MERGERS AND ACQUISITIONS

Does Your Foreign Investment Transaction Need A CFIUS Review?

by Elliot J. Feldman and John J. Burke

The Foreign Investment and National Security Act of 2007 (FINSA)[1] substantially enhances US Government scrutiny of foreign investment, which previously took place pursuant to the Exon-Florio provision of the Omnibus Trade and Competitiveness Act of 1988.[2] It is now more important than ever for persons involved in transactions in which a foreign-owned entity will acquire a substantial stake in a US company to consider early on whether the deal should be notified voluntarily to the Committee on Foreign Investment in the United States (CFIUS) for pre-clearance.[3]

Under FINSA, the President may order the divestment of a foreigner's controlling interest in US assets should he determine that such control threatens US "national security."[4] FINSA authorizes CFIUS to self-initiate an investigation as to whether any "covered transaction" threatens US national security at any time.[5] CFIUS has begun inquiring into transactions consummated without pre-clearance on an institutionalized suspicion that failure to seek CFIUS review may involve an attempt to avoid national security scrutiny. When the parties to a transaction submit it to CFIUS for pre-clearance, however, CFIUS' approval provides a safe harbor, preventing the President from undoing the deal.[6] Consequently, companies should consider seeking a CFIUS review whenever the US business to be acquired plays any role in US national security, defined broadly.

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"Covered Transactions" Are Broadly Defined

FINSA defines "covered transaction" to mean any "mergers, acquisitions, or takeovers . . . by or with foreign persons which could result in foreign control of persons engaged in interstate commerce in the United States."[7] The Treasury Department, on behalf of CFIUS, published Proposed Regulations on April 23, 2008,[8] which define "covered transaction" to mean "any transaction that is proposed or pending after the effective date by or with any foreign person, which could result in control of a US business by a foreign person."[9]

These definitions cover the obvious case in which control over a US company is to be transferred from a US to a foreign owner. However, they also cover less obvious situations, such as when one foreign entity transfers control to another.[10] The Dubai Ports World controversy, which triggered the passage of FINSA, arose when control over certain US port facilities was to move from a British to a Middle Eastern owner.[11] Moreover, structuring a deal as an asset purchase, rather than a stock purchase, will not insulate a transaction from CFIUS' purview: The purchase of substantially all of the assets of a US business is a "covered transaction."[12]

The Proposed Regulations distinguish between the acquisition of an existing US business, on the one hand, and greenfield investments or strictly real estate transactions on the other. The former is a covered transaction, while the latter two are excluded.[13] However, even when a transaction is predominantly a greenfield investment or a real estate transaction, should any aspect of the transaction involve the transfer of control over an existing US business to a foreign person, the parties should assume the transaction would be covered.

"Control" is the critical factor in determining whether a transaction is a "covered transaction." Congress left the definition of "control" to CFIUS, whose Proposed Regulations define "control" as:

> the power, direct or indirect, whether or not exercised, through the ownership of a majority or a dominant minority of the total outstanding voting interest in an entity, board representation, proxy voting, a special share, contractual arrangements, formal or informal arrangements to act in concert, or other means, to determine, direct, or decide important matters affecting an entity . . . .[14]

This definition of "control" is not limited to immediate transfers of control. One of the examples provided in the Proposed Regulations states that even were the foreign acquirer to agree not to exercise its voting and other rights for 10 years, the transaction still would be covered.[15]

The dominant minority language recognizes that control can change even when the acquirer is obtaining substantially less than 50 percent of a company's shares. The Proposed Regulations set 10 percent as the minimum threshold for control, as long as the acquisition is made for purely investment purposes, by providing that the following is not a "covered transaction":

> A transaction that results in a foreign person holding ten percent or less of the outstanding voting interests in a U.S. business . . ., but only if the transaction is solely for the purpose of investment. (citation omitted)[16]

The Proposed Regulations further clarify that

> Ownership interests are held or acquired 'solely for the purpose of investment' if the person holding or acquiring such interests has no plans or intention of exercising control, does not possess or develop any purpose other than investment, and does not take any action inconsistent with acquiring or holding such interests solely for the purpose of investment. (citation omitted).[17]

Thus, whenever a transaction that could impact national security will result in a foreigner acquiring more than a 10 percent interest in an existing US business, or acquiring any interest with a purpose other than a passive investment, the parties should consider notifying the deal to CFIUS for pre-clearance.

Broad Discretion to Define "National Security"

Under FINSA, the President may "suspend or prohibit any covered transaction" whenever he finds credible evidence "that the foreign interest exercising control might take action that threatens to impair the national security" and other provisions of law do not provide adequate authority to protect the national security.[18] The legislation exempts these actions and findings from judicial review.[19] Furthermore, the statute does not define "national security," thus giving the President broad discretion to define it on a case-by-case basis.

