National Security Regulation of Foreign Investments and Acquisitions in the United States

The maturing of China's economy is evidenced by the growing number of local companies making strategic acquisitions offshore. As the principal market for these investments, the US represents a wealth of opportunity for mainland companies to pick up valuable knowledge and technology. Such investments face a rigorous approval process, however, with the US increasingly wary of foreign investment in knowledge-based industries in the post-September 11 world.

By David Marchick, Mark Plotkin and David Fagan, Covington & Burling, Washington D.C.

As Chinese companies, with the encouragement of Chinese government policy, seek to diversify and expand their operations, many are turning to foreign direct investment (FDI) to grow their companies. A few recent examples include Lenovo's acquisition of IBM's personal computer business (the largest Chinese acquisition of an American company); TCL's combination of its television assets with France's Thomson; Shanghai Automotive's acquisition of Korean automaker SsangYong Motor (and its aborted attempt to rescue MG Rover from bankruptcy); and China National Offshore Oil's reported consideration of a bid for the US-based oil company Unocal. Indeed, in 2004, Chinese outward direct investment grew 27% to US$3.62 billion. Though just a fraction of the US$60 billion in inward FDI that China received last year, it is nevertheless an amount almost certain to increase.

The US holds, unquestionably, the greatest market potential for outward Chinese investment. As they explore investment options in the US, however, Chinese companies and their counsel must be aware of an important, but little known investment review law - the *Exon-Florio Amendment*. Exon-Florio enables the US government to restrict, reject or impose conditions on foreign investments into the country on national security grounds. The law has become increasingly relevant in the wake of the September 11 attacks. In particular, Chinese and other Asian companies and investment funds, together with their respective lawyers, need to be mindful of the US government's right to review FDIs on national security grounds when the contemplated transaction involves a US economic sector deemed to be "critical infrastructure".

US OPEN INVESTMENT POLICY AND THE ROLE OF EXON-FLORIO

The US has formally invited foreign investment for decades. In 1983, president Ronald Reagan issued a "Statement on International Investment" that publicly announced, for the first time by a US president, that "the United States welcomes foreign investment". This longstanding policy, reinforced by the attractiveness of the US as the world's largest economy, has led to sustained increases in FDI into the country over the last 30 years. US affiliates of foreign multinational enterprises employed 5.2 million American workers in 2003, accounting for 5% of employment in the private sector. Capital expenditure by these same affiliates, furthermore, totaled US$109 billion in 2004. A substantial component of this foreign investment emanates from companies based in Asia, particularly Japan. Indeed, foreign companies, including Japanese auto and electronics companies, now form the bedrock of economic activity in many regions of the US.

Notwithstanding its success, the open investment policy of the US has been subject to domestic criticism. In particular, in the mid-1980s, many leading officials, companies and labour unions became alarmed at the rate of growth of Japanese investment in the US. In response, the US Congress enacted, in 1988, the *Exon-Florio Amendment* to the *Defense Production Act* of 1950, enabling the president to block corporate mergers, acquisitions and takeovers that threaten US national security. The original law included a three-year expiration provision; Congress made the law permanent in 1991.

Exon-Florio and its implementing regulations pose a number of challenges for companies and counsel attempting to evaluate whether a particular transaction implicates the terms of the law. First, Exon-Florio specifically authorizes the president or his designee to review any merger, acquisition or takeover by or with foreign persons that could result in "foreign control" of enterprises engaged in interstate commerce in the US. The term "foreign control" in this context is potentially very broad - under the plain language of the law and related regulations, it means the ability to control or influence a US company through ownership of voting securities, by proxy voting, contractual arrangements, or other means.[1] The US regulatory body implementing Exon-Florio, the Committee on Foreign Investment in the United States, or CFIUS (discussed further below), has sometimes found a foreign person to be in "control" of a US entity where that foreign person's rights include, for example, the right to appoint directors to the board, veto rights over certain corporate actions and/or the right to reject

This article first appeared in China Law & Practice, June 2005, 19(5), pp. 23-26,
and is reprinted with the permission of Euromoney Publications (Jersey) Ltd.

certain key personnel. A small ownership percentage, therefore, will not necessarily avoid Exon-Florio scrutiny if other factors of control are present.

