

How To Navigate US Real Estate After CFIUS Expansion

By **Peter Mair** (January 22, 2019, 1:45 PM EST)

The U.S. is the world's largest beneficiary of foreign direct investment. In recent years, there has been a strong and steady flow of foreign investment into U.S. real estate. Foreign investors have sought stable classes of assets and U.S. real estate has proved very attractive, particularly trophy assets and real estate in gateway cities. As part of this overall trend the U.S. saw a surge in Chinese foreign investment. Like other countries, including Australia and the United Kingdom, the U.S. government has taken steps to increase oversight and scrutiny of transactions involving foreign investors. While Chinese foreign investment has cooled recently due to both internal restrictions in China and the U.S. government's increased oversight, U.S. real estate remains no less attractive to many investors globally, and these investors still need to assess, and potentially navigate, the requirements of the Committee on Foreign Investment in the U.S., which is the body responsible for the oversight and scrutiny of foreign investment in U.S. business enterprises and real estate.



Peter Mair

This article briefly sets out the workings and history of CFIUS, describes its recently expanded scope and explores key issues buyers and sellers should consider relating to CFIUS; in particular, how foreign capital may be deployed to minimize the chances an investment in U.S. real estate will run afoul of CFIUS and the strategies that should be considered to mitigate execution risk for both buyers and sellers.

CFIUS: A Brief Background

CFIUS is an interagency committee that was established to monitor, assess and address national security implications of foreign investments in U.S. businesses. CFIUS has traditionally had jurisdiction over foreign investments that could, in CFIUS' (expansive) view, result in control of a U.S. business. Most commonly, the transactions scrutinized involved foreign investment in businesses that directly or indirectly support U.S. government agencies with defense or other national security responsibilities, provide or support critical infrastructure or develop sensitive technologies. In recent years, CFIUS has given greater attention to business' access to sensitive personal data of U.S. citizens and business properties located near sensitive government facilities or training areas (including airspace and waterways). In the context of real estate, historically CFIUS review generally applied to acquisitions of developed real estate or acquisitions of businesses that owned real estate as a fundamental part of the business (e.g., REITs) or that happened to occupy real estate in connection with non-real estate businesses. CFIUS would check whether the properties were located in sensitive areas (e.g., beneath airspace used to train military aviators) or had sensitive tenants or neighbors. If CFIUS identified a problem, it could

sometimes be mitigated by restricting foreign access to the property, but in some cases — particularly involving Chinese investors — the subject property would have to be kept out of the transaction.

The Expansion of CFIUS' Jurisdiction

A History of Expansion

Federal regulation of foreign investment in the U.S. has incrementally increased over time. The creation of CFIUS in 1975 by the Ford administration came in response to mounting investments by members of the Organization of the Petroleum Exporting Countries in the U.S., which many in Washington saw as alarming. In the 1980s, concerns over growing Japanese investment in critical U.S. industries resulted in Congress passing the Exon-Florio amendment to the Defense Production Act of 1950, which strengthened CFIUS' review process. Similarly, Congress expanded CFIUS' oversight authority in the wake of the Dubai Ports World controversy, by enacting the Foreign Investment and National Security Act of 2007.

Current Expansion

CFIUS' jurisdiction expanded significantly on Aug. 13, 2018, when President Donald Trump signed into law the Foreign Investment Risk Review Modernization Act. From a real estate perspective, FIRRMA largely codified CFIUS' authority to review real estate transactions, but FIRRMA also extended CFIUS' mandate in three key ways:

- CFIUS now has the power to assess real estate transactions of not only developed land, but also of greenfield land,
- CFIUS can now scrutinize certain transactions that result in foreign influence over, as opposed to control of, certain U.S. businesses (either real estate or non-real estate),
- FIRRMA ended the voluntary nature of CFIUS by introducing mandatory short-form filings for certain transactions involving critical technologies, critical infrastructure and personal information of U.S. citizens..

Real Estate Transactions

As a result of FIRRMA, CFIUS now has authority to review real estate transactions involving "the purchase, lease, or concession of private or public real estate that (1) is located within, or will function as part of, an air or maritime port, or (2) is in close proximity to a U.S. military installation or another facility or property of the U.S. government that is sensitive for reasons relating to national security." [1] This change is notable as follows:

- CFIUS' jurisdiction now expressly covers greenfield real estate investments, leases and "other real estate concessions" [2] — categories of real estate not previously covered by the applicable regulations. There are exceptions for "single housing units and urban properties," [3] subject to limits to be defined in future CFIUS regulations.

- While CFIUS has already been looking for several years at real estate proximity issues in the context of control transactions (including acquisitions of both real estate portfolios and businesses that happen to occupy real estate), FIRRMA codified this practice. Although there is no clear direction on how CFIUS will use its newly codified powers, it has in the past, as a matter of practice, been willing to apply a close proximity analysis as part of its review.

The expanded real estate provisions of FIRRMA will become effective once implementing regulations are issued. Congress has given CFIUS until Feb. 13, 2020, to issue these regulations, but CFIUS may publish interim regulations before then.

Transactions Resulting in Foreign Influence Over a U.S. Business

- Under the previous regime, CFIUS had jurisdiction to review a “covered transaction,” which was defined as “any transaction ... by or with any foreign person, which could result in control of a U.S. business by a foreign person.” FIRRMA expanded the definition of a “covered transaction” to include noncontrolling investments that afford the foreign investor (1) access to material nonpublic technical information of the U.S. business; (2) board membership, observer or appointment rights; or (3) involvement in substantive decision making of the U.S. business relating to personal information of U.S. citizens, critical technologies or critical infrastructure. This change brings within the reach of CFIUS more transactions whose control elements might be uncertain.

