KIRKLAND ALERT
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Treasury Department Publishes CFIUS Final Rule

On November 21, 2008, the Department of the Treasury ("Treasury") published long-awaited final regulations to implement the Foreign Investment and National Security Act of 2007 ("FINSA"), which codified certain aspects of the structure, role, process, and responsibilities of the Committee on Foreign Investment in the United States ("CFIUS"). See 73 Fed. Reg. 70702 (Nov. 21, 2008). Overall, the final regulations, which take effect December 22, 2008, do not significantly depart from the proposed regulations issued by Treasury earlier this year.[1] Indeed, in certain respects the final regulations are more notable for the steps Treasury declined to take to allay concerns regarding the predictability of the CFIUS process. Nevertheless, as detailed below, the final regulations incorporate some meaningful changes in response to comments received by Treasury from the trade and investment community and, by way of a number of new examples, offer a small measure of additional clarity regarding certain key jurisdictional criteria.

I. Substantive Issues

A. "Covered Transaction"

CFIUS is empowered to evaluate the national security implications of covered transactions. A "covered transaction" is any "transaction" by or with any "foreign person" which could result in "control" of a "U.S. business" by a "foreign person." Interestingly, Treasury explicitly acknowledged in the final regulations that the submission of a joint voluntary notice does not constitute an admission by the parties that the noticed transaction is a covered transaction. Indeed, historically it was not uncommon for the parties to advocate for a determination by CFIUS that the noticed transaction does not qualify as a covered transaction. However, as detailed below, the final regulations establish somewhat clearer boundaries between what are and what are not considered to be covered transactions. In addition, Treasury intends to publish guidance on the types of transactions that CFIUS has reviewed and that have presented national security considerations.

1. Greenfield Investment

The final regulations confirm that a so-called "greenfield" investment typically would not be construed as involving the acquisition of a U.S. business and, therefore, would not be treated by CFIUS as a covered transaction. Such investments might include, for example, the arrangement of financing for and the construction of a plant, the purchase of supplies or inputs or any necessary technology, the hiring of personnel, and the acquisition of shares in a newly incorporated subsidiary.

2. Passive Investment

The final regulations confirm that transactions resulting in a foreign person holding ten percent or less of the outstanding voting interest of a U.S. business would not be treated by CFIUS as a covered transaction so long as the transaction was undertaken solely for the purpose of passive investment. Ownership interests are held or acquired "solely for the purpose of passive investment" if the person holding or acquiring such interest does not plan or intend to exercise control, does not possess or develop any purpose other than passive investment, and does not take any action inconsistent with holding or acquiring such interests solely for the purpose of passive

investment. Thus, an acquisition of less than ten percent of the voting interest in a U.S. business would not be treated by CFIUS as a covered transaction if, for example, the investor has no affirmative rights other than the ability to vote its shares pro rata and no negative rights other than certain standard minority shareholder protections. The final regulations make clear, however, that simply negotiating the right to appoint a director is activity inconsistent with holding or acquiring a voting interest solely for the purpose of passive investment.

3. Incremental Acquisitions

The final regulations add a provision clarifying that a transaction resulting in the acquisition by a foreign person of an additional interest in a U.S. business that previously was the subject of a covered transaction for which CFIUS concluded all action would not be treated as a covered transaction. However, if the prior investment by that foreign person was not noticed to CFIUS, or was determined by CFIUS not to be a covered transaction, the subsequent investment could be a covered transaction.

4. Convertible Voting Instruments

The final regulations clarify that CFIUS will consider the circumstances of conversion to determine whether the rights the holder of a convertible voting instrument will obtain upon conversion should be included in the assessment of whether a proposed transaction constitutes a covered transaction by virtue of the holder's ability to control the U.S. business. For example, CFIUS will consider such rights when the results of conversion are "reasonably ascertainable" and the conversion will occur in the near future. By contrast, CFIUS generally will not consider such rights where conversion is "speculative or remote," unless the acquisition of such instruments resulted in the immediate conveyance of rights to the holder with respect to the governance of the entity that issued the instruments.

