# Mergers & Acquisitions

## Foreign Company Acquisitions

### U.S. Proposes Changes in National Security Reviews of Foreign Direct Investment

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After many months of expectation and suspense, the wait is almost over. On 23 April 2008, the U.S. Department of Treasury published proposed regulations that implement changes mandated by the Foreign Investment and National Security Act of 2007 (FINSA) regarding U.S. Government review of foreign investment in the U.S. While the proposed regulations leave such review largely unaltered, they introduce some significant changes as well.

Although the proposed regulations do not provide the clarity in some key areas that many had hoped for, they are likely to come as a relief to the investment community. Indeed, initial reviews have been generally positive, as the regulations signal (as does FINSA) that foreign investment remains welcome in the U.S.

*Background to Statutory Changes*

The current regulations governing the U.S. Government's review of the impact of foreign investment on U.S. national security have been in place for almost two decades. While these procedures had been the subject of occasional attention from the U.S. Congress, two recent transactions generated significant controversy and inspired Congress to act.

First, in 2005 the Chinese Government-owned China National Offshore Oil Corporation (CNOOC) attempted to acquire the U.S. oil company Unocal. Some U.S. politicians expressed concern, and they called on the U.S. Government to block the transaction. This put the little known interagency Committee on Foreign Investment in the U.S. (CFIUS) in the public eye. CFIUS did not review the proposed transaction, however, as CNOOC withdrew its bid in the face of strong political opposition.

The drive for reform of the so-called "CFIUS process" was strengthened by the acquisition by DP World (DPW), a company ultimately owned by the Government of Dubai in the United Arab Emirates, of P&O, a UK-based ports-management company. Because P&O held contracts to provide management services in a number of U.S. ports, the transaction was subject to CFIUS review. Press reports indicate that the parties voluntarily submitted the transaction for such review, and that when the CFIUS raised certain concerns with DPW, DPW agreed to take steps to mitigate such concerns. Notwithstanding the agreement reached between DPW and the CFIUS and the generally favourable relations between the U.S. and Dubai, members of Congress (among others) voiced concern that, as some described it, an Arab government would run U.S. ports. The intensity of the backlash caught many people, including senior Administration officials, by surprise. Even though DPW voluntarily divested the U.S. assets acquired in the transaction, many in Congress remained convinced that the CFIUS review process itself required a fresh look.

Over twenty legislative proposals later, Congress adopted FINSA to address concerns highlighted by the CNOOC and DPW transactions. The proposed regulations implementing FINSA are subject to public comment until early June 2008, and final regulations are expected thereafter.

### *FINSA*

Under FINSA, the general outline, purpose and stakes of the CFIUS process remain largely untouched. The jurisdiction of CFIUS remains the review of transactions in which a foreign entity may acquire "control" over a U.S. entity. If the CFIUS determines that a transaction may threaten U.S. national security, the transaction may be blocked or, if it has already been completed, divestiture may be required. The process is initiated by a notice, which the parties may file voluntarily with CFIUS or which the CFIUS might request. Following the filing of a notice, CFIUS conducts an initial thirty day review of the transaction. If CFIUS decides that the transaction warrants additional scrutiny, it launches a second-stage, forty-five day investigation. If CFIUS then decides that the transaction should be blocked or unwound, it recommends such action to the U.S. President. CFIUS review and clearance of a transaction provides a "safe harbour;" a vetted transaction can be revisited only in exceptional circumstances.

One of FINSA's main changes concerns acquisitions by entities owned or controlled by foreign governments; such acquisitions now must automatically undergo a two-stage, seventy-five day review unless senior government officials expressly certify that the transaction does not pose national security problems. FINSA also makes it more likely that acquisitions of "critical infrastructure" will also undergo an extended review unless senior officials make a similar certification. By reversing the burden of proof (*i.e.*, to avoid a second-stage investigation, CFIUS officials must certify that the selected transactions *do not* threaten national security) FINSA expresses a clear preference for a more careful analysis of these transactions.

Other important changes brought about by FINSA include granting CFIUS express authority, in certain limited instances, to reopen deals that had already been approved, granting CFIUS express authority to negotiate and conclude "mitigation agreements" (*i.e.*, agreements that address the U.S. Government's security concerns, which in turn allows CFIUS to clear the transaction), mandatory assessment of transactions by U.S. intelligence agencies, increased oversight of CFIUS by the U.S. Congress, and mandatory involvement by senior government officials in CFIUS reviews, among others.

### *Proposed Regulations*

The investment community expressed its general satisfaction with FINSA; it was clear that Congress felt the need to act, and FINSA's balancing of national security and investment concerns was viewed as superior to other legislative proposals. The concern remained, however, that the Executive agencies that comprise the CFIUS would tighten the screws on foreign investment when drafting regulations implementing FINSA. In this light, the proposed regulations have been received by the investment community with approval. Whilst a number of provisions leave one wishing for more clarity, the regulations are not seen as upsetting FINSA's balanced approach.

### *Definitions*

One of the common complaints is that the regulations do not achieve what many had hoped for: more specific definitions for a number of important terms set out in FINSA.

Key among these terms is "control," which is a paramount concept in CFIUS reviews, because CFIUS' jurisdiction, and hence the power to block deals, extends only to transactions in which foreign parties may acquire "control" over a U.S. party. It is a peculiar feature of the U.S. system that the trigger for a review is not the acquisition of ownership of the company, its assets or even a given percentage of its shares, but acquisition of "control" over the company, a somewhat malleable concept. In fact, as the definition provides, control can result not only from acquisition of ownership of a majority or significant minority of voting interests, or board seats, but also through "other means." This is not an accident; the preamble to the regulations acknowledges that they "eschew bright lines," and apply a functional, rather than quantitative, analysis. The

regulations do specify that "negative control" – *i.e.*, the power to *block* important decisions – constitutes control that is subject to CFIUS' jurisdiction. The test therefore focuses on all relevant factors that may be indicative of control, and on the acquirer's ability to influence key corporate and business decisions of the company, such as mergers or dissolutions. While the regulations note that "influence" does not constitute "control," little guidance is provided regarding factors that might be seen to distinguish one from the other.