Mandatory Declarations for Critical Infrastructure Transactions

FIRRMA ends the voluntary nature of CFIUS by requiring mandatory declarations for certain transactions involving critical technologies, critical infrastructure and personal information of U.S. citizens. In the case of critical technologies, CFIUS has already issued interim regulations implementing a pilot program requiring short-form declarations of transactions affording foreign investors control over U.S. critical technology companies or access to material nonpublic technical information of those companies.[4]

Once implementing regulations are published by CFIUS, mandatory declarations will also be required when investors in which foreign governments hold a substantial interest acquire interests in U.S. companies that provide or support critical infrastructure or that handle sensitive personal data of U.S. citizens that could be exploited to the detriment of U.S. national security.

Key Considerations Related to CFIUS and Foreign Investment in U.S. Real Estate

If a proposed investment in U.S. is to be made by, or include, a foreign investor and therefore could potentially result in CFIUS review, the following should be considered in structuring the investment:

- General: For the buyer, the obvious and best form of mitigation is to require as a condition to closing that, to the extent needed, CFIUS approval be secured. In the current environment, at best this puts the buyer at a distinct disadvantage and at worst it is immediately disqualifying. It has been a sellers' market for some time now. Financing conditions are a thing of the past. Increasingly representation and warranty insurance is replacing hold-backs and indemnities back-stopped by credit entities. While offering the seller a premium or nonrefundable deposit is one way for the buyer to soften the requirement that a CFIUS condition be included in the deal,

this may not be practical or make economic sense. For a seller, the opposite is true. Resisting demands for a CFIUS closing condition, factoring the increased risk into the price and requiring a nonrefundable deposit are all straightforward ways to mitigate execution risk when negotiating with a foreign investor.

- **Portfolio Acquisitions:** The good news for buyers and sellers of U.S. real estate portfolios is that CFIUS was, and continues to be, willing to look at national security risks on a property-by-property basis; as a result, CFIUS mitigation is targeted to specific properties, not entire portfolios. In evaluating any transaction the investors should identify potentially problematic properties early and, if necessary, structure the transaction in a way so the problem assets are excluded from the transaction or divested concurrently with the closing of the main transaction. While including CFIUS approval as a condition to closing is likely not an option, excluding certain properties from a much larger transaction (including through the use of a closing condition requiring such exclusion) may be palatable to the seller. Note, however, that unwinding complex cross-ownership or cross-financing relationships in real estate portfolios may be difficult to achieve quickly, especially if the purpose to excise only a subset of properties from the portfolio. To the extent exclusion is not an option, creating a parallel investment syndicate (without any foreign investor) to hold problematic assets could be explored.
- **Control:** If a syndicate of investors that includes a foreign party or parties is proposing the investment, both sides of the transaction should be aware of one particularly notable FIRRMA provision that provides for special treatment for indirect foreign investments undertaken through certain U.S. managed investment funds. Under this provision, such indirect investments will not be subject to CFIUS' expanded jurisdiction over noncontrolling investments in U.S. businesses involved with critical technologies and infrastructure, or with U.S. citizens' personal information. As a result, such investments are also not subject to mandatory declarations to CFIUS.[5]
- **Advice:** Given the expansion of CFIUS and period of uncertainty as to how and when certain elements of FIRRMA may be applied, it is imperative that foreign investors, or syndicates that include foreign investors, proactively consider any issues posed by CFIUS as early as possible in the life of a transaction — through structuring and advice, there are ways a foreign investor or syndicate involving a foreign investor can evaluate, and gain valuable insight into, the risks associated with a particular investment in U.S. real estate. The earlier advice is sought, the better. If the increased cost or uncertainty cannot be mitigated and is not tolerable, the sooner that is determined the better.

Conclusion

While global stock markets fluctuate wildly, U.S. real estate remains an attractive and apparently stable asset class. The retreat of Chinese foreign investment, due to a combination of self-regulated restraints and increased oversight of foreign investment by countries such as the U.S., is expected to result in both a shedding by some Chinese investors of U.S. real estate holdings (which will increase supply) and an evolving pool of potential investors (which will reduce demand). Foreign investors who successfully navigate the requirements of CFIUS, will find attractive opportunities to invest in U.S. real estate. When a transaction involves a foreign investor and an asset that could potentially

trigger the scrutiny of CFIUS, the buyer and seller should obtain advice early and determine what, if anything, can be done to structure the transaction in a way to mitigate execution risk and minimize the chances the deal will offend CFIUS.

Peter Mair is counsel at Skadden Arps Slate Meagher & Flom LLP.

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[1] FIRRMA does not define the term “close proximity,” instructing CFIUS instead to promulgate guidelines that would clarify the term.

[2] It remains to be seen how CFIUS will define this term.

[3] This most likely means an exemption for buying one unit as a residence, not buying portfolios of single family homes or condos, but it remains to be seen how CFIUS will define these exemptions.

[4] For more information, see:
<https://www.skadden.com/insights/publications/2018/10/cfius-pilot-program-expands-jurisdiction>.

[5] For more information, see
<https://www.skadden.com/insights/publications/2018/10/governance-implications-of-cfius-reform>.