

UNITED STATES

The impact of FINSA on foreign acquisitions in the US

BY CLAIRE SPENCER



The Foreign Investment and National Security Act (FINSA) came into effect on 24 October 2007. FINSA modified Section 721 of the Defense Production Act of 1950 (commonly known as the Exon-Florio Amendment), which aims to clarify and enhance scrutiny when foreign players acquire critical infrastructure assets in the United States. This development ends two years of debate surrounding foreign direct investments and national security in the post-9/11 world. It started in 2005, when the surprise bid for the Unocal Corporation by Chinese company CNOOC, followed by the controversial acquisitions of certain US marine cargo facilities by Dubai Ports World (since divested after public opposition), inspired Congress and the Administration to investigate the security risks of such investments. Early signs suggest that those affected by the change can expect new risks and difficulties associated with the tighter approval process, more stringent investor criteria, and greater scope for political interference. As such, there are fears that FINSA will have a negative impact on US cross-border M&A.

FINSA is not intended to be a barrier to foreign direct investment. On paper, the

Exon-Florio process has been commended for striking a balance between attracting foreign investment while maintaining national security. The Committee on Foreign Investment in the United States' (CFIUS) ability to maintain such a balance is a separate issue. Although much of FINSA just codifies current CFIUS practice, it also requires greater Congressional oversight of CFIUS' activities, further scrutiny of acquisitions by foreign governments and sovereign wealth funds, and will potentially allow for the reopening of suspect transactions. Certain cases will linger on CFIUS' radar for the foreseeable future. The prospect of possible ongoing regulatory oversight could reduce investment by acting as a deterrent for foreign acquirers.

Historically, CFIUS has focused on two potential threats to US national security when a foreign entity makes a US acquisition: the outflow of sensitive information to a current or potential adversary, or an entity that is likely to pass that information on to that adversary; and foreign control over a strategic asset. "Under FINSA and recent practice in the post-9/11 era, the review has been expanded to focus also on whether foreign

ownership affords the owner access that can be used to disrupt critical infrastructure – for example, by inserting malevolent software in US systems or gaining insight into sensitive information," says Jeffrey P. Bialos, a partner at Sutherland, Asbill & Brennan LLP and former Deputy Under Secretary of Defense who participated in CFIUS reviews during his tenure of office.

FINSA aims to mitigate those potential threats, according to John B. Reynolds III, a partner at Wiley Rein LLP. "Every deal is unique, as are the political and national security factors involved at the time the deal is reviewed, so there is no single set of security risks on which CFIUS focuses," he says. "Nonetheless, FINSA's authors and the CFIUS agencies seek to ensure that foreign ownership of critical infrastructure – a term not yet defined by FINSA, or in CFIUS's regulations – does not impair US authorities' ability to protect national security, respond to national emergencies, or execute important foreign policy goals. In recent years, transactions in the telecommunications arena, from undersea cables and satellites to cellular telephones and VoIP providers, have received close scrutiny for their potential effects on both 'traditional' national security and domestic law enforcement." That scrutiny is expected to continue as new technologies develop. CFIUS regulations expected in 2008 will have to come up with a concrete definition for 'critical infrastructure'. In the meantime, the term is thought to cover assets such as electric power generation facilities, natural gas and oil transmission pipelines, oil reserves and refineries, nuclear plants, telecommunications facilities, certain computer and IT products, bioterrorism drugs and vaccines, bridges, and ports.

The overwhelming majority of transactions should still be approved by CFIUS, but some practitioners are concerned FINSA is sending out a negative message to foreign investors. "The fabled 'open US investment policy' has now become more restrictive ▶▶

and is detrimental to future cross-border US M&A," says Mr Bialos. "The reality is we no longer have an open investment policy with respect to business areas related in some way to US critical infrastructure. The dilemma, in the wake of the Dubai Ports case, is that sometimes the aversion is not to legitimate national security risks, but to risks of domestic political disturbance over a transaction. The fact that potential buyers have powerful business incentives or legal obligations not to take actions adverse to national security is afforded little weight in the CFIUS process. The new law will continue this trend by codifying recent practices that eliminate flexibility and allow for more input from constituencies, including Congress," he says. This can precipitate delay and uncertainty in the transaction as a whole.

However, Stephen Paul Mahinka, a partner at Morgan Lewis, does not believe that FINSA should be regarded with so much apprehension. "Ironically, given its genesis in the outcry over the Dubai ports and CNOOC oil proposed acquisitions, FINSA properly should be perceived as a positive development by overseas companies. The new law essentially codifies much of the recent practice of CFIUS, and adds little that can truly be considered onerous. It is important to focus on what was not done. Congress was not made an active participant in the review process. Considerations of the economic or labour impact of a foreign acquisition were not included as elements of reviews. No industries were excluded from potential foreign investment. On balance, if properly applied, FINSA should be a positive development for the future of US cross-border M&A," he says. As Robert Kimmitt, US Deputy Secretary remarked to the US GCC Investment forum in Bahrain recently, "the process is designed to resolve concerns efficiently, rather than prohibit transactions." Since the Dubai Ports World transaction, 15 other transactions from the Middle East have been evaluated by CFIUS. Three have been investigated, but none have been blocked – although it is unclear how many have been withdrawn or not filed in the first place.

