

Congress Tightens Exon-Florio “National Security” Reviews of Foreign Investment in the United States

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On July 11, Congress passed the Foreign Investment and National Security Act of 2007 (“H.R. 556”), amending Section 721 of the Defense Production Act of 1950 (the “Exon-Florio Provision”) to formalize and tighten the process for Presidential reviews of foreign acquisitions of U.S. businesses that raise national security concerns. The President is expected to sign the bill into law.

H.R. 556 codifies, and in some cases extends, recent trends toward more stringent review of foreign acquisitions by the Committee on Foreign Investment in the United States (“CFIUS” or the “Committee”). However, it also omits many of the provisions of earlier proposals considered most problematic by the business community and retains the essential features of CFIUS review as it exists today (including, most importantly, the voluntary notification scheme). Among other provisions, H.R. 556 makes the following changes to the existing CFIUS process:

- Explicitly includes “homeland security, including its application to critical infrastructure,” in the definition of “national security”;
- Presumptively requires notified transactions involving acquisitions of control by foreign government-controlled entities to undergo a second-stage investigation, unless the Department of the Treasury and the agency leading the review certify that the transaction will not impair national security;
- Explicitly endorses the practice of negotiating agreements with a party in order to mitigate a threat to national security, adds authority to unilaterally impose conditions on parties, and requires CFIUS to monitor compliance with such agreements or conditions;
- Provides that an intentional material breach of an agreement or condition may be grounds to reopen investigation of a previously approved transaction;

- Establishes procedures for CFIUS to track withdrawn submissions and impose interim protections pending resubmission; and
- Requires the Department of the Treasury and the agency leading the review to provide a written certification to certain members of Congress at completion of the CFIUS process.

I. Background

The Exon-Florio Provision empowers the President to suspend or prohibit of foreign acquisitions, mergers, or takeovers of control of U.S. businesses – including U.S. operations of foreign companies – that threaten to impair the national security of the United States.¹ CFIUS, comprising representatives from 12 government agencies, was created by executive order to implement the Exon-Florio Provision and reviews foreign acquisitions and certain acquisitions of research and development facilities. On a recommendation from CFIUS, the President can block a transaction or force divestiture if the transaction is already consummated.

A. Overview of the Current CFIUS Review and Notification Process

CFIUS currently operates under regulations established by the Department of the Treasury (the “CFIUS Regulations”).² The CFIUS process ordinarily begins with the filing of a voluntary notification by the parties, which triggers a 30-day initial review period. The notice includes information such as a detailed description of the transaction and the parties, related government contracts, future plans for the U.S. entity, and foreign government involvement. CFIUS also routinely requires detailed personal information about the individual officers, directors, and significant shareholders of the acquiror and its parents. If, after the initial review, CFIUS decides there may be national security issues, it can open a 45-day second-stage investigation to determine “whether identified concerns require more extensive mitigation efforts or a recommendation to the President for possible action.” A report is then sent to the President, who then has 15 days to decide whether the transaction “threatens to impair the national security” and accordingly block the deal or force divestiture.

Although CFIUS notification is optional, there are two reasons why a foreign acquiror may choose to make such a notification. First, CFIUS is authorized to initiate its own investigations, and the risk of an involuntary investigation has increased as a result of

¹ “Control” for Exon-Florio purposes is a de facto test based on the ability to direct certain decisions of an entity, and it is possible for a minority interest to exercise control. 31 CFR §800.204.

² 31 CFR Part 800.

recent pressures. (CFIUS and its member agencies routinely monitor the press for transactions of interest.) If the government appears likely to review the transaction in any event, the acquiror may choose to take the initiative. Second, if the transaction is not voluntarily notified and cleared, the government retains the power to order that the transaction be unwound at any time after the closing (although it is procedurally difficult to do so after three years). If a transaction later becomes controversial, that power can give the government considerable leverage. However, these risks must be weighed against the burdens and delay of notification and the risk that requesting clearance will effectively increase the acquiror's exposure to demands from CFIUS or its member agencies that the transaction be modified or that other assurances be given as a condition of approval. These considerations must be weighed carefully, together with nature of the acquisition, the identity of the acquiror, and the political environment, in assessing whether to notify.

