Location, Location, Location: Observations on CFIUS Opposition to Investment by Chinese Mining Company in Firstgold Corporation

January 7, 2010

"We're not lost. We're locationally challenged." This euphemism, attributed to the science fiction writer John M. Ford, aptly captures the apparently irremediable flaw in the recently failed attempt by China's Northwest Non-Ferrous International Company (Northwest) to acquire a controlling interest in Nevada-based Firstgold Corporation (Firstgold).

On December 18, 2009, Firstgold disclosed that the Committee on Foreign Investment in the United States (CFIUS) had advised that CFIUS intended to recommend to President Obama that he block this transaction. CFIUS determined that, as presented, the transaction posed "serious, significant and consequential national security concerns" arising specifically from the "proximity of Firstgold's properties to the Fallon Naval Air Station and related facilities." The parties later announced their decision to withdraw the notification to CFIUS with the consequence, according to Firstgold's Chief Executive Officer, that "the whole deal is over."

Contrary to the implications of articles reporting the CFIUS action, cross-border investors should not be concerned that this action marks an expansive analytical approach by CFIUS, or new hostility to Chinese investment. Based on publicly available information, CFIUS opposition to the transaction is entirely unsurprising. Indeed, the Government of Australia took an almost identical action last March involving a proposed Chinese acquisition of a mining company. The action by CFIUS serves only to highlight once again its comprehensive, rigorous analytical approach — and the imperative of managing CFIUS notifications with full appreciation for both substantive and procedural issues.[1]

The Firstgold/Northwest Transaction

Firstgold is a small, publicly traded exploration-stage company that owns four mining leases in Nevada. Northwest is owned by the Northwest Mining and Geological Exploration Group Co. for Nonferrous Metals (NWME). NWME, a large mining company controlled by Shaanxi Provincial authorities, is based in Xi'an, China.

On July 16, 2009, Firstgold accepted a Binding Offer Letter from Northwest that provided for Northwest to acquire 51% of Firstgold's equity, to purchase senior secured promissory notes held by two investment funds, and to make a new loan to Firstgold.[2] Under the agreement, Northwest was entitled to nominate three directors to the Firstgold Board of Directors, with Northwest's Chairman becoming the new Chairman of Firstgold. The agreement contemplated closing of the new loan by August 31, purchase of the senior notes by September 1, and closing of the subscription for new shares by Northwest no later than September 30, 2009.

Although the Northwest investment clearly was a "covered transaction" for CFIUS purposes, the parties apparently did not initially contemplate submission of the transaction for CFIUS review.[3] On September 21, Firstgold disclosed the intent to notify CFIUS. The parties filed their joint notice with CFIUS in early October, and CFIUS initiated its review on October 8. In public comments and by pushing back the closing date only to November 17, the parties made clear their expectation that CFIUS would complete its work at the end of the initial 30-day review period, or very shortly thereafter.

Instead, on November 6, CFIUS advised the parties that it would continue into the second-stage, 45-day investigation, meaning that CFIUS had until December 21 either to complete its work or to forward the matter to the President. The parties once again extended their projected closing (after Firstgold agreed to pay further substantial additional fees to its lenders). The parties withdrew from the process on the December 21 deadline rather than force the decision to assured rejection by the President.

A Troubled Approach to CFIUS

Factors outside the control of the parties influence the outcomes of CFIUS reviews. As CFIUS actions rest on highly confidential national security assessments, occasionally notifying parties will encounter and then be left in the dark about unexpected issues — leaving them unable to propose satisfactory mitigation measures. Pressures to complete transactions, which were plainly evident in the case of financially troubled Firstgold, also may require filing a CFIUS notice without optimal prior preparation.

Nonetheless, the unfortunate experience of Firstgold and Northwest points to planning missteps that, if avoided, might have positioned the parties better to deal with the issues that later arose.

First, the Binding Offer Letter did not did not reference CFIUS, and its projected milestone dates were inconsistent with a normal timetable for CFIUS action. Later, when the need to notify CFIUS became apparent, extensions of the closing date proved both disruptive and costly.

Second, Firstgold's disclosures and public statements provide no indication that the parties considered how Northwest's government ownership might affect the CFIUS timetable and substantive deliberations. Procedurally, Section 721 virtually mandates that CFIUS proceed to the full investigation stage where the foreign investing party is state-owned or controlled. Substantively, investments by Chinese state-owned entities are bound to attract closer attention than others as an initial matter, particularly when national security issues surface. But here, the parties initially reset their closing date to October 31 and then to November 17, neither of which realistically could have accommodated the full CFIUS investigation that was certain to happen.

Third, in their approach to CFIUS, Northwest and Firstgold seem to have focused only on the small size of Northwest's investment and Firstgold's gold mining business. Even after CFIUS proceeded to its full investigation, Firstgold's CEO stated: "We know of no reason why ownership of 51% of our small gold mining company would present a security threat to the United States and therefore are highly confident this review process will ultimately allow this investment to close." But, there is no *de minimis* investment threshold that falls outside of CFIUS's jurisdiction or interest, nor is the nature of the U.S. business determinative.

