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New U.S. Foreign Investment Rules Endorse Broad Restrictions

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As the value of the dollar falls and capital markets continue to tighten, U.S. businesses are increasingly turning to foreign investment for fresh sources of capital. Indeed, as evidenced by the Abu Dhabi Investment Authority's recent $7.5 billion investment in Citigroup, virtually all sectors of the U.S. economy are hungry for investment capital, much of it from outside the United States (with increased focus on sovereign wealth funds). But willing foreign investors are starting to run into a significant barrier, in the form of the "Exon-Florio" statute. A twenty-year-old law, Exon-Florio empowers the President to block or alter terms of "any merger, acquisition or takeover" where "there is credible evidence that the foreign entity exercising control might take action that threatens national security."[1] Transactions that recently have fallen prey to this heightened scrutiny include deals in the energy, telecommunications, transportation, computer technology and construction engineering sectors, in circumstances involving proposed investments by Middle Eastern sovereign wealth funds, Chinese government-controlled companies and even companies with no official ties to foreign governments. The latest casualty appears to have been Bain Capital's proposed $2.2 billion acquisition of 3Com, which failed when the parties could not satisfy Exon-Florio concerns arising from the 16.5% stake to be held by China's Huawei Technologies Co., a private company whose founder reportedly has ties to the Chinese military. These are some of the celebrated cases; there are many others that have arduously but successfully concluded the review process, often by agreeing to restrictions and conditions in a national security agreement (also referred to as a "mitigation agreement").

The escalation of the Exon-Florio approval process – and the broader array of deals to which it is being applied – requires that parties and advisors to any foreign investment in an existing U.S. company ("greenfields" projects remain beyond the scope of Exon-Florio) make provisions in the deal structure and timeline for a potentially long and rigorous U.S. Government review if they believe their transaction may be subject to the law. And now, new rules proposed by the U.S. Department of the Treasury codify and formalize the heightened scrutiny to which these deals are subject.[2] The new rules endorse a broad application of Exon-Florio, impose significant additional reporting and review procedures, and generally ensure that the burden and delay to which many deals have been subject will continue.

The story of Exon-Florio's impact on foreign investment in sensitive U.S. industries is not new. As far back as 1990, the first President Bush ordered a Chinese aerospace company to divest its ownership of a U.S. aircraft parts manufacturer. However, with the post-9/11 focus on homeland security, a broader perspective by the U.S. Government on industries and sectors that potentially impact the nation's security, and the concurrent rise of cross-border economic activity, Exon-Florio is coming increasingly to the fore. In 2005, the China National Offshore Oil Corporation was chased from the bidding for U.S. oil producer Unocal in large measure due to its inability to satisfy Exon-Florio concerns. In 2006, the Committee on Foreign Investment in the United States ("CFIUS"), the interagency body that reviews the national security impact of deals under Exon-Florio, came under intense fire from Congress for approving an acquisition by UAE-based Dubai Ports World ("DP World") of a ports management business from a British concern. (Under the deal, DP World would have assumed management of U.S. port facilities in New York, New Jersey, Philadelphia, Baltimore, New Orleans, and Miami, as well as operations in 16 other ports worldwide.)

That incident led Congress to pass the Foreign Investment National Security Act of 2007 ("FINSA"), a comprehensive revamping of Exon-Florio that imposes heightened scrutiny of any foreign investment transaction involving not just traditional military or national security assets, but also "critical infrastructure." FINSA also mandates that CFIUS conduct a formal review of any transaction in which a "foreign government-controlled entity" (including a sovereign wealth fund or a foreign government-owned company) might acquire a controlling interest in a U.S. business with assets or operations deemed "critical" to U.S. security. The Treasury Department was given six months to issue rules implementing FINSA.

The Treasury Department has proposed new rules (published on April 23, 2008) that offer a window into how complex, intensive and fact-specific the CFIUS review process has become.

"COVERED TRANSACTIONS" EXPANDED

CFIUS's jurisdiction to review transactions is premised on a congressional grant of authority to the President to suspend or prohibit any transaction that would provide a foreign person control over a U.S. person when the exercise of that control could impair national security. Transactions potentially subject to CFIUS review are referred to as "covered transactions" under the new regulations, and include any proposed or pending transaction "which could result in control of a U.S. business by a foreign person."[3] Although the definition of "covered transactions" is consistent with both the prior version of Exon-Florio and the existing regulations, what is covered has arguably been expanded in a number of respects.