B. Recent Developments in CFIUS Practice

CFIUS scrutiny has become an increasingly important factor in cross-border transactions touching the United States. In recent years, driven by an increased focus on homeland security following 9/11 and a number of high-profile cases, CFIUS has broadened the industries it scrutinizes, engaged in lengthier and more intensive reviews, and sought more burdensome remedies. The concept of "national security" now encompasses energy, telecommunications, transportation, and other elements of "critical infrastructure." CFIUS uses informal means to press for extensions of the statutory review period. Transactions between foreign companies with a predominant impact outside the United States have still been subjected to intrusive CFIUS review as a result of their U.S. operations. Finally, CFIUS increasingly requires "mitigation agreements" or divestitures as a condition of approval, seeking ever more draconian enforcement mechanisms. Together with a series of controversial transactions – such as CNOOC-Unocal, DP World-P&O, and Alcatel-Lucent³ – these developments have created substantial regulatory uncertainty for foreign companies acquiring a target with U.S. operations in sensitive sectors.

³ The state-owned China National Offshore Oil Corporation ("CNOOC") was forced to withdraw its bid for Unocal Corp. in 2005 after considerable Congressional outcry. In 2006, when Dubai Ports World ("DP World"), a company controlled by the United Arab Emirates, sought to acquire Peninsular & Oriental Steam Navigation ("P&O"), a British company, Congress objected because the acquisition included operating rights to six U.S. port facilities. DP World was forced to transfer the U.S. port operations to an American entity. Also in 2006, the merger between Alcatel SA, a French company, and U.S.-based Lucent Technologies was heavily scrutinized and subjected to a burdensome mitigation agreement because of Lucent's Bell Labs, which conducts classified research for the U.S. government.

II. The Foreign Investment and National Security Act of 2007

H.R. 556 establishes CFIUS in statute and retains its essential features, such as voluntary notification, the review timetable, and the leadership of the Secretary of the Treasury. H.R. 556 slightly alters the Committee membership,⁴ formalizes the establishment of an Assistant Secretary of the Treasury for CFIUS, and provides for the participation of the Director of National Intelligence.⁵ The chairperson may also designate, as appropriate, a lead agency for certain functions described below.

In addition to these structural changes, H.R. 556 codifies recent CFIUS practice and further tightens the current approach in some respects (most notably by the universal imposition of an “evergreen” provision revoking CFIUS’s approval if any condition to such approval is materially and deliberately violated). The bill introduces the following significant changes to the current CFIUS process:

A. Expanded Definition of “National Security”

Like the CFIUS Regulations, H.R. 556 does not define “national security” – a deliberate choice designed to preserve flexibility in the factors considered – or provide a list of relevant industries or products. However, the bill does “clarify” that the term includes “those issues relating to ‘homeland security’, including its application to critical infrastructure.”⁶ The bill also adds the potential effects on U.S. critical infrastructure, major energy assets, and critical technologies to the list of factors CFIUS may consider in its review.⁷ “Critical infrastructure” is defined as “systems and assets, whether physical or

⁴ H.R. 556 §3(k)(2). The statutory membership includes the Secretaries of Treasury, Homeland Security, Commerce, Defense, State, and Energy, as well as the Attorney General and “any other executive department, agency or office, as the President determines appropriate.” The Secretary of Energy is not currently a member of CFIUS.

⁵ H.R. 556 §2(b)(4). The DNI is designated an *ex officio*, non-voting member of CFIUS and is required to undertake a “thorough analysis” of any threat to national security posed by the transaction, engage the intelligence community in the gathering of relevant information, and report the analysis to the Committee within 20 days of the start of the 30-day review. As a practical matter, the DNI already plays a similar role in CFIUS reviews.