Second, Exon-Florio's actual trigger for the use of presidential authority contains a significant ambiguity. The statute specifically directs the president to exercise his authority to investigate and, if necessary, prohibit a transaction if there is "credible evidence" that the foreign party exercising control "might take action that threatens ... national security". However, the law does not define the term "national security," and the legislative history states only that the term should be "interpreted broadly and without limitation to particular industries". Exon-Florio does list five "factors" for CFIUS to consider in evaluating national security, but those factors are primarily focused on the US defence industrial base and preserving US technical superiority in national security-related technologies. Importantly, as discussed below, the term "national security" is now interpreted in practice by CFIUS to extend well beyond these factors.

THE EXON-FLORIO PROCESS

Notwithstanding the ambiguities of the law, once companies and their counsel determine that a particular transaction meets the Exon-Florio criteria, the structure of the regulatory process is fairly clear. As noted, the president delegated the lead responsibilities for implementing Exon-Florio to CFIUS, which originally had been established by a presidential order in 1975 as a body to monitor and evaluate the impact of foreign investment in the US. CFIUS is chaired by the Secretary of the Treasury and has 11 other member agencies including, but not limited to, the Departments of State, Defense, Commerce, Justice and Homeland Security.

Exon-Florio also establishes a timetable for review. First, CFIUS conducts an initial 30-day review of a particular transaction. If a consensus exists that there is no credible threat to national security, or the threat has been mitigated, CFIUS will decide – within 30 days of filing – not to open an investigation. A CFIUS decision not to pursue an investigation has the effect of approving the transaction. If, on the other hand, the agencies either determine that a threat exists, or the agencies are divided, CFIUS conducts an "investigation" (practically speaking, an extended review) for an additional 45 days, followed by a presidential decision within 15 days thereafter.

Seeking review of a transaction under Exon-Florio is voluntary. Indeed, most foreign acquisitions of US companies never result in the submission of a formal notice under Exon-Florio because the acquiring party and the target do not believe the transaction will implicate national security. Historically, this approach has worked well, but the US government is today scrutinizing an increasingly broad range of transactions as potentially affecting national security. In these circumstances, as discussed below, transaction parties and their counsel are well advised to consider carefully whether a particular transaction could be deemed to affect national security in some very broad sense. The full reach of "national security" for purposes of Exon-Florio can be seen in the types of transactions typically subject to CFIUS review. Specifically, the acquisition of companies that: (i) supply the US Department of Defense or other US security agencies; (ii) possess or control products or technology subject to US export control and non-proliferation laws; or (iii) operate in sectors considered "critical infrastructure".

Parties entering into a transaction that may raise US national security concerns generally choose to "pre-screen" the transaction with CFIUS' member agencies. Most transactions formally reviewed under Exon-Florio are in fact approved within 30 days. For example, since the law's 1988 enactment, there have been approximately 1,555 reviews under Exon-Florio by CFIUS agencies, representing by one estimate about 10% of all foreign acquisitions of US companies during that time period. In this same time period, only 25 transactions have resulted in an "investigation". Of these, the parties withdrew from the transaction in 12 cases, and the president made a final decision in 12 others, approving 11 of them. The limited number of investigations and the single rejection is deceptive. More than anything else, they reflect the established practice of informal review and discussion with CFIUS in advance of any formal filing and the fact that many transactions that encounter resistance from CFIUS are simply never consummated – parties almost always prefer to withdraw a transaction rather than be faced with the stigma of a presidential decision to disapprove a transaction.

