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CFIUS, Bankruptcy, Foreclosures, and Debt Restructuring

Foreign Investment Reviews of Distressed Assets

As discussed in detail in our previous Client Alert, on February 13, 2020, the Committee on Foreign Investment in the United States (“CFIUS”) issued two Final Rules implementing most of the Foreign Investment Risk Review Modernization Act of 2018 (“FIRRMA”). CFIUS, an interagency committee, reviews foreign investments in U.S. businesses and real estate and determines whether transactions should be unwound, blocked, or restricted due to national security concerns. FIRRMA is the first major expansion of CFIUS’ powers in a decade.

CFIUS’ expanded jurisdiction may apply to transactions involving distressed assets, which is especially important as the impact of the COVID-19 pandemic on the global economy becomes acute. Business operations have abruptly slowed or been suspended worldwide, with some businesses now facing existential crises, including bankruptcy, asset impairment, and loan defaults. As U.S. businesses contemplate selling assets to improve cash flow or engaging in restructuring and workouts involving foreign lenders and investors, parties should consider potential CFIUS implications for foreign investments in distressed U.S. business or real estate assets, conversion of instruments held by foreign investors, or foreclosure by foreign lenders exercising default remedies.

CFIUS member agencies are particularly attuned to the very real possibility that foreign parties may acquire stakes in sensitive U.S. businesses or assets in the current economic climate. Thus, it is important that parties to workouts and restructuring transactions consider whether they are required to notify CFIUS of a particular transaction or should voluntarily seek CFIUS approval to obtain safe harbor protections.



CFIUS OVERVIEW

The Rules significantly expanded the types of “covered transactions” subject to CFIUS jurisdiction, including:

- “Covered control transactions” resulting in foreign control of a U.S. business, or certain U.S. real estate located in certain U.S. ports or near sensitive U.S. government installations;
- “Covered investments,” including certain non-controlling foreign investments in U.S. businesses or real estate;
- Change in a foreign investor’s rights resulting in a covered control transaction or a covered investment; or
- Transactions intended to evade or circumvent CFIUS.

Historically, parties could voluntarily determine whether to notify CFIUS about proposed covered transactions. Parties choose to submit their transactions for CFIUS review to gain a safe harbor against future CFIUS intervention because CFIUS retains the right to review covered transactions at any point and can block transactions before they close or force divestment or restrictions on operations post-closing. Under FIRRMA, parties are required to notify transactions involving certain “critical technology” investments and foreign government investments.

CFIUS may unilaterally initiate a review of a covered transaction at any time, including after the transaction closed.

Unwinding or Blocking of Transactions is a Real Threat to Foreign Investments

Between CFIUS’ creation in 1988 and 2015, the President only unwound or blocked two transactions on CFIUS’ recommendation. Since 2016, the President has blocked or forced divestment of at least eight deals, and in 2019 CFIUS formed an enforcement branch to identify deals not notified to CFIUS. These actions underscore significant – and increasing – risks to parties who do not seek CFIUS counsel, assess the national security risks of foreign investments in U.S. businesses, and determine whether a mandatory filing is required or a voluntary filing is warranted.

In March 2020, President Trump ordered Beijing Shiji Information Technology Co., Ltd. (“Shiji”) to divest its interest in StayNTouch, Inc. (“StayNTouch”), a U.S. company involved in hotel mobile technology and property-management systems that collects user personal data. In September 2018, StayNTouch announced its acquisition by Shiji, which the parties did not voluntarily notify to CFIUS.

In April 2019, U.S. cybersecurity firm Cofense Inc. (“Cofense”) announced that CFIUS conducted a post-closing review of the acquisition of Cofense by the private equity firms Pamplona Capital Management LLP (“Pamplona”) and BlackRock Inc., and CFIUS forced Pamplona to divest its minority stake in Cofense. Although Pamplona is a U.S. private equity firm, one of its limited parties is ultimately owned by a Russian oligarch. The parties announced the transaction in February 2018, and, like Shiji and StayNTouch, had not voluntarily notified to CFIUS of the deal.

CFIUS JURISDICTION MAY APPLY TO TRANSACTIONS ARISING FROM BANKRUPTCY CASES

The Bankruptcy Code does not provide an exception to compliance with CFIUS regulations. Prior to FIRRMA and the Final Rules, CFIUS regularly reviewed transactions that were consummated in or were the result of a bankruptcy case. Nevertheless, some in the market viewed bankruptcy as a jurisdictional loophole. As part of reform efforts, CFIUS emphasized its jurisdiction over bankruptcy-related transactions. The CFIUS regulations now explicitly note that “covered transactions” include any otherwise covered transaction involving foreign investment in a U.S. business or U.S. real estate that arises pursuant to a bankruptcy case or other form of default on debt.



Examples of Bankruptcy Transactions Subject to CFIUS Review

In some bankruptcy cases, parties have noted from the outset that a proposed restructuring or sale is subject to CFIUS jurisdiction. For example, in a 2017 Chapter 11 bankruptcy case involving the restructuring of a U.S. software developer and its foreign subsidiaries, the parties filed a declaration stating they had accepted an acquisition bid from a foreign venture capital firm and would seek CFIUS approval. In addition, in some Chapter 11 cases, the U.S. government has filed notices, indicating its intent to consider whether transactions may be subject to CFIUS review.