"National security," however ultimately defined, is not confined to defense contractors and other matters directly affecting the military. FINSA clarifies that national security "shall be construed so as to include those issues relating to 'homeland security', including its application to critical infrastructure."[20] The factors that CFIUS must consider in its reviews include the potential national security related threats to "critical infrastructure, including major energy assets," "critical technologies," and "US requirements for sources of energy and other critical resources and materials."[21]

The Proposed Regulations define "critical infrastructure" to mean "systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of the particular systems or assets of the entity over which control is acquired pursuant to that covered transaction would have a debilitating impact on national security."[22] Given the context in which FINSA and the Proposed Regulations were crafted, foreign investors should not be surprised to see the definition of "critical infrastructure" interpreted to cover transportation, telecommunication, and energy facilities, among others.

The term "critical technologies," as defined in the Proposed Regulations, covers:

- Items controlled under the International Traffic in Arms Regulations;

- Items controlled under the Export Administration Regulations (EAR) for reasons of national security, chemical and biological weapons proliferation, nuclear nonproliferation, missile technology, regional stability and surreptitious listening;
- Nuclear equipment, software and technology specified in the Assistance to Foreign Energy Activities Regulations and the Export and Import of Nuclear Equipment and Materials Regulations; and
- Agents and toxins specified in the Export and Import of Select Agents and Toxins Regulations. (citation omitted).[23]

The inclusion of the EAR in this definition makes it particularly broad because EAR is intended to cover civilian items. For example, the EAR controls for export thousands of models of computers and electronic equipment for at least one of the reasons listed in the definition of "critical technologies."[24] Most of these models could be exported to most countries without an export license. Nevertheless, they remain subject to export control under the EAR and, thus, help provide a very broad definition of "critical technologies" for purposes of CFIUS review.

FINSA also creates a presumption that the threat to national security is greater when a foreign government is the acquirer. As described below, the CFIUS process consists of an initial 30-day national security review and, only if necessary, a subsequent 45-day national security investigation.[25] However, FINSA provides that "if [CFIUS] determines that the covered transaction is a foreign government-controlled transaction, [CFIUS] *shall* conduct an investigation...."[26] The statute defines "foreign government-controlled transaction" to mean "any covered transaction that could result in control of any person engaged in interstate commerce in the United States by a foreign government or an entity controlled by or acting on behalf of a foreign government."[27]

The CFIUS Process

CFIUS pre-clearance acts as a safe harbor under FINSA unless one of the parties to the transaction submits false or misleading material information in connection with the original review, or a party intentionally and materially breaches a mitigation agreement pursuant to which the transaction was pre-cleared.[28] The process should begin when a party to a proposed transaction contacts CFIUS informally to consult on the filing of a voluntary notice seeking pre-clearance for the transaction.[29] These informal consultations may provide sufficient comfort to the parties on some marginal transactions to obviate their perceived need for a CFIUS review.

The formal process begins with a party to the transaction filing a voluntary notice which, when accepted, starts a 30-day review period.[30] The Proposed Regulations detail for several pages in the *Federal Register* the required information about the proposed transaction, the parties to it, and the US business to be acquired, that must be included with the voluntary notice.[31] The person filing the notice, who must be a senior company official, must certify its accuracy.[32] Should the CFIUS staff conclude that not all of the required information has been provided they may reject the notification or defer acceptance of it and the start of the 30-day review period.[33] It is anticipated that most 30-day reviews will end with a determination that the proposed transaction does not require any action to protect national security. In such cases, the parties will be notified in writing, with the notice acting as a bar to subsequent Presidential action prohibiting or undoing the transaction under the authority of FINSA.[34]

Should any member of CFIUS advise the Chair that it believes the proposed transaction poses an unmitigated risk to national security, or should the transaction be foreign government-controlled, then CFIUS will commence a full 45-day investigation. FINSA expressly authorizes CFIUS to enter into agreements with any party to a covered transaction to mitigate the threat to national security.[35]

Most investigations will end with a notification that, in effect, will act as a CFIUS pre-clearance for the transaction. However, many investigations will end with implicit approval because the parties entered into a mitigation agreement with the government. Many such agreements contain provisions that allow CFIUS to monitor the parties'

compliance in perpetuity. The Proposed Regulations provide civil penalties for intentional or grossly negligent violations of mitigation agreements of $250,000 per violation, or the value of the transaction.[36] This civil penalty is separate from any damages the government may seek pursuant to the terms of the mitigation agreement.

The most important consideration for success in a CFIUS review is an understanding in advance of the institutional and other concerns of the CFIUS member agencies, and creative thinking about how to demonstrate that those concerns are not threatened, or to mitigate them. Another key element of success is congressional and media neutrality or support. Therefore, parties considering CFIUS notifications of transactions that might appear controversial should consider supplementing their legal work in the CFIUS process with public and congressional relations campaigns.