⁶ H.R. 556 §2(a)(5).

⁷ H.R. 556 §4(4). These factors will be added to a non-exhaustive list the Exon-Florio Provision provides for – but does not require – CFIUS to consider. Apart from the homeland security-related provisions, H.R. 556 also adds several factors connected to the country of the acquiror, including the relevant country’s adherence to nonproliferation control regimes, its record of cooperation in counter-terrorism efforts, and the potential for transshipment or diversion of military technologies (including an analysis of applicable export controls). *Id.*

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.”⁸ “Critical technologies” include “critical components, or critical technology items essential to national defense.”⁹

This provision formalizes recent CFIUS practice, which is already marked by an expanding definition of “national security.” The Committee has always had wide discretion to interpret “national security,” but historically it found potential threats to national security most often when a target U.S. company provided goods or services to defense or security agencies, especially if a contract involved access to classified information or sensitive technologies (e.g., satellite optics). However, CFIUS has increasingly scrutinized transactions involving “critical national infrastructure” – such as telecommunications, energy, and transportation – as potential threats to national security.

B. Mandatory 45-Day Investigations for Acquisitions by Foreign Government-Controlled Entities

Consistent with current CFIUS regulations, H.R. 556 requires an extended 45-day investigation if: (i) the Committee determines a reviewed transaction threatens to impair national security and no mitigation agreement has been reached;¹⁰ or (ii) the Committee agrees with the lead agency’s recommendation to initiate an investigation.¹¹

However, H.R. 556 also requires CFIUS to conduct an investigation into all acquisitions that would result in control by “a foreign government or an entity controlled by or acting on behalf of a foreign government.”¹² Unlike similar language in the existing statute – which required investigations for such acquisitions that “could affect” national security and was interpreted by successive administrations as effectively the same standard applicable to all reviews – H.R. 556 requires an extended investigation regardless of the potential impact on national security, unless the Secretary of the Treasury and the counterpart at the lead agency (or their respective Deputies) make a specific determination that the transaction will not impair national security.¹³ While the practical impact remains to

⁸ H.R. 556 §2(a)(6).

⁹ H.R. 556 §2(a)(7).

¹⁰ H.R. 556 §2(b)(2)(B)(i)(I).

¹¹ H.R. 556 §2(b)(2)(B)(ii).

¹² H.R. 556 §2(a)(4) (defining “foreign government-controlled transaction”); H.R. 556 §2(b)(1)(B); H.R. 556 §2(b)(2)(B)(i)(II).

¹³ H.R. 556 §2(b)(2)(D). This authority may not be delegated below the deputy level. There is also a requirement to provide published guidance on the types of foreign government transactions reviewed

be seen, a significant increase in scrutiny of acquisitions by government-controlled acquirors is likely. Although the language is less stringent, there are also provisions indicating a Congressional intent to encourage heightened review of transactions involving critical national infrastructure.¹⁴

C. Power to Enter Into or Impose “Mitigation Agreements”

H.R. 556 provides that CFIUS or, on the Committee’s behalf, the lead agency may enter into or impose – and enforce – “any agreement or condition” with any party to a transaction in order to mitigate any national security threat that arises in connection to the transaction.¹⁵ The lead agency is charged with negotiating, modifying, monitoring and enforcing a mitigation agreement; it must also report on any material modifications.¹⁶

Like the interpretation of “national security,” the procedures for mitigation agreements largely reflect existing CFIUS practice, which increasingly requires agreements for transactions in sensitive sectors. In 2006, just one agency, the Department of Homeland Security, required 15 such agreements, more than the previous three years combined. Mitigation agreements have been especially prevalent in “critical national infrastructure” deals; for example, they are now routine in telecommunications transactions.