In February 2020, CFIUS approved the acquisition of U.S. aircraft manufacturer ONE Aviation Corporation (“ONE Aviation”) by Citiking International US LLC (“Citiking”), a Chinese-controlled entity. In October 2018, ONE Aviation voluntarily filed for Chapter 11 bankruptcy, and in September 2019, the U.S. bankruptcy court approved its reorganization plan. Following review and approval by CFIUS, Citiking will acquire ONE Aviation and support its operations post-bankruptcy. This transaction demonstrates that CFIUS may approve certain Chinese-backed foreign investment in sensitive U.S. industries, especially if mitigating factors are present, such as a languishing company.

If a bankruptcy or similar financial restructuring transaction, including debt-equity swaps, meets the definition of a covered transaction, it may be subject to CFIUS jurisdiction. Given the expansion of CFIUS jurisdiction and explicit references to bankruptcy transactions in Final Rules, more transactions arising from bankruptcy cases are likely to be filed with, and gain greater attention from, CFIUS. Foreign buyers or lenders should carefully consider whether they are or may be acquiring assets or equity that may be covered transactions, potentially triggering CFIUS jurisdiction.

CFIUS JURISDICTION MAY APPLY TO CERTAIN TRANSACTIONS INVOLVING FOREIGN LENDERS

Lending Transactions and U.S. Businesses

Lending transactions, such as loans, generally are not subject to CFIUS review, unless a lending transaction confers to a foreign lender financial or governance rights characteristic of equity investments. A loan or similar financial arrangement may constitute a covered transaction and trigger CFIUS jurisdiction where a foreign lender acquires:

- an interest in profits of a U.S. business;
- the right to appoint members of the board of directors of the U.S. business; or
- other comparable financial or governance rights.

CFIUS jurisdiction also may apply to lending transactions in circumstances of imminent or actual default or other conditions with significant possibility that a foreign lender may, as a result of the default or other condition, acquire:

- control of a U.S. business; or
- equity interest and information access, board presence, or certain decision-making rights in a U.S. business involved in “critical technologies”, “critical infrastructure”, or “sensitive personal data”.

Lending Transactions and U.S. Real Estate

Certain lending transactions related to U.S. real estate investments involving imminent or actual default also may trigger CFIUS jurisdiction, as long as the real estate falls under CFIUS jurisdiction due to its location in certain U.S. ports or proximity to sensitive U.S. government installations. Generally, the extension of a mortgage, loan, or similar financing arrangement by a foreign person for the purpose of the purchase, lease, or concession of covered real estate will not, by itself, constitute a covered real estate transaction, even if the foreign person acquires a secured



interest in the covered real estate. CFIUS, however, will review financing arrangements where there is a significant possibility that certain property rights could be conveyed to a foreign investor in the event of default on the debt instrument.

Lending Transactions and Bankruptcy

The CFIUS regulations include an example of a bankruptcy case where a U.S. business defaults on a loan to a foreign bank and seeks bankruptcy protection. The U.S. business is unable to satisfy the foreign bank's claim, which is greater than the value of the U.S. business' assets. The foreign bank's secured claim is the only secured claim against the U.S. business' assets, creating a high probability that the foreign bank will receive title to the U.S. business' assets. The impending bankruptcy case transferring control of the U.S. business' assets to the foreign bank would constitute a covered control transaction subject to CFIUS jurisdiction.

CFIUS JURISDICTION MAY APPLY TO CERTAIN CONVERTIBLE DEBT INSTRUMENTS

Like lending transactions, the creation of convertible debt instruments generally are not considered covered transactions, unless a foreign holder has control over certain elements, such as when the instrument is converted, or obtains equity-like rights upon conversion. When determining whether a contingent debt instrument may be a covered transaction, CFIUS considers:

- the imminence of conversion or satisfaction of contingent conditions;
- whether the acquiror controls the conversion or satisfaction of contingent conditions; and
- whether the amount of interest and the rights acquired upon conversion or satisfaction of contingent conditions can be reasonably determined at the time of acquisition.

Otherwise, a contingent equity interest is not subject to CFIUS jurisdiction until conversion. When conversion becomes imminent, foreign holders should consider the rights that would result from the conversion and whether the conversion may be a covered transaction.



CONCLUSION

CFIUS jurisdiction can be triggered by foreign investments, directly or indirectly, in distressed assets, and certain lending transactions and convertible debt instruments where the foreign person acquires equity-like rights. CFIUS notification may be required in certain circumstances or, when not required, may be prudent to protect investments and avoid situations where an investment is subsequently required to be unwound or divested. Importantly, foreign persons who plan to invest in distressed assets or exercise default remedies – including as a result of the COVID pandemic – should consider the potential CFIUS implications of their transactions, whether CFIUS voluntary or mandatory filing jurisdiction may apply, and the risks or benefits of making a CFIUS filing.

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