This should help alleviate fears that the new Act will restrict foreign acquisitions into the

US, particularly from fast-growing regions such as Asia and the Middle East. These regions were particularly concerned since the CNOOC and Dubai World Ports deals that were the catalyst for FINSA involved a Chinese and UAE company, respectively. However, it is important to remember that CFIUS did not initially oppose either of the two catalysing deals – objections instead arose in Congress. Recent deals, albeit minority investments, show the door is still open to foreign companies from emerging markets. Advisers hope the pendulum will not swing too far towards protectionism. "There is no intrinsic reason that transactions by companies, or even governments, from any particular region should be more burdened or handicapped by FINSA than deals originating from other regions," says Mr Reynolds. "Recent major investments by Asian and Middle Eastern sovereign wealth funds in US financial services companies, computer chip manufacturers, private equity firms and so on suggest that FINSA need not impair any region's access to the US market. Sovereign wealth funds and other entities where the distinction between private and public sector roles in the acquirer is not always clear will almost certainly attract additional scrutiny, at least until the entities and underlying legal systems become more familiar to CFIUS," he says.

Political involvement

All major transactions have scope for political meddling, but relatively few sound transactions will suffer as a result of such interference. "There is always a chance that a transaction becomes overly politicised, and FINSA certainly increases the probability that a transaction will be exposed to public comment and scrutiny before the entire national security review process has been completed," observes Mr Reynolds. "Over its lifetime, however, CFIUS has established a deserved reputation for discretion in handling sensitive business information. For its part, FINSA balances new mandatory Congressional reporting requirements with efforts to limit Congressional involvement until the Executive Branch has largely completed its work. How that balance works out in practice remains to be seen," he says. Indeed, the Dubai Ports World

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transaction demonstrated that Congressional furore can cast aspersions on a reputable foreign buyer – even if a deal has already cleared CFIUS review.

Generally though, foreign government investment funds could be hit hardest by the new Act. "FINSA must be said to increase the uncertainty for investments by foreign-government controlled entities, which now face a greater potential for a second-stage, additional 45-day, CFIUS review. A most interesting issue will be how sovereign wealth funds are considered by CFIUS, and whether they also will be subject to an increased likelihood of additional review time," explains Mr Mahinka. It would only take a single member of Congress to oppose the deal for this additional review to kick in. He continues, "for most purchasers, however, the degree of concern should remain at the same level as prior to the new Act. As a practical matter, for all foreign ►

investors, the new Act will likely result in more decisions to make voluntary filings with CFIUS, rather than take the risk of not filing, particularly in view of CFIUS' new ability to decide to investigate on its own. Overseas bidders need, consequently, to do what we have always advised: develop a strategy beforehand, contact the target's government customers, discuss the proposed deal with CFIUS officials prior to filing and, in certain circumstances, let appropriate representatives in Congress know of the deal," he says. This course of action is encouraged by CFIUS, as pre-filings can disclose all of the information required in a notice to the member agencies without starting the 30-day review period. Furthermore, it gives CFIUS extra time to conduct the threat and vulnerability assessments required by FINSAs. However, this should not be used as an excuse by CFIUS to move slowly – FINSAs' success will lie in its efficiency.

However, following the FINSAs guidelines efficiently will only mitigate costs to a point – all legal reviews impose additional costs on transactions. "The new law will certainly increase the costs for most transactions where a filing is necessary," asserts Mr Bialos. "The review is more robust, and more cases are going to full investigation. In a case with potentially serious issues, or where mitigations

may be required, the parties should consider presenting draft documents to the US government for an informal 'early look' prior to any formal submission. This may involve not just one component of a department, but the acquisition community, the component with CFIUS responsibility, and in some cases other agency units. Buyers should also assess and marshal the necessary resources for obtaining CFIUS approval. This means putting together a plan and retaining appropriate counsel, lobbyists or public relations specialists," he says. Spending money at the beginning of the journey will help an acquirer reach its destination.

Scope for interpretation

As with most new statutes, FINSAs is currently open to interpretation. To some extent, CFIUS can interpret this in the manner of their choosing, says Mr Mahinka. "Notwithstanding FINSAs not having any provisions which properly should be considered too adverse to continuing foreign investment, the potential remains for CFIUS to take a more restrictive view than the new Act would demand. This could occur from changes in the views of member agencies of CFIUS, who could raise more objections than they have historically, or from increased caution by the agency if it receives continued Congressional scrutiny, with the result that deals are delayed and crater because of more

questions being raised," he says. However, it is unlikely that changes in the US Administration will interpret the rules in a radically different manner to the current Administration, or indeed change CFIUS' approach after the next election. Both the Democratic and Republican parties seem to agree that a decline in overseas investing would be detrimental to the US economy – particularly now that speculation over a recession is mounting. The reality of this remains to be seen, but it is unlikely that there will be a sharp upswing in blocked transactions under CFIUS.

As with any new, controversial statute, time is needed to explore and perfect its application in daily life. It is hoped that it will not precipitate a spate of negativity towards competent foreign companies, or that it will somehow deter these same companies from investing in critical assets. These are worst-case scenarios, and are unlikely when few fundamental changes have been made. The fact that Congress has not been made an active participant in the review process is undeniably positive, as the potential for political interference is now much lower than many were anticipating. In the short term, CFIUS should concentrate on ironing out imperfections, such as the exact definition of 'critical infrastructure', and continue to act as they have been, albeit within a structured framework. ■



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In the competition area, Mr. Mahinka's practice includes counseling and litigation regarding mergers and acquisitions, joint ventures, pricing and price discrimination, marketing and advertising, Department of Justice, Federal Trade Commission, and state investigations, consumer protection issues, and the application of the antitrust laws to regulated industries, particularly pharmaceuticals and energy. He has

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