DechertOnPoint

May 2008 / Special Alert

A legal update from Dechert's Mergers and Acquisitions Group

U.S. Treasury Proposes Regulations Regarding Exon-Florio Reviews of Foreign Investments in the United States

On April 21, 2008, the U.S. Department of the Treasury issued proposed regulations implementing the Foreign Investment and National Security Act of 2007 ("FINSA"). FINSA, which became effective on October 24, 2007, provided new guidelines for the Committee on Foreign Investment in the United States ("CFIUS") with respect to CFIUS' national security reviews of foreign investments in U.S. businesses.

The Proposed Regulations

- Formalize the existing practice of CFIUS to encourage parties to consult with CFIUS prior to making a formal filing
- Significantly increase and expand the information required for a formal CFIUS filing
- Clarify and expand the concept of foreign "control" to include both significant negative as well as positive rights with respect to a U.S. business
- Provide for civil penalties for including materially false or misleading information in a CFIUS filing or for breaching any mitigation agreement imposed as a condition to CFIUS clearance of a transaction

Background

CFIUS, an interagency committee chaired by the Secretary of the Treasury, serves the President by reviewing the national security implications of acquisitions, mergers and takeovers which could result in foreign control of any person engaged in interstate commerce in the United States (referred to as a "covered transaction" under FINSA). Upon a recommendation from CFIUS, the President may suspend or prohibit the consummation of any covered transaction that threatens the national security of the United States.

Originally created by Executive Order in 1975, the CFIUS process was subsequently codified by the 1988 Exon-Florio Amendment to the Defense Production Act of 1950. Generally, the CFIUS review process begins with a voluntary notification by the parties to a covered transaction with potential national security concerns.[1] Upon receipt of the initial formal notification, CFIUS will conduct a 30-day review of the transaction. If CFIUS determines that a particular transaction represents a threat to U.S. national security (and such threat has not been mitigated during the initial 30-day review), CFIUS may commence a further 45-day investigation. Upon the conclusion of the 45-day investigation, CFIUS will normally make a recommendation regarding the transaction to the President. The President will then have 15 days from the date of such recommendation to clear, prohibit, or suspend the transaction.

[1] CFIUS may nevertheless initiate its own review of any covered transaction or request that the parties make a voluntary submission. Moreover, CFIUS retains the authority to investigate any transaction, even after the transaction has closed, notwithstanding the parties' decision to forego a voluntary CFIUS notification.

Dechert LLP

FINSA, which amends the Exon-Florio Amendment, formalizes the membership, structure, process and responsibilities of CFIUS. FINSA codifies:

- the membership of CFIUS to include the Secretary of the Treasury, the Secretary of Commerce, the Secretary of State, the Secretary of Homeland Security, the Secretary of Defense, the Attorney General, the Secretary of Energy, and two nonvoting members consisting of the Secretary of Labor and the Director of National Intelligence;[2]

- several new factors for CFIUS to consider in reviewing the national security implications of a transaction, including the national security impact of a particular transaction on critical infrastructure or critical technologies; and

- the authority of CFIUS to negotiate, enter into, and enforce an agreement or condition with any party to a covered transaction in order to mitigate any potential threats to national security arising from such transaction (commonly referred to as a "mitigation agreement").

Mitigation agreements may impose any number of requirements and restrictions on parties to a covered transaction including, among other things, (i) adopting a security plan, (ii) appointing a security officer, (iii) conducting background checks for key personnel, (iv) limiting the involvement of foreign personnel with sensitive projects, (v) certifying compliance with export control laws and regulations, (vi) notifying the government of certain security incidents (including cyber attacks), and (vii) permitting the government to conduct onsite visits or audits and granting access to relevant records. Given the current political climate, foreign investors face a greater likelihood of being compelled to enter into potentially burdensome mitigation agreements in order to obtain CFIUS clearance for a transaction.

FINSA makes clear that transactions previously cleared by CFIUS may be reopened (and perhaps unwound) after the transaction has closed if any party submitted false or misleading material information to CFIUS or intentionally and materially breached a mitigation agreement. FINSA requires CFIUS to conduct a 45-day investigation for transactions in which the acquiring entity is controlled by a foreign government.[3]

The Proposed Regulations

The proposed regulations make a number of changes to the procedures for filing a notification with CFIUS. They formalize the current practice of CFIUS to encourage parties to consult with CFIUS prior to making a formal filing. Such consultations may involve providing CFIUS with a draft notice or a portion thereof to ensure that CFIUS has the necessary information to efficiently evaluate the transaction. Information provided to CFIUS prior to a formal filing will be afforded the confidentiality protections of FINSA.