Typical agreements might require a security plan, restrictions on foreign personnel, restrictions on locating assets outside the U.S., reserving certain matters to U.S. management, and reporting or cooperation obligations. Agreements in other sectors tend to follow a similar pattern of attempting to wall off the operations of concern, requiring that sensitive U.S. operations be managed separately by U.S. citizens.¹⁷ There is also an

by CFIUS and a provision adding foreign government control to the list of factors to be considered in the national security analysis. H.R. 556 §§2(b)(2)(E) & 4(8).

¹⁴ Absent a mitigation agreement, H.R. 556 also requires an investigation for transactions regarding critical infrastructure that CFIUS determines could impair national security. H.R. 556 §2(b)(2)(B)(i)(III). This standard for investigation – could impair – appears intended to be lower than the ordinary standard – threaten to impair national security – and may as a practical matter heighten scrutiny of infrastructure-related transactions. As with foreign government transactions, critical national infrastructure transactions are subject to additional reporting requirements and are added to the list of national security factors. H.R. 556 §§2(b)(2)(E) & 4(8).

¹⁵ H.R. 556 §§5(l)(1) & (3). The bill requires a mitigation agreement be imposed according to risk-based analysis of the potential threat.

¹⁶ CFIUS must develop methods for evaluating compliance that do not unnecessarily divert resources from the Committee or unduly burden parties to the relevant transaction. H.R. 556 §5(l)(3)(b)(ii).

¹⁷ For example, when IBM sold its PC unit to Lenovo in 2005, CFIUS required certain restrictions on the access of foreign personnel to IBM’s research facilities.

increasing trend toward draconian enforcement mechanisms in the agreement. The Alcatel-Lucent security agreement was the first reported instance of an “evergreen” clause allowing the government to order Alcatel to divest Lucent if, at any time in the future, its security commitments are breached (a concept now included in the revised statute, as described below); in other transactions, the government has sought penalty clauses providing for massive fines in the case of a breach.

D. Reopening Review or Investigation of Approved Transactions

H.R. 556 authorizes senior officials of the CFIUS agencies to unilaterally reopen a transaction that had previously been approved if any party to the transaction or entity resulting from the deal “intentionally materially breaches a mitigation agreement or condition.”¹⁸ Such a breach must be certified by the lead agency monitoring the mitigation arrangement, and CFIUS must determine that there are “no other remedies or enforcement tools” available to address it. Previously, the parties making a CFIUS notification were guaranteed legal certainty once the transaction was cleared (with the recent exception of an “evergreen” clause imposed in the relevant mitigation agreement).

E. Procedures for Tracking Withdrawn Notices

Both the CFIUS Regulations and H.R. 556 allow a party that has submitted a voluntary notification to withdraw from review, provided the Committee approves the party’s written request for such withdrawal.¹⁹ However, H.R. 556 explicitly states that such a request does not preclude “informal discussions” with CFIUS regarding possible resubmission.²⁰ It also creates a tracking regime for a withdrawn submission whereby the lead agency may establish, pending resubmission: (i) “interim protections” to address concerns raised during review or investigation; (ii) a specific timeframe for resubmission; and (iii) a process for tracking actions taken by the parties in connection with the transaction before resubmission.²¹

In recent years, the practical time to complete CFIUS reviews has lengthened as the Committee’s caseload has increased and it has faced difficulty meeting the 30-day deadline. As well as encouraging parties to make “pre-filings” or submit draft notifications

¹⁸ H.R. 556 §2(b)(1)(D)(iii). The bill also codifies CFIUS’s existing power to reopen a transaction if any party makes a materially false or misleading submission. H.R. 556 §2(b)(1)(D)(ii).

¹⁹ See 31 CFR 800.505; H.R. 556 §2(b)(1)(C)(ii).

²⁰ H.R. 556 §2(b)(1)(C)(iii).

²¹ H.R. 556 §5(1)(2).

to lengthen the effective review period, CFIUS also may request at the end of the process that the parties voluntarily withdraw and re-file their notification to restart the 30-day period. The threat of an investigation provides leverage to the CFIUS agencies and forces the parties into a difficult choice between: (i) insisting on the statutory timetable, with the likely result that a 45-day investigation will be opened and a risk of irritating the reviewing agencies; and (ii) agreeing to restart the initial 30-day review period, with no guarantee that an in-depth investigation will not ultimately be initiated.