THE CHALLENGE OF EXON-FLORIO AFTER THE SEPTEMBER 11TH TERRORIST ATTACKS

Since September 11 2001, transactions requiring CFIUS review have been subjected to greater scrutiny and tougher conditions for approval. A number of factors have led to these changes. First, the security environment has been broadly strengthened, and a greater awareness of security vulnerabilities has been established. Second, CFIUS is rare among inter-agency committees of the US government in that it includes agencies with widely disparate interests and missions. Thus, CFIUS includes economic agencies that are typically pro-investment (e.g., the Departments of Treasury and Commerce and the United States Trade Representative office), as well as agencies with security missions that tend to be more US-centric in their views (e.g., the Departments of Defense and Justice). In 2003, the president added the Department of Homeland Security to CFIUS, shifting the Committee's balance of power significantly in favour of the "security" agencies. Third, a number of senior officials in the Bush administration, particularly at the Department of Defense, do not embrace foreign investment in the US with the same vigour as did their predecessors in the Reagan, Clinton and George H.W. Bush administrations.

The heightened emphasis on security within CFIUS has resulted in more "investigations" of transactions in the past three years than in the previous 10 years combined. And foreign acquirers are agreeing to stricter security-related conditions in order to receive approval from CFIUS. Indeed, it is fair to say that the CFIUS interpretation of "national security" has broadened since September 11.

Telecommunication Transactions

Transactions in the telecommunications sector provide the best evidence that conditions imposed by CFIUS have toughened since September 11. The telecom sector is the only sector subject to

CFIUS review that can be readily analyzed since it is the only sector for which security agreements are made public. These agreements are made public, and posted to the US Federal Communications Commission's (FCC's) website. Indeed, this requirement is contingent, by order of CFIUS, for the FCC's grant of licenses for firms to operate a telecommunications company in the US. To be sure, CFIUS reviewed and imposed security conditions on telecommunications transactions prior to September 11. But the security requirements imposed by CFIUS have become more intrusive, limiting foreign-owned telecommunications firms' freedom of action in key areas in which American-owned telecommunications firms face no similar restrictions.

Before September 11, security requirements, as embodied in Network Security Agreements (NSAs), negotiated between the parties and the US government, typically focused on the ability of US law enforcement to conduct electronic surveillance and access data transiting telecommunications networks through wiretaps and the service of lawful process, and to prevent foreign governments from accessing such data. For example, the NSAs only permitted calls originating and terminating in the US to be routed outside the country for bona fide commercial reasons. Likewise, a telecommunication provider subject to a NSA would be required to maintain key network equipment, including network operating centers, routers and switches, and to store data in the US, absent of a bona fide commercial reason for maintaining such network equipment or data abroad. Other pre-September 11 NSA requirements typically included a prohibition on foreign governments' access to data and content related to calls originated and terminated in the US. Companies entering into a NSA, furthermore, had to comply with lawful US law enforcement requests to access data and conduct surveillance.

Since the Department of Homeland Security joined CFIUS, NSAs have become tougher and have pursued a much broader US government objective: the protection of critical infrastructure. Indeed, many of the recent NSAs have borrowed heavily from security agreements, typically utilized by the US Department of Defense, in order to mitigate security concerns associated with foreign-owned companies that have classified contracts with the Department. For example, to varying degrees, these NSAs have:

- Eliminated the bona fide commercial exception of data storage and call routing outside of the US;
- Eliminated the bona fide commercial exception for critical network equipment located abroad, thereby requiring the network to be controlled entirely from within the US;
- Permitted only US citizens to serve in sensitive network and security positions (e.g., positions permitting access to monitor and control the network);
- Required third party screening of senior company officials and personnel having access to critical network functions;
- Restricted or prohibited the outsourcing of functions covered by the NSA, unless such outsourcing is approved by the Department of Homeland Security or occurs pursuant to a policy approved by the Department of Homeland Security;
- Provided US government agencies the right to inspect US-based facilities and to interview US-based personnel on very short notice (as short as 30 minutes);
- Required third party audits of compliance with the terms of the NSA;
- Required the implementation of strict visitation policies regulating foreign national access (including by employees of the acquiring company) to key facilities, including network operating centers; and
- Required senior executives of the US entity, and certain directors of its board, to be US citizens approved by the US government and responsible for supervising and implementing the NSA.