First, although the new regulations provide some additional examples of when a minority stake does not confer "control," they also expand the agency's jurisdiction for reviewing certain kinds of transactions. For instance, the new regulations pointedly *reverse* the agency's prior interpretation of what constitutes foreign "control" over a U.S. joint venture. Specifically, the existing regulations declare that where a U.S. and foreign party form a joint venture with each holding a 50% interest, and where each holds a veto over major corporate decisions, the formation of the joint venture is *not* an acquisition subject to Exon-Florio.[4] The proposed regulations, *on the identical facts*, declare that the joint venture transaction *is* a "covered transaction."[5]

In a similar vein, the proposed regulations would tighten the so-called "ten percent passive investment" rule. Under the existing regulations, the acquisition of ten percent or less of the outstanding voting securities of a U.S. corporation is not subject to Exon-Florio, so long as the purchase is deemed "solely for the purpose of investment."[6] While the proposed regulations maintain both the ten percent threshold and the "solely for the purpose of investment" requirement, they make clear that, even with an investment of less than ten percent, a right to appoint even one out of 11 seats on the U.S. corporation's board of directors will mean that the purchase was not "solely for the purpose of investment" and thus could be deemed a "covered transaction."[7]

Moreover, through FINSA, Congress arguably broadened the scope of Exon-Florio jurisdiction by requiring that CFIUS consider the impact of a proposed transaction on homeland security, including "critical infrastructure." Many observers were looking in the proposed regulations for a more precise description of what qualifies as "critical infrastructure," but in this respect the regulations disappoint, defining the term somewhat vaguely as "systems and assets, whether physical or virtual, so vital to the United States that incapacity or destruction of particular systems or assets of the entity over which control is acquired pursuant to a covered transaction would have a debilitating impact on national security."[8] By perpetuating a vague definition and providing little guidance on what constitutes "critical infrastructure," the regulations leave a relatively empty vessel for U.S. security officials to fill on a case-by-case basis. Parties will continue to require the advice of experienced counsel and other advisors in anticipating whether a transaction raises concerns under this category.

REVIEW PROCESS INTENSIFIED

Consistent with FINSA's broader view of what transactions might trigger Exon-Florio concerns, the proposed regulations envision a significantly more intense review of proposed transactions by the CFIUS staff. Formal review of a transaction is typically triggered by the filing of a *voluntary* notice with CFIUS. Unlike other government clearance procedures, such as Hart-Scott-Rodino antitrust review, nothing in Exon-

Florio requires that parties file a notice or subject their transaction to government scrutiny.

However, CFIUS also has the authority to review a transaction even when the parties have not filed a voluntary notice, and the agency has recently demonstrated its willingness to act on that authority. Post-FINSA, the U.S. Government's increased vigilance, heightened level of review and expanded view of what industries and sectors impact "national security" or "critical infrastructure" have significantly raised the stakes for companies that elect not to file with CFIUS. CFIUS recently doubled the size of its staff, and when news gets out of a proposed transaction that might be covered, parties can expect CFIUS to reach out and "strongly encourage" that a filing be made. As a result, parties that elect not to file incur significantly more risk that, like the Chinese aerospace transaction 18 years ago, the President might intervene and block or unwind the deal after closing. By filing the notice, parties can seek formal clearance of a transaction and can obtain a degree of certainty that the transaction can go through.

FINSA also requires that, for certain transactions, CFIUS must conduct a more intense, second-stage investigation. Thus, in addition to the normal 30-day initial review period, any transaction in which a foreign government-controlled entity might obtain control of a U.S. business, or where CFIUS (or a member agency) believes that a foreign person could gain control of "critical infrastructure", under circumstances in which the transaction could impair U.S. national security is now subject to a mandatory second-stage 45-day investigation.[9] At the end of the 45-day investigation period, CFIUS may send a report to the President recommending that the transaction be cleared (often on condition that mitigation measures be agreed to and implemented by the parties), blocked or otherwise subject to decision by the President, who has 15 additional days to act. Thus, transactions subject to full investigations face a potential timeline of 90 days from acceptance of a completed voluntary notice to final clearance. Moreover, the new regulations strongly encourage parties to undertake the practice – which is now commonplace – of consulting with CFIUS informally before submitting an official notice, including providing CFIUS with a draft filing for review and comment. Thus, the actual timeline for clearance could extend significantly beyond this 90-day period. Parties to a potentially-sensitive foreign investment transaction who close prior to completion of CFIUS review do so at their peril and are well advised to provide ample time for Exon-Florio clearance in the deal timeline.[10]