NOTES

1. Foreign Investment and National Security Act of 2007, Pub. L. No. 110-049, 121 Stat. 246. (2007),

2. Section 721 of the Defense Production Act of 1950, 50 U.S.C. App. § 2170, as amended by Section 5021 of the Omnibus Trade and Competitiveness Act of 1988, 102 Stat. 1107 *et. seq.*, Aug. 23, 1988.

3. CFIUS is chaired by the Secretary of the Treasury and by statute is comprised of the Secretaries of the Treasury, Homeland Security, Commerce, Defense, State, Energy, Labor, the Attorney General and the Director of National Intelligence or their designees. FINSA § 3. FINSA authorizes the President to name additional members and by Executive Order the President added the United States Trade Representative and the Director of the Office of Science and Technology Policy. Executive Order 11858 (Jan. 23, 2008).

4. 50 U.S.C. App. § 2170(d)(1) (2007).

5. 50 U.S.C. App. § 2170(b)(1)(D)(i).

6. *See* Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons, Proposed Rule, 73 Fed. Reg. 21,861 § 800.601. (Apr. 23, 2008) (Proposed Regulations).

7. 50 U.S.C. App. § 2170(a)(3).

8. *See* Proposed Regulations.

9. Proposed Regulations. 73 Fed. Reg. at 21,870 § 800.206. The effective date is August 23, 1988, the day on which the original Exon-Florio Amendment became effective.

10. *See* Proposed Regulations, 73 Fed. Reg. at 21,872 § 800.301(b) ("A transaction in which a foreign person conveys its control of a US business to another foreign person.")

11. *See* Rachelle Younglai, "U.S. Rules for Foreign Takeover Deals Seen in April," *Reuters*, (Apr. 8, 2008).

12. Proposed Regulations, 73 Fed. Reg. at 21,872 § 800. 301(c) Example 4.

13. *See id.* at § 800.301(c), Examples 3, 6, and 7.

14. Proposed Regulations, 73 Fed. Reg. at 21,869 § 800.203(a). The regulatory definition provides 10 examples of important matters, which indicate control when a person has a right to decide them. The definition also provides five examples of standard minority shareholder protections that in and of themselves do not confer control.

15. *See* Proposed Regulations, 73 Fed. Reg. at 21,872 § 800.301(a), Example 3.

16. Proposed Regulations, 73 Fed. Reg. at 21,873 § 800.302(c)

17. Proposed Regulations, 73 Fed. Reg. at 21,871 § 800.223.

18. 50 U.S.C. App. §§ 2170(d)(1) and (4).

19. *See* 50 U.S.C. App. § 2170(e).

20. 50 U.S.C. App. § 2170(a)(5).

21. 50 U.S.C. App. §§ 2170(f)(6), 2170(f)(7), and 2170(f)(10).

22. Proposed Regulations, 73 Fed. Reg. at 21,870 § 800.207.

23. *Id.* at § 800.208.

24. 15 C.F.R. Pt. 774 Supp. 1 (Categories 3 and 4) (2008).

25. *See* 50 U.S.C. App. §§ 2170(b)(1)(E) and 2170(b)(2)(C).

26. 50 U.S.C. App. § 2170(b)(1)(B) (emphasis added); *see also* 50 U.S.C. App. § 2170(b)(2)(B)(i)(II).

27. 50 U.S.C. App. § 2170(a)(4).

28. *See* 50 U.S.C. App. §§ 2170(b)(1)(D)(ii) and 2170(b)(1)(D)(iii).

29. *See* Proposed Regulations, 73 Fed. Reg. at 21,874 § 800.401(f).

30. *See* 50 U.S.C. App. § 2170(b)(1)(E); Proposed Regulations, 73 Fed. Reg. at 21,878 § 800.502(b). Any member of CFIUS also can file an agency notice instituting a CFIUS review of the transaction up to three years after its completion, or thereafter upon request from the Secretary of the Treasury. Proposed Regulations, 73 Fed. Reg. at 21,874 § 800.401(c).

31. *See* Proposed Regulations, 73 Fed. Reg. at 21,874-77 §§ 800.402(a) through 800.402(k). Among the information that must be provided is the export commodity classification numbers for the US company's products. *See* Proposed Regulations, 73 Fed. Reg. at 21,874-77 § 800.402(c)(4). This requirement could force a company to undertake a very complicated export classification process under extreme time pressure for products it has never exported.

32. *See* Proposed Regulations, 73 Fed. Reg. at 21,877 § 800.402(l).

33. *See id.* at 877 § 800.403.

34. *See* Proposed Regulations, 73 Fed. Reg. at 21,878, 21879 §§ 800.504 and 800.601(a).

35. *See* 50 U.S.C. App. § 2170(l)(1)(A).

36. *See* Proposed Regulations, 73 Fed. Reg. at 21,880 § 800.801(b).