.⁸ CFIUS was created initially under Executive Order issued in 1975, and then by statute under the Foreign Investment and National Security Act of 2007 ("FINSA"), which amended the provisions of Section 721 of the Defense Production Act of 1950.

There is no actual requirement that a foreign investor obtain the approval of CFIUS or any other U.S. federal government agency prior to making its acquisition of U.S. energy assets. The risk, however, is that the President of the United States could act to unwind the acquisition after it is closed if the President determines that such transactions present "credible threats to United States national security" under FINSA.

To mitigate the risk of uncertainty as to whether an acquisition is vulnerable to being set aside by the President or not, CFIUS was created to screen transactions and advise the President.

FINSA was enacted in the wake of the withdrawal of a bid to acquire California-based oil and gas company, Unocal, in 2005, by the Chinese government-owned China National Offshore Oil Corp. ("CNOOC"). The bid was met with loud objection from politicians worried that the deal threatened national security. CNOOC withdrew its bid as a result of complications and delays associated with the CFIUS process prior to the enactment of FINSA.

FINSA provides a more definite process for foreign acquirers to obtain a clear answer as to whether their proposed acquisition will be permitted, as opposed to the uncertainty of the process CNOOC was presented with in the Unocal takeover bid. Under the FINSA procedures, an acquirer can make a filing of its intended acquisition with CFIUS, which starts a 30-day time clock for CFIUS to either approve the transaction or to commence an investigation within a 45-day period following the initial 30-day review period. The goal is for there to be certainty as to whether CFIUS will recommend to the President that the transaction presents a national security threat within no later than the combined 75-day period and hopefully, within the shorter 30-day period.

In determining whether to investigate a pending acquisition filed under FINSA, CFIUS will focus primarily on the following three factors:

- (a) whether control over a U.S.-owned business is being acquired,
- (b) whether the U.S. business being acquired is in possession of "national security assets" or "critical infrastructure," and
- (c) whether the foreign acquirer of control is perceived as likely to control or restrict access to the acquired assets for purposes of political or military advantage, as opposed to maximizing profits for its shareholders.

The pattern of application of these factors in the reported cases coming before CFIUS in the case of potential Chinese buyers has been along the following lines:

1. If the foreign investor acquires a 51% or greater interest in producing oil and gas wells, it will be considered to have acquired control over a United States business. By reducing the percentage ownership acquired to the range of 35-40%, it may be possible to obtain an understanding with the CFIUS staff, even before a formal filing, that the proposed acquisition is not a "covered transaction" subject to the jurisdiction of CFIUS. However, with a 51% interest, there is no question that control is being acquired and that CFIUS has jurisdiction to evaluate the acquisition.

2. Producing oil and gas wells are considered to constitute "critical infrastructure" if they represent "major energy assets." There is no safe harbor threshold in terms of valuation or quantity of production that determines whether "energy assets" are "major" or "minor," although obviously the smaller the acquisition, the more likely that the assets will be determined not to be "major." Other factors would include whether pipelines or processing and transmission facilities are being acquired which serve critical military and other industrial installations to the point that if they are shut off, there is no alternative source of supply.

3. Historically, acquisitions of a controlling interest in a U.S.-owned business by Chinese acquirers have been given greater scrutiny than acquisitions by non-U.S. acquirers from nations that have historically been military allies of the United States. However, "covered transactions" by Chinese nationals have been frequently approved by CFIUS, particularly where CFIUS is satisfied that the acquirer is not subject to the control of the Chinese government.

4. The chances of approval are increased if (a) a Chinese buyer is owned by private shareholders and not the Chinese government, and (b) the quantity of assets being acquired by the buyer is relatively small and therefore less likely to constitute "major energy assets."

5. A buyer could acquire nonproducing mineral leases or unleased minerals and drill wells to produce them without being under the jurisdiction of CFIUS, because in that case, they would not be acquiring a U.S. business. The regulations under CFIUS are clear that acquisitions of hard assets which are not being operated as a business at the time of the acquisition do not constitute a covered transaction.

CFIUS's Track Record

A review of statistics from CFIUS indicates that this committee is not a deal killer as it has been characterized. Between 2008 and

2012, there were a total of 538 notices filed with CFIUS that were deemed "covered transactions," and on average, 31% were subject to further investigation.⁹ In some cases, during the investigation process, the parties to a transaction will re-file their notice after addressing initial concerns of CFIUS. For example, in 2012, CFIUS reviewed 114 notices of transactions and all were approved except for 22.¹⁰ With respect to those 22 covered transactions, the parties withdrew their notices, but 10 re-filed later in 2012 and were concluded successfully and two were refiled in 2013.¹¹ Of the remaining 10 cases, the parties abandoned the transaction for commercial reasons or in light of CFIUS's national security concerns.¹²

The most recent report of CFIUS indicates that 39 acquisitions were filed by Chinese acquirers and three by Hong Kong acquirers.¹³ Twelve of those acquisitions were in the industry sector "mining, utilities, and construction."¹⁴

Since the failed bid in 2005 by CNOOC to acquire Unocal, CNOOC and other Asian companies have successfully closed on substantial transactions in the U.S. oil and gas industry. This includes Chinese state-owned SINOPEC's \$2.2 billion joint venture with Devon Energy for a 33% interest in certain shale assets; two transactions between CNOOC and Chesapeake Energy valued at \$2.2 billion and \$1.3 billion for a 33% interest in certain shale assets; Japanese company Sumitomo Corporation's \$1.4 billion venture with Devon for a 30% interest in certain shale assets; and Chinese state-owned Sinochem Group's \$1.7 billion investment for a 40% stake in certain of Pioneer Natural Resources' shale assets.

Given the fundamentals of the American energy industry, there should be continued strong foreign-investor interest in oil and gas assets in this country. When proposed transactions are properly structured to meet the established guidelines of CFIUS, foreign investors should consider the U.S. energy industry is open for business. ■

1. Theresa A. Einhorn, "Developments and Trends In Oil and Gas Financing 2013," 31st Annual Review of Developments in Business Financing, American Bar Association Business Law Section, Spring Meeting 2013.

2. Charles Dewhurst and Clark Sackschewsky, "Globalization of US Energy," Oil & Gas Financial Journal, February 2014.

3. "Globalization of US Energy," Oil & Gas Financial Journal, February 2014.

4. See "Globalization of US Energy," Oil & Gas Financial Journal, February 2014; Dave Fehling, "Why Foreign Companies Love Texas (Hint: Oil & Gas)," Statelmpact Texas, December 11, 2013; Ryan Dezember and James T. Areddy, "China Foothold in U.S. Energy," Wall Street Journal, March 6, 2012.

5. "Developments and Trends In Oil and Gas Financing 2013," 31st Annual Review of Developments in Business Financing, American Bar Association Business Law Section, Spring Meeting 2013

6. "Globalization of US Energy," Oil & Gas Financial Journal, February 2014.

7. Doug Guthrie, "CFIUS: Often Misunderstood and Maligned," Forbes, December 20, 2013.

8. See <http://www.treasury.gov/resource-center/international/Pages/Committee-on-Foreign-Investment-in-US.aspx> for information concerning the origins of CFIUS and its acquisition screening criteria and policies.

9. Committee on Foreign Investment in the United States, Annual Report to Congress, Report Period: CY 2012, December 2013.

10. *Id.*

11. *Id.*

12. *Id.*

13. *Id.* Hong Kong is reported as a separate country in the CFIUS report.

14. *Id.*