However, in a welcome change, the new regulations provide explicit examples of certain types of minority shareholder protections, such as the power to prevent the sale of all or substantially all the assets or to prevent contacts between the company and its major investors that do not constitute control.

A highly-anticipated element of the new regulations is the treatment of the so-called "ten percent test," a provision in the previous regulations that some argued generally provided that a passive investment below ten percent would be deemed by CFIUS not to give the acquirer control, and hence would be exempt from CFIUS' scrutiny. A recent wave of investments by foreign sovereign wealth funds into U.S. financial institutions that fell slightly below ten percent generally gave credence in the public eye to the existence of a ten percent exemption. The new regulations maintain the rule but clarify that the investment must be "passive" and not exhibit indicators of control. This is exemplified by a hypothetical provided in the regulations in which an entity acquiring only a five percent voting interest would not qualify for the exemption if its holding entitled it to appoint one of eleven directors. Whilst this factor, in itself, would not qualify as "control," it would disqualify the investor from the exemption for which it may have thought to qualify by limiting its investment below ten percent.

Another example of a definitional deficit in the new regulations is the treatment of "critical infrastructure," the acquisition of which makes a two-stage scrutiny of the deal by CFIUS likelier. While many would associate "critical infrastructure" with telecommunications, transportation, or energy assets, FINSA's definition is far broader: "systems and assets, whether physical or virtual, so vital to the United States that their incapacity or destruction would have a debilitating effect on national security." This definition is no more specific than that provided in FINSA, allowing CFIUS as much discretion as possible in this regard. In this case, more guidance may come in the future, as under FINSA CFIUS is bound to publish a list of cases it has handled where critical infrastructure concerns were analysed. Unsurprisingly, the regulations also do not provide more guidance on other terms impacting the classification of assets as "critical infrastructure," such as "national security" and "homeland security."

*More Information*

The new regulations require the transaction parties to provide more information than before. In addition to general information about the transaction and the parties, the regulations now require a range of information including the value of the transaction, an organisation chart reflecting all the entities between the foreign acquirer and its ultimate parent (which, in large companies, may include a number of entities), the names of all financial institutions involved in the transaction (including advisers), information on production or trade in critical technologies, and copies of cyber-security plans. The new regulations also require the foreign acquirer to provide "personal identifier information" to CFIUS regarding board members and senior executives of the acquirer and also of any other entity between the acquirer and the ultimate parent, raising concerns for personal privacy. An analogous set of corporate information (so-called "business identifier information") is required with respect to all entities in the ownership chain between the acquirer and the ultimate parent. Overall, the burden imposed on transaction parties has increased considerably.

### *Enforcement and Penalties*

The new regulations also strengthen CFIUS' enforcement powers. While CFIUS' authority in this regard previously was not clear, FINSA remedied this in two ways. First, it clarified that if the parties to a transaction submit false or misleading material information to CFIUS, or if they intentionally and materially breach a "mitigation agreement," they can lose the very benefit they gained from the CFIUS process: CFIUS' blessing for the transaction. In these scenarios, CFIUS can unilaterally reopen its review of any transaction. Second, FINSA authorised the CFIUS to impose civil penalties. Implementing this mandate, the proposed regulations provide for penalties of up to $250,000 per violation.

### *Prefiling*

The fourth key change introduced by the regulations is the codification of CFIUS' well-known preference for the parties to engage in pre-filing consultations with CFIUS on incoming transactions. Due to the short deadlines and increasing scope of CFIUS' inquiries, CFIUS agencies were reported to have too little time to properly assess transactions for national security concerns. The new regulations explicitly state that parties are "encouraged" to contact CFIUS before filing, and even provide for the opportunity to submit draft notices before the filing.

### *Mitigation Agreements*

The regulations also are notable for what they do not cover. One of FINSA's interesting novelties was the provision codifying the pre-existing and growing practice of negotiating and concluding "mitigation agreements" that allowed the parties to the transaction to address and remedy the national security concerns that CFIUS agencies had raised about the transaction, while simultaneously allowing CFIUS to approve the deal. Due to a previous lack of regulations, many expected more clarity on the specific procedures used to negotiate the agreements. While an Executive Order issued by the President in January 2008 resolved some procedural aspects of internal CFIUS workings with respect to determining that a mitigation agreement was necessary (for example, by requiring that the agency advocating the use of mitigation agreements document the national security threat and the mitigation measures needed to address it, and requiring CFIUS' agreement with this recommendation before negotiations began), many other issues remained unresolved. The new regulations unfortunately do not bring any more clarity.

### *Conclusion*

Overall, the foreign investment community should be relieved. For while the regulations could be improved (and may well be, following analysis of public comments), they largely maintain the balance achieved in FINSA. Although the increased reporting obligations will impose an additional burden in corporate transactions, it should be acknowledged that these requirements support CFIUS' mandate: to identify the key persons involved in the transaction and assess the risk they pose to national security of the U.S. Also, while the lack of precise definitions is likely to increase the number of cases in which parties will choose to file (where they may not have, had the definitions been clearer), it is also understandable that CFIUS, whose main task is assessment of the risk the transactions have on national security, chose to keep its options open, as opposed to locking itself into concepts that may, over time, become too rigid to deal with a changing business/national security environment. Overall, the conclusion non-U.S. investors should draw from the new regulations is that while foreign investment will be subject to national security review, it remains welcome in the U.S.

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