As the recent NSAs demonstrate, the security commitments extracted by the US government through the Exon-Florio review process can impose significant costs, which prospective foreign acquirers of entities involved in US critical infrastructure sectors must consider in their pre-deal due diligence. For global communication companies, for example, the limitations on outsourcing, routing of domestic calls, storage of data, and location of network infrastructure can have significant competitive effects.

But NSAs are not without potential competitive benefit. Companies that can operate successfully under NSAs with the Departments of Justice, Homeland Security and the FBI can market themselves as having exceptionally secure networks. Moreover, the US government does not seek to impose a one-size-fits-all security agreement template on acquirers. For example, in two recent satellite transactions, the US government required only the appointment of a security committee (or a special audit committee) comprised of US citizens to supervise implementation of the NSA. Similarly, for several smaller transactions, the US government did not require the appointment of a third-party auditor or the creation of a security committee at the board of director level.

These NSAs in the telecommunications sector are suggestive of the way CFIUS analyzes the risk associated with the transactions and the measures required to mitigate that risk. For example, backbone and fiber networks seem to be viewed as more sensitive from a national security perspective than satellite or wireless networks. Further, companies based in countries considered close strategic and political allies to the US are likely to be deemed as lower security risks. Finally, government ownership tends to result in tougher security requirements. Depending on the factors of a particular transaction - including the asset being acquired, the reputation of the acquirer and the home country of the acquirer - it is possible for parties to negotiate security agreements that satisfy US government concerns and provide the parties with sufficient flexibility to be competitive, if not have a commercial advantage.

CHINA - A SPECIAL CASE

The US security agencies within CFIUS are less likely to offer flexibility when it comes to Chinese investment. Whether or not it is justified, the US government considers Chinese investment to present special concerns. These include:

- ***State ownership.*** Many large Chinese companies either have, or at one time had, significant ownership interests by the Chinese government. Under a 1992 Amendment to Exon-Florio,

CFIUS is required to conduct an investigation (the second phase of the review by CFIUS) of acquisitions by foreign companies controlled by foreign governments. Thus, if a Chinese company is either a state-owned enterprise, or a company with anything more than minimal government ownership, it is likely to face a formal investigation of any acquisition.

- ***Espionage.*** The Department of Justice and the FBI are intensely focused on efforts by the Chinese government and Chinese nationals to conduct state and commercial espionage in the US.
- ***Technology transfer and non-proliferation/export control laws.*** US government agencies have long been concerned with the transfer of dual use technology to China and may have concerns about Chinese companies' compliance with US export control laws.

In addition, concern in the US Congress over China's increasing competitiveness, the size of the US trade deficit with China, and the loss of US manufacturing jobs in general (and to China in particular) has recently reached a fever pitch. Several important members of Congress, including congressmen Henry Hyde, Duncan Hunter and Donald Manzullo, expressed strong concerns regarding Lenovo's acquisition of IBM's personal computing division. While the Exon-Florio law does not include job loss or economic competitiveness as factors that CFIUS should consider, congressional pressure can still have an impact on the CFIUS review process.

In short, China is unique among all of the US' major trading partners because of the asymmetrical trade and security relationships between the two countries. In 2005, China is expected to be the US' third largest trading partner. At the same time, China is the only major trading partner that US security agencies view with particular suspicion and concern (just as Chinese security agencies view the US). This dynamic, and the likelihood of future significant Chinese acquisitions (or attempted acquisitions) in the US, promises to thrust Exon-Florio into the center of US-China trade relations. Chinese companies and their counsel, therefore, would do well now to familiarize themselves with the Exon-Florio law and work with their US partners in devising a strategy on how to approach CFIUS prior to entering into any transaction that would implicate Exon-Florio.

Endnote

1 For example, under the applicable regulations, there is a rebuttable presumption of control if a foreign person acquires 10% of the equity of a US company.