



Foreign Investment Update

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No “Bright Lines” Drawn By New Foreign Investment Regulations

New Development

The Committee on Foreign Investment in the United States (“CFIUS”) has issued long-awaited proposed regulations implementing amendments to Section 721 of the Defense Production Act of 1950 that were enacted last year as the Foreign Investment and National Security Act of 2007 (the “Act” or “FINSA”). While promoted by CFIUS as increasing clarity, the regulations explicitly avoid using “bright lines” to delineate the transactions subject to CFIUS review. What the regulations do make clear, however, is that there is no minimum threshold of investment required for CFIUS to exercise jurisdiction – foreign control remains the key focus, and CFIUS retains considerable flexibility in determining whether control will be conveyed in a particular transaction regardless of the level of investment.

Background

FINSA was signed into law in July 2007 as the culmination of

efforts to codify and reform the process by which CFIUS reviews acquisitions of U.S. businesses by foreign and foreign-owned or controlled interests (*see* our July 2007 *Foreign Investment Update* for a summary and analysis of key FINSA provisions). CFIUS was directed to issue new regulations within 180 days of FINSA taking effect on October 24, 2007.

Key Provisions

Covered Transactions

Section 721, as amended by FINSA, authorizes the President to suspend or prohibit a “covered transaction” when there is credible evidence to believe that proposed foreign control of a U.S. business might cause harm to national security that cannot be curtailed by other means. The regulations define a “covered transaction” to mean “any transaction . . . which could result in control of a U.S. business by a foreign person.” The term “U.S. business” includes any business engaged in interstate

commerce in the United States, including such businesses that may be directly or indirectly owned by foreign persons. A “transaction” may take the obvious form of an acquisition of ownership interests or less obvious forms such as the formation of a joint venture that involves the contribution of a U.S. business or entry into a long term lease that permits the lessor to make substantially all business decisions concerning the operation of a leased entity.

At the heart of the definition of “covered transaction” is the term “control” – broadly defined in the regulations to mean “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.” Within this category are old standards such as transfer of principal assets, dissolution, closing or relocation, or termination or non-fulfillment of the contracts of an entity. New additions to the list of indicia of control include the power to (1) appoint or dismiss officers, senior management or employees with access to sensitive technology or classified U.S. Government information, (2) establish policies or procedures of the business governing the treatment of non-public technical, financial or other proprietary information of the entity, or (3) approve significant contracts, operating budgets, major expenditures or investments, or new lines of business.

The regulations thus reserve a considerable degree of flexibility for CFIUS in determining whether the control threshold has been met. In addition, the regulations make clear that voluntary restrictions on or forbearance from exercising control do not eliminate the presence of control, just as the extent to which the acquirer can control the timing of conversion will influence whether control is deemed to be conferred upon acquisition or conversion of a convertible investment. However, the regulations do preserve a limited “investment purposes” exemption for acquisitions involving 10 percent or less of the voting interests in a U.S. business, and clarify that certain minority shareholder protections (*e.g.*, the right to veto sale of substantially all of the assets of an entity or contracts with affiliates, or anti-dilution rights) will not, without more, be deemed to give rise to control. The regula-

tions also continue to exclude greenfield investments from the scope of CFIUS review, and contain guidance on the limited circumstances under which a lending transaction may be a covered transaction.

Critical Infrastructure and Technologies

Although FINSA contemplated that rules issued in the future might elaborate on the definition of critical infrastructure, the regulations simply reiterate the FINSA definition in the context of covered transactions (“systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems or assets would have a debilitating impact on national security”).

On the other hand, the definition of the term critical technologies now explicitly enumerates “critical technology, critical components, or critical technology items essential to national defense” as consisting of (1) defense articles or services (including technical data) controlled for export by the International Traffic in Arms Regulations (“ITAR”), (2) items (including technology and software) specified on the Commerce Control List set forth in the Export Administration Regulations as being controlled for various reasons, (3) certain nuclear facilities, equipment, parts and components, material, materials software and technology specified in the Assistance to Foreign Energy Activities Regulations or the Export and Import of Nuclear Equipment and Materials Regulations, and (4) select agents and toxins specified in the Export

and Import of Select Agents and Toxins Regulations.

Given that FINSA directed CFIUS to consider the potential national security-related effects of covered transactions on critical infrastructure and critical technologies, the treatment of these terms in the regulations suggests that CFIUS intends to continue to exercise broad discretion in identifying critical infrastructure and treat virtually all export controlled goods, technology, software and services as critical technologies.

Procedural Changes

Consistent with FINSA, the regulations preserve the historic voluntary nature of the review process, while reserving to CFIUS the right, in certain circumstances, to initiate a notice or request the parties to a transaction to do so.

According to CFIUS, the principal new development in the procedural arena is that the regulations explicitly encourage the parties to a covered transaction to consult with the Staff Chairperson of CFIUS at least five business days prior to filing a formal notice.

The regulations also enhance transparency of the review process by explicitly requiring the notice to include certain categories of information that CFIUS has requested from parties to covered transactions in the past but which were not previously identified in the existing regulations as mandatory. While some of this information typically has been requested of parties to all covered transactions (such as personal identifier information for directors, officers, key personnel and beneficial owners holding interests of five percent or more of the acquirer and certain

of its affiliates), other information now required to be included in the notice to CFIUS has not necessarily been requested in all cases (*e.g.*, a list of all financial institutions involved in the transaction, whether as advisors, underwriters or a source of financing; information regarding contracts held by the target U.S. business directly or indirectly with *any* U.S. government agency (not just those with national defense responsibilities, as under the existing regulations), and so on). On balance, therefore, the regulations appear to have the effect of increasing the overall burden of preparing notices to CFIUS for parties to covered transactions. The regulations also now require submission of additional detailed information designed to permit CFIUS to determine whether any foreign persons have agreed to act in concert with respect to the proposed transaction or whether a proposed transaction would result in foreign government control.

CFIUS expects that the expanded mandatory content of the notice will reduce the need for follow-up requests for information, but the regulations nevertheless impose a two business day response period for any such requests that may still be made (subject to the granting of a written request for an extension of time), and permit CFIUS to reject the notice if the parties fail to provide requested information promptly.

The regulations do, however, recognize the procedural difficulties faced by the parties to a hostile takeover, allowing CFIUS to accept an otherwise complete notice that does not provide complete information on any non-

notifying party, so long as the notice contains such information as is known or reasonably available to the notifying party or parties.

Finally, as required by FINSA, the new regulations establish the role of the Secretary of Labor with respect to mitigation agreements as limited to identifying any risk mitigation provisions proposed to or by CFIUS that would violate U.S. labor laws.

Penalties

The regulations provide for civil penalties of up to \$250,000 per violation to be imposed on any person who intentionally or through gross negligence submits a material misstatement or omission in a notice to CFIUS or makes a false certification of information provided to CFIUS. Violation of a mitigation agreement or condition will attract a civil penalty not to exceed \$250,000 per violation or the value of the transaction. In addition, the regulations authorize CFIUS to impose mitigation agreements that include a provision for liquidated or actual damages for breaches of the agreement by parties to the transaction and to recover such damages in civil actions in federal district court.

Conclusions and Recommendations

The regulations are open for public comment until June 9, 2008. Interested parties should consider submitting comments, responses to which will be published with the final regulations. In addition, parties exploring a deal that may involve a covered transaction should seek advice on the application of Section 721 and the regulations early in their process so that they can be sure to collect all relevant information and weigh the likelihood and potential impact of a mitigation agreement or conditions prior to concluding an agreement. ■

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