New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
Web address: http://www.nylj.com

An incisivemedia publication
VOLUME 240—NO. 11
WEDNESDAY, JULY 16, 2008

BY KATHLEEN A. SCOTT

The Committee on Foreign Investment in United States

Under §721 of the U.S. Defense Production Act of 1950,[1] the so-called Exon-Florio Provision (Exon-Florio), the president of the United States has the authority to suspend or prohibit the acquisition, merger or takeover of a U.S. "person engaged in interstate commerce" by a non-U.S. ("foreign") person that might threaten the national security of the United States if he or she finds that there is credible evidence that the foreign person exercising control might take action that threatens national security and the provisions of law, other than economic sanctions laws, do not provide adequate and appropriate authority to protect the national security.

When one thinks about foreign investment in the United States, transactions by sovereign wealth funds often come to mind. However, investments by non-U.S. banks in U.S. companies also potentially are subject to review under Exon-Florio.

This month's column will discuss recent legislation and proposed regulations that could affect a potential investment in the United States by a non-U.S. bank.

CFIUS

The Committee on Foreign Investment in the United States (the CFIUS), originally established by executive order in 1975, is an interagency committee that reviews either potential or completed acquisitions, mergers or takeovers of a U.S. person engaged in interstate commerce by a foreign person. Regulations may be found in Part 800 of Title 31 of the Code of Federal Regulations. The U.S Treasury Department's Web site contains a Web page devoted to CFIUS matters at http://www.treas.gov/offices/international-affairs/cfius/.

FINSA

Exon-Florio was amended in 2007 by the Foreign Investment and National Security Act of 2007 (FINSA), Pub. L. 110-49. FINSA was signed into law by President George W. Bush on July 26, 2007, and it became effective on Oct. 24, 2007. The basic structure of Exon-Florio remains: the president is authorized to review mergers,

acquisitions, and takeovers by or with any foreign person which could result in foreign control of any person engaged in interstate commerce in the United States, to determine the effects of such transactions on the national security of the United States. What FINSA did was to codify the existence of the CFIUS and various aspects of its structure, role, processes, and responsibilities as well as outline the responsibilities of the various U.S. government agencies that will participate in the review of transactions by the CFIUS.

Proposed Regulations

On April 23, 2008, the U.S. Treasury Department issued proposed regulations (proposed regulations) to amend 31 C.F.R. Part 800 to implement the FINSA amendments.[2] Comments were due by June 9, 2008.

FINSA did not fundamentally change the voluntary reporting structure of Exon-Florio but the proposed regulations implement a number of procedural changes, some of which are discussed below. Two issues that should be of particular interest are (i) what is considered "control" for purposes of control over a covered U.S. person by a non-U.S. person and (ii) the concept of "critical infrastructure."

Under the proposed regulations, the decision to file a voluntary notice with the CFIUS depends on whether the transaction would be considered a (1) "covered transaction" and (2) raise national security considerations.

Covered Transaction

FINSA introduced a new term, "covered transaction," to identify the types of transactions that are subject to review by the CFIUS. Under FINSA, a "covered transaction" pertains to any merger, acquisition, or takeover by or with a foreign person which could result in "control" of a U.S. business by a foreign person.

Transaction

The proposed regulations define the term "transaction" (§800.224) as a proposed or consummated merger, acquisition, or takeover, including:

(a) The acquisition of an ownership interest in an entity

(b) The acquisition or conversion of convertible voting instruments of an entity

(c) The acquisition of proxies from holders of a voting interest in an entity

(d) A merger or consolidation

(e) The formation of a joint venture

(f) A long-term lease under which a lessee makes substantially all business decisions concerning the operation of a leased entity, as if it were the owner.

Control

FINSA does not define control, but rather requires the CFIUS to prescribe a definition by regulation. Control has always been a key threshold concept in Exon-Florio, and the proposed regulations adopt the CFIUS long-standing approach to defining "control" in functional terms as the ability to exercise certain powers over important matters affecting a business. Specifically, "control" is defined as "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." The proposed regulations provide sample scenarios as guidance to follow in determining whether the transaction would lead to control.

While the definition in the proposed regulations provides examples of control, it does not provide a bright-line test. Control is not defined in terms of a specified percentage of shares or by a number of board seats. Although these items play a role, they are not the sole

Kathleen A. Scott *is counsel at Arnold & Porter LLP.* **Binoy Dharia,** *an associate at White & Case, assisted in the preparation of this article.*

determinant. Non-U.S. banks with banking operations in the United States should be somewhat familiar with this concept of "control" from the federal banking regulations regarding change of control of a banking institution or acquisition of a nonbanking company by a non-U.S. bank.[3]

Covered Transactions

Examples also are used in the proposed regulations to illustrate the types of transactions that are and are not covered transactions.

The general definition of a covered transaction in §800.301 is broad:

- A transaction which, irrespective of the actual arrangements for control provided for in the terms of the transaction, results or could result in control of a U.S. business by a foreign person;
- A transaction in which a foreign person conveys its control of a U.S. business to another foreign person; and
- A transaction that results or could result in control by a foreign person of assets that constitutes a U.S. business.