In addition, the proposed regulations expand the information required for a voluntary CFIUS notice to include information typically requested by CFIUS during its review. Such information includes, among other things, information regarding:

- the ultimate and intermediate parents of the foreign acquirer;

- the value of the transaction;

- contracts between the target company and the government;

- goods supplied by the target company to the government;

- the nature of the product(s) manufactured by the target company;

- any special rights held by a foreign government with respect to the foreign acquirer;

- any agreements among foreign persons to act in concert; and

- personal identifier information for key personnel.

[2] Under FINSA, the President has the authority to appoint additional members of CFIUS from other agencies.

[3] The "lead agency" with respect to a particular transaction and the Treasury Department may waive the 45-day investigation if they jointly determine that the transaction will not impair national security.

Any voluntary notice is required to include a description of any critical infrastructure or critical technology involved in a transaction. The proposed regulations define "critical infrastructure" to include systems or assets so vital to national security that the incapacity or destruction of such systems or assets would have a debilitating impact on national security. The proposed regulations also expand the definition of "critical technology" to include certain items covered by various regulatory regimes, including the U.S. Munitions List (as set forth in the International Traffic in Arms regulations), the Commerce Control List (as set forth in the Export Administration regulations), the Assistance to Foreign Energy Activities regulations, the Export and Import of Nuclear Equipment and Materials regulations, and the Export and Import of Select Agents and Toxins regulations.

As set forth in FINSA, the proposed regulations also require the parties to a CFIUS filing to provide a certification regarding the accuracy and completeness of certain information submitted to CFIUS. A CFIUS filing will be considered to be incomplete if the required certifications are missing, and any previously accepted filing will be rejected if the required certification has not been received by CFIUS.

Significantly, the proposed regulations amend and clarify the meaning of several important terms used in the definition of "covered transaction." Any transaction involving a merger, acquisition or takeover by or with a *foreign person* which could result in foreign *control* of a *U.S. business* is considered to be a "covered transaction" and therefore subject to CFIUS review. The proposed regulations consider the concept of "control" in terms of the ability to exercise (either affirmatively or negatively) certain powers regarding important matters affecting a business.[4] Specifically, "control" is defined as the "power, direct or indirect, whether or not exercised, through the ownership of a majority or a dominate 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." Such "important matters" include, among others:

- the sale, lease, mortgage or transfer of principal assets of an entity;
- the reorganization, merger or dissolution of the entity;
- major expenditures or investments (including the issuance of equity or debt) by the entity;
- the execution or termination of significant contracts; and
- the appointment or dismissal of officers or senior managers.

According to the Treasury Department, the concept of control is not subject to any bright line test based on share ownership or board representation. Rather, all relevant factors must be considered with respect to a foreign person's ability to determine important matters affecting a company.

A foreign person will not be deemed to "control" an entity if such person holds 10% or less of the voting interest in such entity and its interest is held solely for the purpose of investment.[5] Nevertheless, the proposed regulations make clear that, contrary to a widespread misconception in the investment community, no exemption will be provided if the foreign person's interest in a particular entity is not held solely for investment purposes, regardless of whether such person owns 10% or less of the entity.

Certain protections afforded to minority investors will not be deemed to constitute "control" of an entity. Such protections include:

- the power to prevent the sale or pledge of all or substantially all of the assets of an entity;

4 The concept of "control" is prevalent throughout the proposed regulations. For example, a "foreign government-controlled transaction" (i.e., a transaction in which the acquirer is *controlled* by or acting on behalf of a foreign government) is generally subject to a 45-day investigation by CFIUS. Additionally, a joint venture may be a covered transaction if it would result in *control* of a U.S. business by a foreign person.

5 An ownership interest will be held "solely for the purpose of investment" if the person acquiring such interest "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."

- the power to prevent majority investors from entering into contracts with the entity;
- the power to prevent the entity from guaranteeing any obligation of the majority investors;
- anti-dilution provisions designed to preserve an investor's pro rata interest in the entity; and
- the power to prevent any amendments to an entity's constituent documents with respect to the foregoing matters.

The proposed regulations introduce the term "U.S. business" to the definition of a covered transaction. A "U.S. business" is defined to include any entity engaged in interstate commerce in the United States, but only to the extent of its activities in interstate commerce. An "entity" is not limited to separately organized legal entities or governments. The proposed regulations make clear that an "entity" may include, among other things, a division of a corporation or a collection of assets operated as a business undertaking in a particular location or for particular products or services.

