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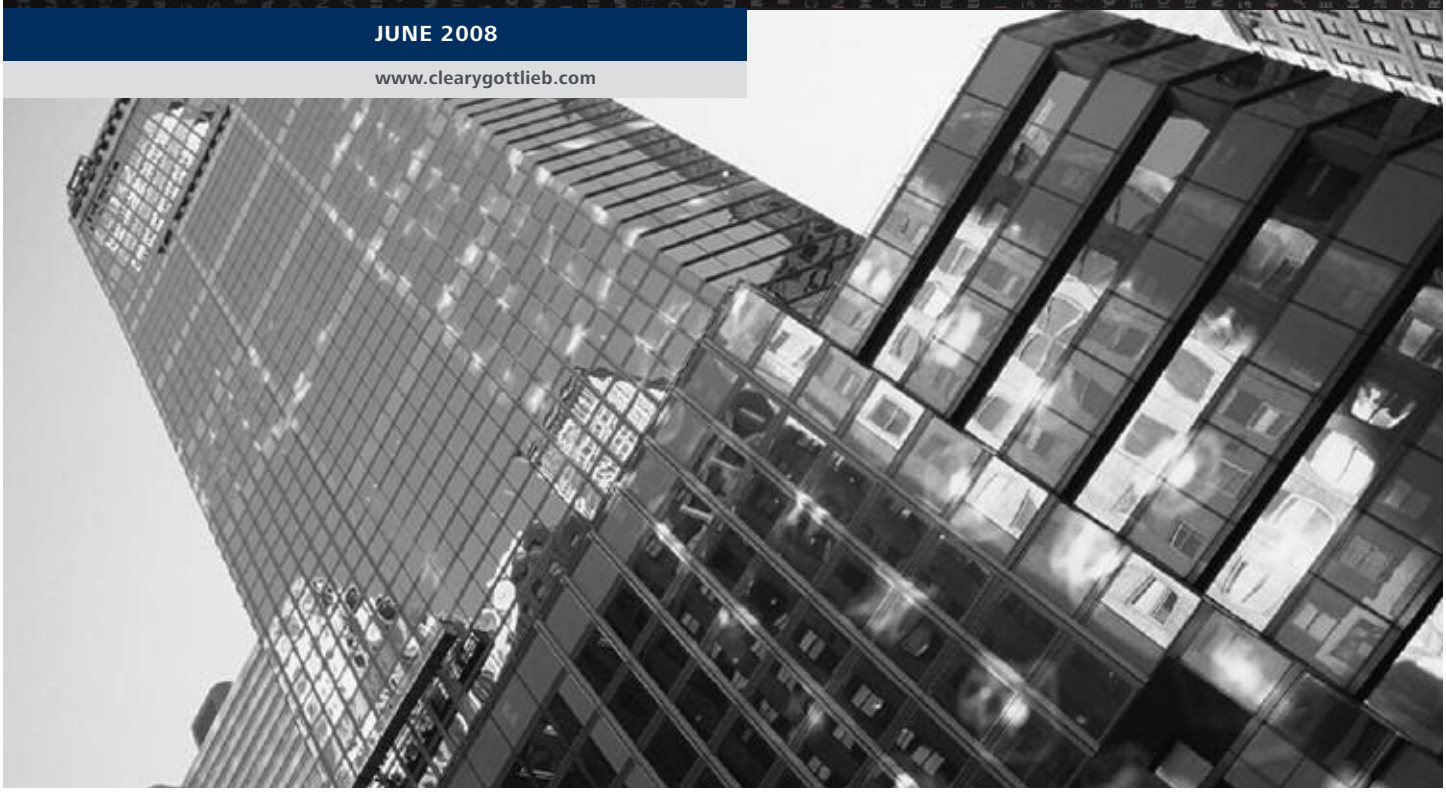

Treasury Proposes Changes to the Regulations Governing Exon-Florio "National Security" Reviews of Foreign Investment in the United States

BY PAUL D. MARQUARDT, W. RICHARD BIDSTRUP AND NATHANIEL F. STANKARD

The Foreign Investment and National Security Act of 2007 ("*FINSA*") amended the existing legislation dealing with national security reviews of foreign investment in the United States, commonly known as Exon-Florio. On April 21, 2008, the U.S. Department of the Treasury proposed new regulations to implement FINSA that include significant changes to the current review process, but do not expand the scope of reviews to the extent many predicted.

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Mr. Marquardt is a partner, Mr. Bidstrup is counsel and Mr. Stankard is an associate at Cleary Gottlieb Steen & Hamilton LLP.

