PROPOSED REGULATIONS CLARIFY AND EXPAND U.S. GOVERNMENT FOREIGN DIRECT INVESTMENT REVIEWS

On April 23, 2008, the U.S. Treasury Department, as the agency chairing the Committee on Foreign Investment in the United States ("CFIUS"), issued proposed regulations to implement the Foreign Investment and National Security Act of 2007 ("FINSA"). FINSA amended the U.S. law that authorizes the President to suspend or modify any merger, acquisition, or takeover of a U.S. entity by a foreign person (a "covered transaction") if such covered transaction might impair U.S. national security. That law, known as the Exon-Florio provision, has been in effect since 1989, but recent, controversial proposed foreign takeovers of U.S. companies prompted Congress to codify the existence of CFIUS, impose new requirements on parties to covered transactions, and increase executive and legislative scrutiny of those transactions.

The proposed regulations were required by FINSA, and they primarily make explicit many of the informal practices CFIUS had established as part of its review process before FINSA was enacted. However, they also substantially increase the communication and reporting burdens on parties to a covered transaction and make clear that while the CFIUS process is still theoretically voluntary, CFIUS now expects parties to seek review of a very broad range of transactions with respect to both the type of transaction involved and the nature of the U.S. entity being acquired.

Broad Scope of Covered Transactions: What Constitutes "Control"?

Throughout the history of the Exon-Florio provision, a key issue to be resolved in determining whether to file a voluntary notice seeking CFIUS review has been whether, as a result of the transaction, a foreign person will obtain control of a U.S. person. A very substantial portion of the proposed regulations involves defining "control." In keeping with historic CFIUS regulations, the proposal defines control as the

> power, direct or indirect, whether exercised 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.

The proposal substantially expands the illustrative list of matters that are considered to "affect" an entity for purposes of determining control and makes clear that the list is not a limitation and that "any other similarly important matters" can also evidence control. The list not only covers major corporate decisions, including disposition of assets, reorganization, closing or relocating key facilities, the adoption of an operating budget, debt or equity issuance, and dividend declaration, but also includes such day-to-day operating decisions as the selection of new business lines, actions affecting significant contracts, company policies regarding non-public information, the hiring or firing of officers or senior managers, and the hiring or firing of "employees with access to sensitive technology or classified U.S. Government information."

The proposal also states for the first time that traditional minority shareholder protections will not be deemed to confer control on a foreign entity, absent other considerations. Such protections include the right to prevent the U.S. entity from (1) selling or pledging all or most corporate assets, (2) entering into contracts with majority investors, (3) guaranteeing obligations of majority investors, and (4) amending corporate documents to allow any of those matters. Under the proposed regulations, minority shareholder rights to purchase additional shares to avoid dilution of ownership also do not evidence control.

In an important clarification, the proposal, along with public comments by Treasury Department officials, indicates that the fact that a foreign entity is acquiring less than ten percent of the voting interests of a U.S. business will not be considered presumptive evidence of lack of control. Ownership of less than ten percent must be accompanied by evidence that the voting interests are being acquired for passive investment purposes only and that no attributes of control are being conferred on the minority owner. By way of example, the proposal indicates that, if ownership of less than ten percent of voting interests were to be accompanied by even one seat on the board of directors of a U.S. business, this could (and probably would) be evidence of control and could bring the transaction within the coverage of the Exon-Florio provision.

While the proposal indicates that transactions in which a foreign person acquires convertible voting instruments but not control are not considered covered transactions, this exception may not apply if the acquirer can determine when conversion takes place and if the level of voting interests that will be acquired on conversion can be determined at the time of the acquisition. The acquisition of assets that do not constitute a business is not a covered transaction, but again this exception is limited because the proposal also deems most sales that involve more than real estate and equipment to constitute the sale of a business, whether or not an entity is legally organized as a business. This could include the sale of a single facility if it is sold as an operating entity.

If there is a "significant possibility" that a foreign person might acquire control of a U.S. entity as a result of a loan or similar financing, the loan could be considered a covered transaction. The proposal sets out an example in which a U.S. company defaults on a loan from a foreign company and enters bankruptcy, creating a "high probability" that the foreign lender will take control of the U.S. entity. Such a situation would constitute a covered transaction for which CFIUS would "accept" a notification.

CFIUS applies essentially the same criteria, in principle, in determining when there is foreign control of an acquirer (*i.e.*, a transaction in which a U.S. acquirer is in turn controlled by a foreign person would be a covered transaction). Therefore, it appears that, unless foreign entities can control key decisions of a U.S. hedge fund or other U.S. limited partnership investor, U.S. lending syndicate, or similar U.S. investor, their acquisitions in the United States would not be considered covered transactions. However, each such situation should be reviewed on a case-by-case basis, since CFIUS has the right to initiate a review of a transaction, pre- or post-closing, if it determines that it is a covered transaction and has national security implications.

The Standard for Review: What Constitutes "National Security"?

