Steering the deal through

Outbound investments from India to the US face scrutiny on national security grounds. A thorough understanding of the review process and early consultation with regulators are crucial in achieving a successful outcome

Mark Plotkin, David Fagan and Adam Smith explain

Indian foreign direct investment (FDI) flows to over 120 countries, with the US among the largest recipients. The Indian Ministry of External Affairs has described the US market as "the most important destination of Indian investment abroad". Indian companies undertook more than 140 acquisitions in the US between 2007 and 2009, almost half being in the information technology sector with the remainder mostly divided between manufacturing and pharmaceuticals. Recent transactions include Tata Chemicals' US$1 billion acquisition of General Chemical Industrial Products in January 2008, Rain Calcining's US$595 million acquisition of CII Carbon in June 2007 and Wipro's US$547 million acquisition of Infocrossing in August 2007. While the size of some transactions during the 2007-2009 period is unknown, those announced total nearly US$5.4 billion.

All Indian businesses considering investments in the US must consider relevant US laws and institutions that govern, restrict and in some cases prohibit FDI. The national security-based regulatory review process, administered by the Committee on Foreign Investment in the US (CFIUS), is a central concern.

CFIUS law and mechanics

CFIUS operates pursuant to section 721 of the Defense Production Act, 1950, commonly called the "Exon-Florio Amendment". The name originates from the original statutory amendment in 1988 that provided the president with express authority to review the national security effects of foreign acquisitions, mergers and takeovers. The law was amended by the Foreign Investment and National Security Act (FINSA) of 2007, making CFIUS the regulatory body that administers the president's authority to review inbound M&A deals.

That review authority covers "any merger, acquisition, or takeover … by or with any foreign person which could result in foreign control of any person engaged in interstate commerce in the United States". The president, represented by CFIUS, must investigate any transaction that: (1) threatens to impair US national security; (2) would involve control by a foreign government; or (3) would result in foreign control of US critical infrastructure, if such control threatens to impair US national security. The president ultimately has authority to suspend or prohibit any transaction if, after a full investigation

is completed, "there is credible evidence that leads the president to believe that the foreign interest exercising control might take action that threatens to impair the national security". The president is also allowed to oppose such transactions, if other laws do not provide adequate authority for him to protect the national security interests at stake in the transaction. Simply put, the president may choose to block a deal – any deal – that is deemed to threaten US national security interests.

CFIUS is chaired by the US Department of Treasury, and includes eight other voting member agencies: the Departments of Commerce, Defense, Homeland Security, Justice, State, and Energy; the US Trade Representative; and the White House Office of Science and Technology. Permanent non-voting members include the director of national intelligence, the Department of Labor and several other White House offices that act as observers and, on a case-by-case basis, participate in CFIUS reviews. The designation of the Department of Treasury, a naturally pro-investment agency, as chair of the national security-based review process was an intentional signal of the seriousness with which the US seeks to maintain its open investment regime.

Subtleties of the review process

Similarly, the CFIUS process aims to preserve US open investment policy, while still allowing close scrutiny. The committee operates on a tight schedule, having just 30 days to complete the initial review of the often-detailed submissions it receives, after which it must either approve the proposed transaction or decide that a longer investigation (of up to 45 days) is required. If after this the committee's concerns have not been mitigated satisfactorily by the parties, CFIUS reports to the president, who must then either permit or block the transaction within 15 days.

More flexibility is possible than this schedule might suggest. For example, if the committee believes it will be unable to approve an acquisition during the first 30 days, the prospective investors may elect to withdraw the request for review and file again after modifying the transaction or providing additional information. The process then begins anew and the committee has another 30 days to complete the initial review. Additionally, CFIUS encourages transacting parties to begin informal consultations before officially requesting a review, thus giving parties a clear sense of the information CFIUS needs and any concerns it may have, and extending the effective time span of the initial review beyond 30 days.

Perhaps surprisingly, and in another signal of the country's openness to FDI, applications for CFIUS reviews are voluntary; yet there are important incentives for parties to file with the committee even if a transaction is only tangentially related to US national security interests. CFIUS actively monitors M&A activity and does have the authority to compel parties to file for a review. It is therefore preferable, and usually quicker, for parties to raise an investment with the committee voluntarily rather than to unexpectedly hear from CFIUS after a deal is announced. Furthermore, given that the president has authority to unwind a transaction after closing without any statute of limitations, CFIUS approval of a deal functions as an important safe harbour for transactions. Deals that have been approved by the committee are revisited only in exceptional circumstances.

FINSA avoids damaging politicization of FDI by defining a limited oversight role for congress, to which CFIUS reports only after reviews have been completed – a reassuring arrangement for investors.

Indian investment practice

The law's provisions cover a broad range of potential Indian acquisitions. For example, FINSA provides CFIUS with wide discretion to determine that a particular foreign investment in a US business is "controlling" (and therefore, subject to the committee's jurisdiction).

In recently amended regulations CFIUS emphasized that it makes this determination on a case-by-case basis, assessing whether the foreign entity has practical authority to "determine, direct, or decide important matters" affecting the US business. Given that a significant proportion of Indian outbound FDI has been for majority stakes in foreign firms, and that the preferred method of financing has been cash (providing no other entity a call on the investment), many Indian investments into the US are likely to be considered "controlling". In fact, CFIUS has often found control to exist where the foreign investor's equity stake is well below 50% (as in the case of Chinese firm Huawei Technologies' proposed acquisition of a roughly 16% equity and voting interest in the US telecommunication equipment maker 3Com, which was ultimately rejected).