On April 21, 2008, the Department of the Treasury issued new proposed regulations (the "*Proposed Regulations*") implementing the Exon-Florio amendments to the Defense Production Act of 1950 (50 U.S.C. App. § 2170) ("*Exon-Florio*"), as recently amended by the Foreign Investment and National Security Act of 2007 ("*FINSA*").[1] The good news for foreign acquirors is that the Proposed Regulations – the most significant amendment to the regulations since their initial promulgation in 1991 – do not go as far as many had feared in expanding the review of foreign acquisitions of U.S. businesses by the Committee on Foreign Investment in the United States ("*CFIUS*"). Notification remains voluntary; only acquisitions of "control" are subject to notification, and not every acquisition of control will raise national security issues. Some of the recent alarmist predictions of radically expanded CFIUS reviews have been overblown.

However, while the Proposed Regulations retain the essential structure of current CFIUS reviews, they also expand the scope and nature of such reviews in limited but important ways. The key considerations for parties to foreign investment transactions in the United States are as follows:

- The Proposed Regulations reaffirm in clear terms that CFIUS notification remains voluntary and that acquisitions of influence short of "control" by a foreign entity are not subject to Exon-Florio. However, the Proposed Regulations also stress that "control" remains a flexible concept to be determined in light of all the facts and circumstances (including formal and informal governance arrangements in addition to formal ownership interests) and that there is no bright-line test for whether control exists.
- Furthermore, the Proposed Regulations explicitly expand the definition of "control" in two key ways: first, "control" now includes the power to block key corporate decisions as well as the affirmative power to determine the matters in question; and second, the list of key corporate decisions implicating "control" has been significantly expanded to include a number of matters commonly subject to super-majority voting.[2] As a result, relatively standard shareholders' and joint venture agreements could result in "control" for purposes of Exon-Florio, potentially subjecting the investment (or investments by the "controlled" company) to CFIUS review. In addition, minority investors could be deemed to "control" a company they invest in if they obtain certain market-standard minority rights intended solely to protect their economic interests – *e.g.*, limits on company indebtedness, removal of key personnel or material acquisitions and dispositions.
- The definition of "transactions" subject to Exon-Florio has also been expanded, most notably by including the acquisition of convertible interests that are exercisable by a foreign person without any conditions beyond that person's control other than the passage of time. For example, the acquisition of warrants exercisable in two years (or out-of-the-money options) that, if exercised, would give the holder sufficient votes to block key corporate decisions is an immediate acquisition of "control" for Exon-Florio purposes, no matter how remote the economic terms of the warrants or situation of the issuer might make their exercise. Proxy contests that, if successful, would result in control over a U.S. business and the contribution of an existing U.S. business to a joint venture over which a foreign person can exercise control are also expressly made subject to Exon-Florio.
- The treatment of lending transactions is not entirely clear. The Proposed Regulations clearly state that rights acquired by a lender upon default (for example, a security interest in the shares of a borrower) may be notified only if a default has occurred or is imminent, and the Proposed Regulations give an example in which a requirement in a loan agreement not to dispose of the assets of the borrower (one of the corporate decisions listed in the definition of "control") does not result in "control" by the lender. However, the Proposed Regulations do not explicitly address the treatment of loans that include extensive negative pledge clauses requiring lender approval for a wider range of corporate decisions – *e.g.*, limitations on capital expenditures, changes in control, material acquisitions of assets, changes in

lines of business, the incurrence of additional debt – that may have a fundamental effect on the corporate or capital structure of the borrower. Under the Proposed Regulations, the uncertain treatment of these lender protections – common in merchant banking or private equity transactions – could increase the regulatory risks for foreign lenders seeking routine protections in *bona fide* lending transactions. Furthermore, foreign lenders could face uncertainty as to whether and on what terms they will be permitted to execute upon the assets of a secured borrower that defaults.

