

Treasury Department Issues Proposed Regulations Reforming U.S. National Security Reviews of Foreign Investments

1. Executive Summary

The U.S. Treasury Department yesterday issued its proposed regulations implementing the Foreign Investment and National Security Act of 2007 (FINSA), which President Bush signed into law on July 26, 2007. FINSA substantially revised U.S. national security reviews of foreign investments in U.S.-based entities and transactions involving an entity controlled by a foreign government. The changes make reviews more rigorous, particularly for transactions in certain sensitive sectors, including critical infrastructure and critical technologies. FINSA specifically modified the operations of the interagency Committee on Foreign Investment in the United States (CFIUS), which reviews the national security implications of foreign acquisitions of, mergers with, or investments in U.S.-based entities.

Consistent with FINSA, the proposed regulations build on CFIUS review procedures and do not replace them. Most notably, the regulations formalize existing practice by encouraging parties to meet with CFIUS officials during the “prefiling” CFIUS period and to provide CFIUS with a draft notification at least five days before the formal filing. The proposed regulations also significantly increase the information that must be submitted with the formal notification, including information not historically provided to CFIUS. By solidifying the prefiling consultation process and expanding the notification requirements, the proposed regulations will extend the overall timetable for CFIUS review and clearance of covered transactions. Parties to a covered transaction should factor these expanded obligations into their contemplated closing schedule and adjust their due diligence procedures accordingly to ensure that all necessary information is obtained before filing the formal notification to ensure a timely submission.

In addition, the proposed regulations continue the long-standing approach of eschewing a bright-line equity ownership test for purposes of determining whether a foreign entity has acquired “control” over a U.S. business. The regulations instead analyze control in functional terms — taking into account all relevant factors, including equity ownership, representation on the board of directors and ability to direct matters of importance to a U.S. business. The proposed regulations also provide greater detail regarding the parameters of minority shareholder rights that do not, in the absence of other rights, confer foreign control over a U.S. entity. In doing so, the regulations should provide dealmakers with additional guidance in structuring transactions, especially passive minority investments in U.S. entities. Finally, the proposed regulations provide for civil penalties, including liquidated damages, for the breach of any agreement or requirement imposed on a party as a condition to obtaining CFIUS clearance of a transaction.

The proposed regulations reflect CFIUS’ careful balancing of U.S. national security with continued openness to foreign direct investment in the United States and foreign markets to U.S. direct investment. Parties that properly approach the CFIUS review process and U.S. national security considerations can expect a fairly straightforward CFIUS review.

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

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II. Analysis of Proposed Regulations

A. “Prefiling” Procedures

The proposed regulations continue the tradition of encouraging parties to a covered transaction to meet on an informal basis with CFIUS staff in advance of filing the formal notification. This “prefiling” period allows CFIUS additional time to develop its analyses and request supplemental information from the parties. Although the proposed regulations do not mandate prefiling discussions, they make clear CFIUS’ preference for such consultations. Given the greatly expanded scope of the formal notification (described below), parties to a covered transaction should strongly consider undertaking these prefiling discussions to ensure that reviews of covered transactions are commenced (and concluded) as efficiently and quickly as possible.

B. Contents of Formal Notification

In addition to expanding the information that must be included with the formal CFIUS notification, the proposed regulations also confirm that failure to include any of the required information will delay commencement of the CFIUS review and ultimate clearance of a transaction. Under the proposed regulations, information that would be submitted with the formal notification that is not currently required includes the following:

- identity of all financial institutions involved in a covered transaction (*e.g.*, advisers, underwriters, etc.) and the source of financing for the transaction;
- market share information for the primary product or service lines (including an explanation of how the estimate was derived) and a list of direct competitors for those primary product or service lines;
- all contracts with any U.S. government agency in effect during the last three years;¹
- biographical information for members of the board(s) of directors, senior management and each ultimate beneficial owner of five percent or more of the outstanding securities of the foreign acquiring entity and its ultimate parent;
- personal identifying information for the board(s) of directors and senior executives of the immediate foreign acquirer and its ultimate parent (and any other entities in the chain of ownership);²
 - o information provided should include dates and nature of foreign government military service;
- an organizational chart illustrating all of the entities in the foreign acquirer’s ownership chain, including the percentage of shares held by each entity; and

¹ Current regulation only requires the identification of contracts with U.S. government agencies that have national defense responsibilities.

² Current practice permits the filing of this “personal identifier” information after the filing of the formal CFIUS notification.

- a certification that the notice and any follow-up information provided to CFIUS are accurate and complete.

C. Definition of “Control”

Because CFIUS’ authority to review a transaction is predicated on the acquisition of control of a U.S. business by a foreign entity, the definition of control has always been a key factor for practitioners and dealmakers. Consistent with current practice, the proposed regulations define control in functional terms rather than specific equity ownership levels or representation on the board of directors. This proposed definition of control also is relevant to the stricter review applicable to acquisitions by foreign government-controlled entities. Under the regulations, CFIUS reviews all relevant factors to determine whether the foreign entity has acquired the ability to “determine, direct or decide important matters” of a U.S. business. Of particular importance, the proposed regulations identify several minority shareholder rights that do not, by themselves, confer foreign control over an entity. These rights include the following:

- the power to prevent the sale or pledge of all or substantially all of the assets of an entity;
- the power to prevent an entity from entering into contracts with majority investors or their affiliates;
- the power to prevent an entity from guaranteeing the obligations of majority investors or their affiliates;
- the power to prevent the amendment of the Articles of Incorporation, constituent agreement or other organizational documents of an entity with respect to the above-listed matters; or
- the power to purchase additional shares to prevent the dilution of an investor’s *pro rata* interest in a U.S. entity.

While continuing its commitment to a case-by-case analysis to determine whether a foreign entity has acquired control, the proposed regulations could expand the universe of covered transactions. For example, equity investments of less than 10 percent, previously considered by some to be outside of CFIUS’ jurisdiction, may now be subject to review if they include a board seat and grant the minority shareholder the right to determine, direct or cause decisions regarding important matters affecting the U.S. entity (*e.g.*, sale of principal assets, closing of facilities, dismissal of officers or senior management, etc.).

D. Penalties for Breach

Finally, the proposed regulations provide CFIUS with the authority to impose civil penalties if a party fails to comply with any condition imposed by CFIUS to obtain clearance of a covered transaction. The regulations specifically empower CFIUS to include a provision for liquidated or actual damages in any mitigation agreement it negotiates with a party. The regulations further permit CFIUS to set the amount of any liquidated damages “as a reasonable assessment of the harm to the national security that could result from breach of the agreement.” The regulations do not contain any indication of the scope of any liquidated damages provision (*e.g.*, ability to cure, judicial review) as CFIUS is likely to address such issues on a case-by-case basis.

Written comments on the proposed regulations will be due 45 days after their publication in the Federal Register (expected April 23, 2008). In addition, there will be a public meeting to discuss the regulations on May 2, 2008, from 10 a.m. until noon at the Department of the Treasury. However, staff may effectively implement many of the proposed regulations while the period for review is pending and require parties submitting notifications in the coming weeks to comply with certain of the above-referenced requirements.