The fact that a foreign person may acquire control of a U.S. entity in a transaction does not necessarily mean that the parties should automatically file a voluntary notification with CFIUS. The criterion for CFIUS review is the potential impact of a transaction on U.S. "national security." Neither the statute nor the proposed regulations define this term. Instead, the proposed regulations define what CFIUS considers to be major elements of national security -- "critical infrastructure" and "critical technologies." The implication of the proposal is that transactions involving either of these areas warrant notification and will receive careful scrutiny. "Critical infrastructure" is defined as physical or virtual systems or assets "so vital to the United States that the incapacity or destruction of" the acquired entity's systems or assets "would have a debilitating impact on national security." This definition offers little additional help in that there is no guidance as to what would constitute a "debilitating impact on national security."

The definition of "critical technologies" is much more specific and helpful, in that the term is defined to mean goods or services covered by the United States Munitions List set out in the International Traffic in Arms Regulations ("ITAR"), certain items subject to Department of Commerce export controls, goods and software related to nuclear weapons or nuclear power, and trade-restricted agents and toxins. Foreign acquisitions of U.S. entities involved in any of these areas should almost certainly be notified to CFIUS, as should any transaction involving a U.S. entity performing classified work for the U.S. Government.

Notifying CFIUS: What is Required?

Historically, the formal notification to CFIUS that parties may voluntarily file has required a relatively minimal amount of basic information about the U.S. entity being acquired and the foreign acquirer. It has also generally required that all parties to the acquisition sign a certification indicating that the information being supplied is accurate and complete. The proposed regulations expand significantly the information required to be supplied, change the certification requirement, and incorporate the concept of informal, prenotification consultation with CFIUS.

Noteworthy new information requirements for notification include:

- identification of the ultimate parent of the foreign acquirer, and if the ultimate parent is a public company, identification of any shareholder with a five percent or greater interest;
- identification of "any and all financial institutions involved in the transaction, including as advisors, underwriters, or a source of financing";
- identification of the primary product or service lines of the U.S. business being acquired and "a list of direct competitors for those . . . lines";
- identification of any products or services that the U.S. business supplies to third parties that the U.S. business knows are rebranded "or incorporated into the products of another entity, and the names or brands under which such . . . products or services are sold";

- a "description and copy of the cyber security plan, if any, that will be used to protect against cyber attacks on the operation, design, and development of the U.S. business's services, networks, systems, data storage, and facilities";
- a description of any production or trading in goods or services subject to the U.S. export or other controls listed in the definition of "critical technologies";
- description of any foreign government power or control over the foreign acquirer;
- description of any formal or informal arrangements among foreign holders of ownership interests in the foreign acquirer to act together on matters affecting the U.S. entity;
- biographical and "personal identifier" information (including passport and national identity numbers) for members of the board of directors, senior management, and individuals who are beneficial owners of five percent or more of the foreign acquirer or its intermediate or ultimate parents; and
- a "statement of the view" of the entity filing the notification as to whether it is a foreign person, controlled by a foreign government, and acquiring control of the U.S. entity, and the bases for that view.

Each party to a transaction must now provide a separate certification that the information regarding that party is complete and correct.

The proposal explicitly encourages parties to a transaction to consult with CFIUS, file a draft notice, and invite CFIUS to request information in advance of the filing of a formal notification, and extends the statutory confidentiality protections to such information.

The proposal sets out a number of bases upon which CFIUS may reject a notification. In addition to failure to file all required information, such bases include failure to provide follow-up information requested by CFIUS "within two business days of the request" unless upon written request CFIUS grants a longer response period. In addition, the intentional filing of false information, or making a material misstatement or omission in a notification, is subject to civil penalties of up to $250,000, as is any violation of any agreement entered into as a condition of CFIUS's clearance of a transaction.

Conclusion

The proposed regulations, which will almost certainly be adopted with little substantive change, indicate that CFIUS review has been transformed from a relatively informal regulatory process applied in selected transactions into a major regulatory clearance obligation that is effectively required in a very broad range of transactions. This change is coupled with heightened CFIUS scrutiny, including identifying and initiating investigations of transactions for which no voluntary notification was filed, and more aggressive enforcement of mitigation agreements imposing conditions on cleared transactions.

Parties to transactions involving U.S. business operations in which there will be foreign stock ownership, creditor rights, or other forms of participation need to consider, as early as possible in the deal-making process, the nature and impact of CFIUS review. Questions to be addressed may include whether critical infrastructure or technology is involved, who has "control," including the role, if any, of a foreign government, and the countries involved and their strategic relationships with the United States. While the statutory timetables for CFIUS review once a formal notification has been accepted have not changed (30-day initial review, with an additional 45-day investigation if national security issues are unresolved), the time and resources necessary for preparing a notification, and for prefiling briefings and consultations with CFIUS, will increase as a result of the proposed regulations. Parties should also be prepared to negotiate mitigation agreements with CFIUS agencies to address real or perceived national security concerns, and to be subject to ongoing oversight by those agencies even after a transaction has been completed.

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If you have any questions concerning the foregoing or would like additional information, please contact Russell Smith (202-303-1116, rsmith@willkie.com), Michael Jones (202-303-1141, mjones@willkie.com), Miriam Bishop (202-303-1126, mbishop@willkie.com), or the attorney with whom you regularly work.

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April 28, 2008