- The Proposed Regulations retain the safe harbor for purely passive investments of less than 10 percent of the voting interest in a U.S. entity, but they stress two features of the existing safe harbor that are often misunderstood. First, the safe harbor does not apply when any governance rights (*e.g.*, a directorship) are obtained with the equity stake or when the acquiror intends to acquire control at a later time. Second (and equally important), the fact that an investment falls outside the safe harbor does not automatically mean that it is subject to Exon-Florio. An acquisition of "control" is still required.
- The definition of "foreign person" has been expanded to include any entity organized under the laws of a foreign jurisdiction that is more than 50 percent beneficially owned by foreign persons. Although this provision was intended to more clearly capture publicly held foreign companies not "controlled" by any foreign individual, it has the perhaps unintended effect of making acquisitions by offshore investment vehicles (such as limited partnerships) that are fully controlled by U.S. entities, but more than 50 percent beneficially owned by foreign persons, subject to Exon-Florio. Even with lower levels of beneficial ownership by foreign persons, the typical minority protections afforded such persons in investment vehicles (even those organized in the United States) may be viewed as creating "control" under Exon-Florio.
- Consistent with the requirements of FINSA, an extended 45-day investigation of acquisitions by entities controlled by foreign governments is not made mandatory; however, a decision that no such investigation is required must be approved at the Deputy Secretary level by the Treasury Department and the lead agency or agencies reviewing a notification.
- The Proposed Regulations clarify the concepts of "critical infrastructure" and "critical technologies" that are the subject of increased CFIUS scrutiny under FINSA. A transaction involves "critical infrastructure" if the incapacity or destruction of the particular assets involved in the transaction would have a debilitating impact on national security – a much narrower definition than many had assumed. "Critical technologies" are defined by reference to certain technologies with military applications regulated under the export control, arms control or nuclear regulatory laws.
- The information required to be provided in an Exon-Florio notification has been expanded significantly and the timetable for review has become less certain. Notifications now must include details such as market shares and downstream users of the products in question. Consistent with recent CFIUS practice, detailed information on the chain of ownership of the foreign acquiror and personal identifying information of officers and directors of acquiring entities is also required. CFIUS's ability to reject a filing and re-start the 30-day review period has been significantly expanded, most notably by enabling CFIUS to reject a filing at any time if the parties do not respond within two business days to any request for additional information from CFIUS (though CFIUS may agree to extend that deadline). CFIUS now also formally encourages the practice of submitting a draft notification one week in advance of the anticipated official notification date.
- Enforcement of mitigation agreements with CFIUS has been clarified, providing that any material violation of an agreement voids CFIUS approval, may result in civil penalties, and may (if provided in the relevant agreement) require the payment of significant liquidated damages to the government.

The Proposed Regulations retain the basic structure of CFIUS notifications, codifying and clarifying practices that have developed over the years. Moreover, by largely implementing the current practice – and, more importantly, by conspicuously failing to adopt some of the more sweeping requirements that some have suggested could or would be implemented – the Proposed Regulations will not fundamentally change the nature of the CFIUS review process or the basic calculus of the decision as to whether to submit a voluntary notification. Although in recent years it has become clear that national security reviews extend well beyond the defense industry to sectors such as energy, telecommunications, and transportation, the Proposed Regulations have not further expanded that scope.

Nevertheless, while the Proposed Regulations' updating and clarification of CFIUS's jurisdictional analysis is welcome, it also

remains the case that there are few bright lines and little detailed guidance on whether particular transactions should be notified, and balancing the political and administrative risks of notification in particular cases will remain a challenge for foreign acquirors in a broad range of industries outside the defense sector. Although outright prohibitions of transactions appear destined to remain rare, the Proposed Regulations signal that the recent evolution of more stringent reviews (particularly of acquisitions by foreign government-controlled entities), more burdensome mitigation agreements, and CFIUS involvement in a variety of "national infrastructure" industries such as telecommunications, energy, and transportation will likely remain in place (although not to continue expanding to the extremes predicted by some). Certain provisions in the Proposed Regulations, particularly the treatment of minority protection rights, lender consents and new filing requirements, could also impose significant practical burdens on parties to cross-border acquisitions if not refined in the final rules.

The issues raised in the public comment period (which ended June 9) and any changes made in the final regulations, which will not be issued for an indeterminate time, may clarify or mitigate some of these issues or shed additional light on the current state of CFIUS practice. In the meantime, the Proposed Regulations serve as a useful guide to CFIUS's current views and practices under the existing regulations.

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1 *See M&A and Corporate Governance Report*, March 2007, for a summary of the CFIUS process and FINSA. For a detailed discussion of FINSA, see Cleary Gottlieb's alert memo "Congress Tightens Exon-Florio 'National Security' Reviews of Foreign Investment in the United States," July 12, 2007.

2 As set forth in Section 800.203(a) of the Proposed Regulations, the list now includes: (i) the sale, lease, mortgage, pledge, or other transfer of any of the tangible or intangible principal assets of an entity, whether or not in the ordinary course of business; (ii) the reorganization, merger, or dissolution of an entity; (iii) the closing, relocation, or substantial alteration of the production, operational, or research and development facilities of an entity; (iv) major expenditures or investments, issuances of equity or debt, or dividend payments by the entity, or approval of the operating budget of an entity; (v) the selection of new business lines or ventures that an entity will pursue; (vi) the entry into, termination, or non-fulfillment by an entity of significant contracts; (vii) the policies or procedures of an entity governing the treatment of nonpublic technical, financial, or other proprietary information of the entity; (viii) the appointment or dismissal of officers or senior managers; (ix) the appointment or dismissal of employees with access to sensitive technology or classified U.S. Government information; or (x) the amendment of the Articles of Incorporation, constituent agreement, or other organizational documents of an entity with respect to the matters described in items (i) through (ix).