The contents of the voluntary notice required by the new regulations have also been expanded, and providing a filing that CFIUS deems sufficient to start the clock on the initial 30-day review period will be more challenging than ever. Notably, parties must now describe all products or technology of the U.S. acquisition target that are "subject to" the U.S. Export Administration Regulations, a detailed compendium covering a broad array of U.S.-origin goods, technology and software, and even items that are not controlled for export to the foreign acquirer's jurisdiction.[11] The regulations also require (as CFIUS has been requesting for some time) the submission in a separate filing of detailed biographical information on senior managers and directors of the foreign party, as well as its intermediate and ultimate parent entities, including names, known aliases, addresses, dates and places of birth, U.S. Social Security numbers (where applicable), National identity numbers (where applicable), passport information and a description of previous military service.[12] The obvious purpose of this requirement is to permit U.S. security officials to conduct background checks of the foreign individuals involved in the acquisition.

FINSA also imposed significant additional reporting requirements on CFIUS, which now must respond to inquiries from and submit information to Congress on the work of the Committee and, in some cases, specific transactions that have been reviewed. These reports may identify parties to transactions that were reviewed, as well as "cumulative and, as appropriate, trend information" on filings made and industries affected by foreign investment activity. Moreover, information uncovered during Exon-Florio reviews will be used to report to Congress on whether there is "credible evidence of a coordinated strategy by 1 or more countries or companies to acquire United States companies involved in research, development, or production of critical technologies for which the United States is a leading producer" and "an evaluation of whether there are industrial espionage activities directed or directly assisted by foreign governments against private United States companies aimed at obtaining commercial secrets related to critical technologies."[13] While the statute provides that some or all of the contents of these reports can be classified, unclassified

versions will be made public. Moreover, the proposed regulations state that while voluntary notices are confidential and exempt from disclosure under the Freedom of Information Act, they remain subject to disclosure "to either House of Congress or to any duly authorized committee or subcommittee of the Congress…."[14]

It is the official position of the U.S. Government that foreign investment is strongly encouraged and that U.S. markets remain open and virtually free of investment barriers. However, this statement of principle is tempered by the reality of the post-9/11 world. FINSA, and the Treasury Department's proposed implementing regulations, make clear that Exon-Florio scrutiny will remain a substantial hurdle for foreign investors in those aspects of the U.S. economy deemed sensitive to national security. Nevertheless, a clear conception of what such aspects are remains elusive. In preparing to clear the Exon-Florio hurdle, parties must give careful thought to the structure of the deal, the elements of the U.S. business likely to give pause to U.S. officials, and mitigation measures that might be required. Perhaps most importantly, parties must build sufficient flexibility – and time – into the transaction to ensure that clearance can be obtained.

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[1] Section 721 of the Defense Production Act of 1950, 50 App. U.S.C. § 2170.

[2] *See* Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons, 73 Fed. Reg. 21861 (proposed April 23, 2008) (to be codified at 31 C.F.R. § 800). The proposed regulations are subject to a 45-day comment period; all written comments must be received by June 9, 2008.

[3] 73 Fed. Reg. at 21870 (to be codified at 31 C.F.R. § 800.206).

[4] *See* 31 C.F.R. § 800.301(b)(5) (Example 2).

[5] 73 Fed. Reg. at 21873 (to be codified at 31 C.F.R. § 800.301(d) (Example 1)).

[6] *See* 31 C.F.R. §§ 800.219 and 800.302(d).

[7] 73 Fed. Reg. at 21873 (to be codified at 31 C.F.R. § 800.302(c) (Example 2)).

[8] 73 Fed. Reg at 21870 (to be codified at 31 C.F.R. § 800.207).

[9] 73 Fed. Reg. at 21878 (to be codified at 31 C.F.R. § 800.503). Previously, initiation of investigations was entirely discretionary.

[10] The new regulations provide CFIUS with authority to impose civil penalties for certain violations of Exon-Florio, including breaches of any mitigation agreement. *See* 73 Fed. Reg. at 21880 (to be codified at 31 C.F.R. § 800.801).

[11] 73 Fed. Reg. at 21875 (to be codified at 31 C.F.R. § 800.402(c)(4)(i)).

[12] 73 Fed. Reg. at 21876 (to be codified at 31 C.F.R. §§ 800.402(c)(6)(vi)-(vii)).

[13] *See* Section 7 of FINSA for a complete description of new Congressional reporting requirements.

[14] 73 Fed. Reg. at 21879 (to be codified at 31 C.F.R. § 800.702(a)).