One of the numerous examples addresses so-called "greenfield" investments. A greenfield investment is one where a non-U.S. corporation expands its U.S. operations by original establishment and not acquisition of a going concern (i.e., a green field). For example, an international bank may establish a new bank in the United States, rather than purchasing a currently operating bank. Such a transaction would not be subject to review by the CFIUS.

National Security

In order for a transaction to pose national security considerations, the acquired U.S. business has to be involved in either the "critical infrastructure" of the nation or in "critical technologies." Under the proposed regulations, "critical infrastructure" means, in the context of a particular covered transaction, systems and assets, whether physical or virtual, so vital to the United States that their incapacity or destruction would have a debilitating impact on national security. The proposed definition of "critical technologies" is a specific list of articles, items and services, such as defense articles on the U.S. Munitions List.

Notice

The proposed regulations explain how voluntary notices are to be filed and how CFIUS or agencies within it may request review of a transaction. FINSA provides for an initial 30-day review of the proposed transaction to determine the effect on national security and address any threat. There also is an additional 45-day review period in certain cases such as a transaction involving a foreign government-controlled transaction.

Many information items that must be included in a CFIUS notice would be familiar to any non-U.S. bank that has applied to the Federal Reserve Board to acquire a U.S. bank. For example, the notice would need to include an explanation of the structure and purpose of the transaction and its purpose, details on the foreign acquirer and its affiliates, description of the business of the U.S. company and its direct competitors, and biographical information on all foreign nationals involved in the transaction and key personnel in a parent company.

Impact on Financial Sector

The proposed regulations are unclear as to specifically which financial services transactions would come under review by the CFIUS. As noted above, the president's determination under Exon-Florio also includes an analysis of whether laws other than economic sanctions laws would provide adequate and appropriate authority to protect the national security. No one should disagree with the statement that the banking industry in the United States is heavily regulated. Potential acquisitions of U.S. banks by non-U.S. banks are not approved by the Federal Reserve Board and other bank regulators unless the regulators have first reviewed and closely scrutinized (among other areas) the potential acquirer's business operations, financial strength, management expertise and supervisory regime. Certain nonbank investments by non-U.S. banks also are subject to prior review and approval. Even loan terms have been reviewed to determine if there is control for purposes of the banking regulations. Thus, although an explicit national security review is not required at this time in any of the foregoing consequences, a threat to the safety and soundness of the U.S. banking system could be seen as a threat to the security of the United States and thus could give the regulators grounds upon which to deny an acquisition application (or other control determination) without the need for a CFIUS review.

The Committee on Foreign Investment in the United States, established by executive order in 1975, is an interagency committee that reviews either potential or completed acquisitions, mergers or takeovers of a U.S. person engaged in interstate commerce by a foreign person.

The proposed regulations require consideration of any transaction related to "critical infrastructure" as defined above. However, while finding that an entity is part of the nation's critical infrastructure remains a subjective judgment, CFIUS review likely would be required of any acquisition transaction that created the potential for "control" of large financial entities (e.g., Citigroup, JPMorgan) that play a significant role in nation's payment system or those that, if ruined, would create systemic risk, regardless of the current bank regulatory review and approvals that might be needed. Using the foregoing analysis, smaller entities should not come under CFIUS review unless the parties in the transaction sought voluntary review.

In addition to a traditional acquisition or merger transaction, another issue regarding financial institutions is the degree to which a non-U.S. bank could assume control through the usual course of its ordinary financial activities. The proposed regulations address these activities by making it clear, for example, that an extension of credit accompanied by ordinary lender protections or holding securities in the course of underwriting should not constitute an acquisition of control and thus are not subject to CFIUS review. However, the proposed regulations leave the door open for review of certain lending transactions because, for example, "control" could occur if, as a result of a borrower defaulting on a loan, ownership of a U.S. business is transferred to a non-U.S. lender or loan syndicate. Such a stance could have unintended consequences by complicating loan work-outs and even endangering the lender's recoveries.

In addition, while the most basic negative covenant that a lender may impose on a borrower—to not sell or pledge the borrower's principal assets—is not seen as a presumption of control, what about other negative covenants that currently are market practice: restrictions on a borrower's capital expenditures, changes in control, varying of business plans and operations and even declaration of dividends? One cannot expect that the Treasury Department will be able to include in the regulations examples of every possible transaction that could occur and the potential CFIUS effect. However, the Treasury Department could go beyond the easy examples currently provided and add examples of transactions that may reflect today's more complex world of lending with negative covenants, multiple guarantors and workouts to avoid default. Non-U.S. lenders should review their standard loan agreements to target provisions that may need to be revised in order to anticipate and/or avoid the new risk.

Conclusion

When the proposed regulations are finalized, it is hoped that there is clarification on how extensively they apply to financial services businesses such as non-U.S. banks, particularly with respect to loan transactions. Until then, non-U.S. banks may want to perform a CFIUS risk analysis of any potential transaction involving directly or indirectly a company in the United States.

1. 50 U.S.C. §2170, et seq.
2. 73 Fed. Reg. 21861-21880.
3. See 12 C.F.R. §§225.2(e), 225.31.