Apparently, CFIUS first advised the parties on December 8 specifically of its concern with the proximity of Firstgold's mining properties to Fallon Naval Air Station (NAS Fallon). It is well known, however, that many highly sensitive defense-related facilities are located throughout Nevada. In addition to NAS Fallon, these include the Nellis Air Force Range and the Department of Energy's Nevada Test Site.

NAS Fallon's Web site notes that "NAS Fallon and the Fallon Range Training Complex [FRTC] are the Navy's premier integrated strike warfare training facilities supporting present and emerging National Defense requirements." Further, "[t]he FRTC is particularly significant to the Department of Defense (DoD) because of its unique training and tactics development capabilities, extensive instrumentation and target sets, live ordnance impact areas, and its capability to provide Basic, Integration and Sustainment Phase training of Naval forces in the Fleet Readiness Training Plan (FRTP)." The FRTP encompasses numerous, publicly identified Military Operations Areas, at least one of which is quite close to Firstgold's Relief Canyon mine.

Interpreting the CFIUS Determination

The CFIUS decision to oppose the investment closely mirrored a decision announced on March 27, 2009 by Australian Treasurer Wayne Swan to disapprove the proposed acquisition of OZ Minerals by China Minmetals Non-ferrous Metals Co. Ltd.[4] OZ Minerals' assets include the Prominent Hill mining operation located in the Woomera Prohibited Area in South Australia. As Mr. Swan explained: "The Woomera Prohibited Area weapons testing range makes a unique and sensitive contribution to Australia's national defence. It is not unusual for governments to restrict access to sensitive areas on national security grounds."

Simply put, location matters when military facilities occupy the neighborhood. In the current environment of exceptional concern about electronic warfare and intelligence gathering by potential adversaries, the combination of Northwest's identity as a Chinese state-owned enterprise and the proximity of Firstgold's mining properties to known, secretive military installations predictably ensured close CFIUS examination, even if the full scope of potential sensitivities could not be pre-determined.

The outcome in Firstgold, therefore, should neither be taken as an expansive new direction by CFIUS, nor hostility to investments by Chinese state enterprises. In April 2009, for example, CFIUS cleared an acquisition of a controlling interest in Kennecott Copper, with its operations centered in Utah, by Chinalco, a state-controlled Chinese metals and mining company. (The parties later terminated that transaction for other reasons.) There are numerous other examples of foreign investments in U.S. natural resource assets, including uranium mining properties.

Given the locations of Firstgold's assets, Northwest and Firstgold could not avert a negative CFIUS decision. CFIUS advised the parties that all four of Firstgold's mining properties were problematic. On December 14 — seven days before the CFIUS deadline for completing its investigation — the parties floated the idea of reducing Northwest's ownership stake to 20%. Perhaps presenting an entirely different ownership structure as an initial, agreed transaction might have overcome the locational challenge, but again unsurprisingly, CFIUS declined to consider a transaction that was not before it.

One can only speculate whether, removed from the pressure of a looming government deadline, Northwest and Firstgold could have agreed to an acceptable business structure that would mitigate the concerns of CFIUS.

What may clearly be drawn from the Firstgold/Northwest experience, however, is the necessity of (i) taking a broad, precautionary approach to potential CFIUS concerns, (ii) factoring CFIUS consideration carefully into transaction planning and documentation, and (iii) fully engaging with CFIUS informally before initiating the time-constrained review process. Following these fundamental guidelines can help parties to avoid becoming lost in the CFIUS process and to identify the challenges before them, if not always the solutions.

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[1] Section 721 of the Defense Production Act of 1950, 50 U.S.C. App. § 2170, authorizes the President to block an acquisition of control of a U.S. business by a foreign person if he determines that the transaction presents a threat to the U.S. national security that cannot be addressed by other measures. "National security" is not defined in law, and the President's national security determinations are entirely within his discretion. To implement this authority, the President relies on CFIUS, an inter-agency committee chaired by the U.S. Department of the Treasury. This memorandum assumes basic familiarity with CFIUS. For more complete information on Section 721 and CFIUS practice, please see our client alerts "Treasury Department Issues Final Rule Updating CFIUS Regulations and Guidance on CFIUS National Security Assessments" (December 12, 2008), and "Closing the CNOOC and Dubai Ports World Debate: The Foreign Investment and National Security Act of 2007" (July 30, 2007).

[2] On August 6, the parties executed a revised Binding Offer Letter, but it made no material changes to the July 16 Letter.

[3] Section 721 and its implementing regulations do not require parties to covered transaction to notify CFIUS. CFIUS, however, may self-initiate a review of a transaction that the parties do not notify voluntarily.

[4] See "Foreign Investment," Treasurer of the Commonwealth of Australia Media Release No. 029 (March 27, 2009). One month later, Australia conditionally approved a revised transaction that omitted the Prominent Hill assets.

O'Melveny & Myers LLP has extensive experience representing parties concerning CFIUS matters, including experience from prior service in senior government positions. We welcome your comments and questions on the subject of this memorandum. Please contact the author for additional information.