The law's approach to the meaning of national security is similarly flexible. The statute does not define the term but instead provides a non-exhaustive list of factors that CFIUS may consider in assessing whether a transaction poses a national security risk. These include the transaction's potential effects on the ability of domestic industries to meet national defence requirements, potential effects on US critical infrastructure, whether the transaction involves foreign government control, and the relevant foreign country's record of cooperation with US counter-terrorism efforts. The breadth of the control definition together with the elasticity of the national security concept gives CFIUS considerable discretion to exercise jurisdiction over foreign investment in the US.

In addition to these factors, several other considerations may lead CFIUS to take an interest in an investment originating in India:

- Many Indian companies with active outbound FDI programmes remain government-owned or controlled, a factor that CFIUS considers in its analysis.

- Indian investor interest in the US has been weighted heavily towards information technology, telecommunications and specialty manufacturing – sectors that touch on the interests of some CFIUS member agencies – and the committee usually carefully investigates such investments even if the connection with national security is minimal.

- Indian businesses that have commercial links with countries that are subject to US trade sanctions (particularly Iran), may attract special attention from the CFIUS member agencies.

These factors alone are unlikely to block Indian investments. Indeed, the open investment policy of the US and the positive status of the US-India bilateral relationship (recently strengthened by the path-breaking 2008 Indo-US Civilian Nuclear Agreement) will in most cases weigh heavily in favour of the investor. Nevertheless, the potential breadth of the committee's powers suggests that prudent Indian investors should undertake a careful analysis of potential CFIUS interest in any controlling investment, merger or acquisition of an existing US business.

Rare insights

All CFIUS proceedings are confidential so as to protect US security interests and the privacy of transacting parties. As a result the number of Indian acquisitions that have faced CFIUS reviews is not publicly known. However, details of some such transactions have been obtained through other channels such as related, but separate, regulatory filings. A review of these cases indicates that a significant number of Indian investments were approved only after close CFIUS scrutiny and the adoption of significant risk mitigation measures that at least one CFIUS member agency believed were necessary to address a national security risk posed by the transaction.

Under the CFIUS process, risk mitigation measures can be insisted upon by the committee as a condition for the approval of an investment. However, in order to be formalized in such a fashion, the committee as a whole must agree with the risk mitigation measures proposed and provisions of other laws must not adequately address the risk.

Mitigation agreements have the effect of law. Material breaches are subject to a variety of statutory penalties (including the president's unwinding of the transaction), with FINSA regulations also providing for monetary fines of up to the full value of the transaction. Among Indian transactions reviewed by CFIUS, two in particular – the VSNL-Tyco deal and the Reliance-Yipes transaction – stand out for their mitigation agreements.

In VSNL's US$130 million acquisition of Tyco International's trans-Atlantic subsea network of telecommunications cables, CFIUS' interest was aroused by the fact that the Indian government owned 25% of VSNL (a legacy of VSNL's former status as a government-owned enterprise) and because the transaction involved US strategic infrastructure. Even though the subsea cables that were the subject of the transaction were used primarily for non-military purposes, CFIUS viewed them as critical pieces of the US communications network.

To alleviate its concerns, CFIUS insisted on a number of mitigating measures. After five months of negotiations between the acquirer and certain CFIUS agencies (including the Departments of Homeland Security, Defense, and Justice, and the Federal Bureau of Investigation), VSNL agreed to implement a comprehensive Network Security Agreement (NSA) requiring it to: facilitate US government surveillance of communications originating or ending in the US; store saved data from such communications solely in the US; store personal information about American consumers solely in the US; adopt special procedures to safeguard sensitive US government communications; restrict visits by non-US citizens to VSNL's US facilities; obtain approval from the US Department of Justice before complying with any foreign government request for access to communications data or other company information; seek US government approval before adopting a personnel screening plan; and facilitate US government background checks of VSNL security personnel.

In a more recent telecommunications transaction, Mumbai-based Reliance Communications had only negligible Indian government ownership (less than 0.2%) at the time it purchased California-based Yipes Communications in 2008. Yet the deal was subject to similar NSA mitigation requirements as those in the VSNL-Tyco transaction.

HOUSE RULES: The US president has the authority to block any transaction.

They included agreements that Yipes' transactional data, subscriber information and billing records would be stored in the US, and that its domestic communications infrastructure would be supervised and managed from within the US. Additionally, Reliance agreed to restrict access to Yipes' domestic network and data by foreign persons and prohibit access to, and the disclosure of, domestic communications and data to foreign governments; to appoint a US-citizen security officer and implement personnel screening procedures; to configure its US network to enable authorized interception of communications by the US government; and to provide annual reporting on mitigation compliance and allow the US government inspection and audit rights.

The regulatory filings required in connection with these two transactions offer an unusual insight into the CFIUS process, which applies equally to FDI in a wide range of other sectors including information technology, defence, telecommunications, aviation, chemicals and ports.

Future opportunities

Indian companies enjoy certain distinct advantages over some other would-be investors in the US. A shared language and links with a highly successful community of expatriate entrepreneurs in the US help facilitate Indian investors' access to deals, as well as subsequent integration of US assets. Furthermore, acquisitions by Indian firms – while not free from scrutiny by CFIUS – are not viewed with the same degree of concern as investments made by companies from some other emerging nations.

India's investment presence in the US is expected to continue and strengthen, especially with the healing of the global economy, and CFIUS will continue to play an important role in India-US trade relations. Indian companies and their counsel would do well to familiarize themselves with the CFIUS process, and work with their US partners in devising strategies to approach CFIUS prior to entering into any transactions involving potentially sensitive US sectors or strategic infrastructure. ■

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