

D.C. Circuit Issues Important Ruling in National Security Case

Gray Reed & McGraw Legal Alert

August 13, 2014

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D.C. Circuit Court of Appeals Finds That CFIUS Violated Foreign-Controlled Company's Due Process Rights, But Rejects Review of Presidential Determination

The Case: *Ralls Corporation v. National Security (Committee on Foreign Investment in the United States)*, 13-5315, July 15, 2014

The D.C. Court of Appeals has ruled that a Presidential order requiring the Ralls Corporation, a U.S. company owned by Chinese investors, to divest its interest in four Oregon wind farms, based on national security concerns, deprived "Ralls" of Fifth Amendment due process of law. [The above national security concerns fall under the Defense Production Act of 1950, as amended by the Exon-Florio Amendments in 1988, and as further amended by the Foreign Investment and National Security Act of 2007 ("Exon-Florio").]

The case has now been remanded to the D.C. District Court for further review. While the consensus of commentators is that the decision will result in greater transparency in the CFIUS process, the ultimate effects of the decision remain unclear.

Background: CFIUS and Exon-Florio

CFIUS is a multi-agency group authorized by Exon-Florio to advise the President on transactions involving acquisitions of U.S. businesses by foreign persons (including U.S. businesses controlled by foreign persons) that may raise national security issues. CFIUS considers the impact on U.S. national security concerning..... "any merger, acquisition, or takeover...by or with a foreign person which could result in foreign control of any person engaged in interstate commerce in the United States." A thorough discussion of CFIUS is beyond the scope of this Client Alert, but we caution that both "control" and "national security" are broadly defined and broadly applied by CFIUS. For example, in 2013, CFIUS investigated, but did not seek to block, a Chinese company's acquisition of Smithfield Foods, the world's largest pork processor and hog producer. Given the lack of national security interest in raising and slaughtering hogs and buying and selling pork, the fact that CFIUS elected to fully investigate the Ralls transaction evidences the uncertain and expansive scope of national security considerations by CFIUS.

Please note that a pre-consummation CFIUS filing is not mandatory but has important benefits, discussed below.

A CFIUS filing triggers an initial 30-day review period in which CFIUS decides whether or not to begin an investigation. This initial 30-day review period does not begin until CFIUS is satisfied that the filing is complete.

Once CFIUS moves forward with an investigation, it has 45 days to complete its investigation, but, as with other regulatory filings, once an investigation is begun, the timing for clearance, as a practical matter, is uncertain. **Regardless of whether the parties voluntarily seek approval, initially, CFIUS can review any transaction, including completed transactions, on its own initiative, and can advise that completed transactions be unwound, as Ralls discovered.**

The Case Specifics:

Ralls, a Delaware corporation owned by two Chinese nationals, acquired four American-owned LLCs, organized to develop wind farms in north-central Oregon. The four wind farms were either within, or near, restricted airspace and a bombing zone maintained by the U.S. Navy.

It is significant to note that **Ralls did not submit a voluntary pre-consummation filing with CFIUS. Rather, Ralls submitted a CFIUS notice after the transaction closed and two months after the construction on the project began and only because CFIUS requested that it do so. During the CFIUS review, Ralls did not stop construction.**

After conducting the initial 30-day review, **CFIUS determined that a full investigation was needed, and imposed an interim mitigation order against Ralls to stop all construction and operations at the wind farms. Ralls complied with the order. Thereafter, President Barack Obama issued an order to unwind the transaction, citing the threat to U.S. national security, but did not offer evidence thereof.**

Ralls then sued CFIUS and the President, claiming that the CFIUS mitigation order and the President's divestiture order were unconstitutional, due to the "taking of property without due process of law" and that the Administrative Procedure Act was violated because Ralls was not given the opportunity to review, respond to, or rebut any evidence upon which the President or CFIUS based their orders.

The U.S. District Court for D.C. dismissed Ralls' claims, finding, among other things, that Exon-Florio prohibits judicial review of the President's rulings thereunder. The U.S. District Court also found that the CFIUS review process was sufficient to satisfy due process requirements.

On Appeal:

The Court of Appeals reversed the District Court, holding that CFIUS and the President had deprived Ralls of due process. The Court of Appeals found that while Congress may have precluded judicial review of the President's national security determination, it did not preclude "the reviewability of a constitutional claim challenging the process preceding such presidential action". The Court of Appeals ruled that due process in this context required,

at a minimum, that Ralls:

- (i) be informed of the action to be taken against it
- (ii) be given access to the evidence on which CFIUS and the President relied, and
- (iii) that Ralls be afforded an opportunity to rebut such evidence.

The Court of Appeals remanded the case to the District Court with instructions that Ralls be provided due process, including access to the unclassified evidence on which CFIUS and the President relied in ordering the unwinding of the transaction. **The Court of Appeals was careful to note that due process does not require disclosure of classified information.** Further, the Appeals Court refused to offer an opinion on an executive privilege argument raised by the U.S. for the first time during oral argument. This issue will likely be raised again in the District Court on remand and could limit the information the President and CFIUS are required to provide concerning the rationale underlying their respective national security determinations.

Our Takeaway

1. In light of the substantial deference that courts usually afford the Executive Branch on national security matters, ***Ralls is a surprising decision.***
2. In addition to proceedings at the District Court on remand, it is possible that the U.S. will seek a rehearing by the D.C. Circuit en banc (“on the bench” or with all judges) and/or an appeal to the Supreme Court.
3. The decision opens the door to the prospect of a more transparent process in which CFIUS will be required to **disclose unclassified information on which it relied.** Also, CFIUS may collect more information from parties to bolster the factual record in the face of potential judicial review. Both developments may prolong CFIUS reviews and investigations. Moreover, this decision creates the incentive for CFIUS to rely more heavily on classified information in making its determination.
4. In the past, parties have been reluctant to challenge CFIUS actions. **This decision could encourage parties to fight CFIUS decisions in court.**
5. Some commentators have pointed to the Court’s statement that **Ralls’ due process claim was enhanced by the fact that Ralls had established a protectable property right by consummating the transaction before CFIUS review occurred,** and commentators have suggested that parties consider not making a voluntary pre-consummation CFIUS filing. **We caution that a party to a potential “CFIUS-Covered Transaction” that does not make a voluntary pre-closing CFIUS notice filing does so at its peril.** As *Ralls* demonstrates, CFIUS’ concerns are heightened when parties fail to voluntarily file in advance of a proposed transaction. Parties need to weigh procedural benefits against potential substantive losses in a non-reviewable CFIUS or Presidential national security determination. Had Ralls made such a filing, it might have been possible to work out a mitigation arrangement with CFIUS that would

have allowed most or some part of the transaction to go through, and, therefore, the costs of litigating CFIUS issues and the forced divestiture resulting from the President's action would possibly have been avoided.

6. In any event, after Ralls, the authority of CFIUS to review acquisitions remains intact. Its ability to challenge unfiled transactions remains undisturbed, and the authority of the President to block or unwind transactions that may threaten national security, without any substantive judicial review, remains in full force.

If you have questions about CFIUS matters, please call your attorney or the Securities Law Section of Gray Reed & McGraw at 214.954.4135.

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