H.R. 556 appears to reinforce this practice, formalizing the status of withdrawn submissions and providing CFIUS with tools to manage withdrawn notifications. Thus, while previous proposals for a longer review period were dropped from H.R. 556, pressure to extend the statutory deadlines may persist as a practical matter.

F. Certification to Congress

H.R. 556 requires the Secretary of the Treasury and the head of the lead agency to provide a written certification to certain members of Congress at completion of a CFIUS review or investigation.²² The certification must: (i) describe the actions taken by the Committee; (ii) identify the determinative factors it considered; and (iii) state that CFIUS considers there are no unresolved national security concerns. The members may request and receive briefings on transactions for which all CFIUS action has concluded, or on compliance with a mitigation agreement.²³ Earlier proposals to require notification to Congress while reviews were pending attracted considerable criticism and do not appear in the final measure.

III. Conclusion

Although H.R. 556 rejects some of the most controversial and burdensome proposals for CFIUS reform, it confirms and codifies the new reality that significant political and administrative risks remain for foreign acquirors in a broad range of industries outside the defense sector. The clearest example of political intervention in the CFIUS process is DP World, a transaction that was actually cleared by CFIUS before Congressional pressure (initiated largely by a Florida labor union and the “Hardball” television show)

²² H.R. 556 §2(b)(3). The certification must be transmitted to: (i) the Majority and Minority Leaders of the Senate; (ii) the Speaker and Minority Leader of the House of Representatives; (iii) chairs of appropriate oversight committees; and (iv) with respect to transactions involving critical infrastructure, the members of Congress from the relevant area in which the principal place of business of the acquired U.S. person is located.

²³ H.R. 556 §7(a). The same confidentiality of information that applies to the CFIUS process applies to such briefings.

forced DP World to agree to reopen the procedure. Congressional pressure also played an important role in the CNOOC-Unocal transaction, and opponents to transactions (whether targets of hostile bids, disappointed competitors, or local constituents fearing downsizing of the U.S. business) are becoming increasingly sophisticated and active in attempting to generate national security concerns regarding transactions. Even where external political pressure is not involved, the national security agencies clearly are taking a more conservative approach to foreign acquisitions (even acquisitions involving large and reputable acquirors from friendly countries). A number of sectors that several years ago would not have been thought to raise security concerns, such as telecommunications, now routinely face increased scrutiny.

For both political and security reasons, acquirors from certain countries are particularly susceptible to heightened CFIUS scrutiny. Most notable is China, where a series of transactions has demonstrated that CFIUS closely scrutinizes acquisitions by Chinese-linked entities. There are also indications that acquisitions by Russian-controlled entities are facing increasing scrutiny. Industries or parties to acquisitions that appear geopolitically “strategic” may also face increased scrutiny when acquirors from a perceived rival to the United States are involved.

H.R. 556 largely codifies current CFIUS practices, and it has generally been well received by the business community (primarily because it does not contain a number of more aggressive provisions contained in early CFIUS reform proposals). However, the recent development of those practices has significantly increased the regulatory risk to foreign acquirors in a variety of sectors. Outright prohibitions of transactions remain rare, but foreign acquirors will continue to face longer and more aggressive reviews, more burdensome mitigation agreements, and CFIUS involvement in a variety of “national infrastructure” industries (e.g., telecommunications, energy, and transportation). Foreign acquirors must now seriously weigh the delays and consequences of a potential CFIUS review – whether resulting from genuine national security concerns, political considerations, or competitive maneuvering – in their business strategy.

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Any questions regarding the Exon-Florio Provision or CFIUS review may be discussed with Paul Marquardt or Rick Bidstrup in the Washington Office (+1 202 974 1500).

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