The proposed regulations have also expanded the definition of "foreign person" to include any "foreign entity."[6] A "foreign entity" includes: (i) any public company organized under the laws of a foreign state whose equity securities are primarily traded on a foreign exchange; or (ii) any other entity organized under the laws of a foreign state in which foreign nationals hold at least 50% of the outstanding ownership interest. According to the Treasury Department, an entity may be a foreign entity notwithstanding the fact that a number of foreign persons hold ownership interests and no single foreign person controls the entity.

The proposed regulations provide for civil penalties in an amount not to exceed $250,000 for certain violations of the Exon-Florio Amendment (as amended by FINSA) or of any mitigation agreements between the parties and CFIUS. CFIUS is also permitted to include a liquidated damages provision in any mitigation agreement.

[6] A foreign person also includes any foreign national, foreign government or any entity over which control is exercised or exercisable by a foreign national, foreign government or foreign entity (including a U.S. acquirer controlled by a foreign person).

The Treasury Department is requesting comments on the proposed regulations for a period of 45 days from the date of publication in the Federal Register.

Practice Pointers for M&A Participants

Additional Timing Constraints

As noted, the proposed regulations encourage pre-filing consultations with CFIUS and expand the information required for a CFIUS filing. Parties should therefore be aware that the overall time frame for CFIUS review and clearance will often extend beyond the statutorily prescribed review periods. This will likely place added pressure on buyers and sellers in many transactions because obtaining CFIUS approval of the transaction will often be a condition to closing.

Attractiveness of Certain Foreign Bids

The expense and delay associated with a CFIUS review may place foreign bidders at a competitive disadvantage in an auction situation or where time to closing or conditionality of offers is particularly sensitive.

Mitigation Negotiations

FINSA formalizes the authority of CFIUS to negotiate and enforce mitigation agreements containing any number of conditions designed to mitigate perceived national security threats. The parties to a CFIUS review should consider whether to include the absence of certain particularly onerous or burdensome mitigation conditions as a condition to closing in the relevant purchase document, much in the same manner that parties negotiate divestment or other behavioral hurdles with respect to antitrust issues.

When in Doubt, File?

In many instances, the CFIUS review is at once a political and regulatory process. FINSA and the proposed regulations incorporate a number of broadly defined and fluid concepts, such as "control" and "critical infrastructure," which may be subject to differing interpretations depending upon the nature of the transaction and the political climate at the time it is reviewed. CFIUS estimates that it will receive notification of approximately 120 transactions per year with approximately 12 of those transactions subject to a 45-day investigation or mitigation agreement. Although CFIUS filings may remain relatively rare over-

all, given the current political climate, especially in the wake of the failed 3Com and Dubai Ports World deals and the expansion of the concept of "national security" under FINSA, we expect CFIUS filings to increase in the short term. However, it is unclear whether the level of CFIUS filings will increase over the long term.

Parties electing not to make a CFIUS filing should remember that the government may unwind a transaction if it is later determined to adversely affect national security. CFIUS staff actively review financial publications and other resources for relevant transactions and will make inquires regarding transactions that may have merited a voluntary CFIUS filing.

But Filing May Come with a Price

When deciding whether to make a formal CFIUS filing, parties should consider that in connection with a CFIUS filing, the government may insist upon a burdensome mitigation agreement or other conditions to address perceived national security threats before approving a transaction.

Limited Ability to Test Drive with Regulators

Given the fact-intensive nature of a decision whether to make a CFIUS filing, the parties may have difficulty preserving anonymity when conducting pre-filing discussions with CFIUS. In addition, it remains to be seen whether the CFIUS staff will provide guidance as to substantive or interpretative "file/don't file" issues as opposed to more technical advice regarding informational filing requirements.

Practice group contacts

For more information please, contact one of the Dechert lawyers listed or the Dechert attorney with whom you regularly work. Visit us at www.dechert.com/corporateandsecurities.

William G. Lawlor
Philadelphia
+1 215 994 2823
william.lawlor@dechert.com

Michael J. Budicak
Philadelphia
+1 215 994 2336
michael.budicak@dechert.com

Lisa C. S. Burnett
Philadelphia
+1 215 994 2716
lisa.burnett@dechert.com

Dechert LLP

www.dechert.com

U.S. Austin • Boston • Charlotte • Hartford • Newport Beach • New York • Philadelphia Princeton • San Francisco • Silicon Valley • Washington, D.C. • **EUROPE** Brussels London • Luxembourg • Munich • Paris • **ASIA** Hong Kong