5. Lending Transactions

The final regulations further clarify that a lending transaction is not transaction for CFIUS purposes unless a foreign person acquires economic or governance rights in a U.S. business that are characteristic of an equity investment, and that the acquisition of such rights would not be treated by CFIUS as a covered transaction unless these rights are tantamount to control over a U.S. business. Subject to limited exceptions, the acquisition of control over a U.S. business by a foreign lender as a result of a borrower's default would be treated as a covered transaction.

6. Joint Ventures

In a significant departure from pre-FINSA practice, the final regulations take the position that the creation of a joint venture is a covered transaction if a U.S. business is contributed to the joint venture and a foreign person could gain control over that U.S. business through the creation of the joint venture. Specifically, for example, the creation of a 50/50 joint venture under these circumstances would be treated by CFIUS as a covered transaction. In Treasury's mind, when all ownership interests in a U.S. business are held by two equal partners, each partner has the ability to veto all important matters affecting the U.S. business, so each partner has the ability to control the U.S. business.

B. "Foreign Person" and "Foreign Entity"

The final regulations define a "foreign person" as a foreign national, foreign government, or foreign entity, or any entity over which control is exercised or exercisable by a foreign national, foreign government, or foreign entity. The final regulations revise the definition of "foreign entity" to cover branches, partnerships, groups, subgroups, associations, estates, trusts, corporations, or divisions of corporations, or organizations organized under the laws of a foreign state if wither its principal place of business is outside the United States or its equity securities primarily are traded on one or more foreign exchanges. However, an entity that otherwise would be treated as a foreign entity will not be treated as such if a majority of the equity interest in such entity ultimately is owned by U.S. nationals.

C. Control Versus Influence

Perhaps the most difficult issue attendant to determining whether a proposed transaction constitutes a covered transaction is whether, as a result

of such transaction, a foreign person could exercise control over a U.S. business. For that reason, numerous commenters implored Treasury to develop a process whereby control questions could be resolved by CFIUS even prior to the submission of a joint voluntary notice. Treasury declined to adopt such a proposal citing the additional burden to be borne by CFIUS.

Furthermore, Treasury did not revise the definition of control from that previously proposed and did not expand the illustrative list of "important matters affecting an entity" incorporated within that definition. The final regulations define "control" as "the power, direct or indirect, whether or not exercised, through the ownership of a majority or 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; in particular, but without limitation, to determine, direct, take, reach, or cause decisions regarding the following matters, or any other similarly important matters affecting an entity":

- the sale, lease, mortgage, pledge or other transfer of any of the tangible or intangible principal assets of the entity, whether or not in the ordinary course of business;
- the reorganization, merger, or dissolution of the entity;
- the closing, relocation, or substantial alteration of the production, operational, or research and development facilities of the entity;
- major expenditures or investments, issuances of equity or debt, or dividend payments by the entity, or approval of the operating budget of the entity;
- the selection of new business lines or ventures that the entity will pursue;
- the entry into, termination, or non-fulfillment by the entity of significant contracts;
- the policies or procedures of the entity governing the treatment of non-public technical, financial, or other proprietary information of the entity;
- the appointment or dismissal of officers or senior managers;
- the appointment or dismissal or employees with access to sensitive technology or classified U.S. Government information; or
- the amendment of the Articles of Incorporation, constituent agreement, or other organizational documents of the entity with respect to these matters.

There remains no bright-line test for assessing control, such as a specified percentage of share ownership or numbers of board seats. Furthermore, like the proposed regulations, the final regulations contemplate that control can be exercised both positively and negatively. Importantly, however, the final regulations continue to specifically identify a number of negative rights intended to protect the investment-backed expectations of minority shareholders that do not, by themselves, confer control over an entity:

- the power to prevent the sale or pledge of all or substantially all of the assets of an entity or a voluntary filing for bankruptcy or liquidation;
- the power to prevent an entity from entering into contracts with majority investors or their affiliates;
- the power to prevent an entity from guaranteeing the obligations of majority investors or their affiliates;
- the power to purchase an additional interest in an entity to prevent the dilution of an investor's pro rata interest in that entity in the event that the entity issues additional instruments conveying interests in the entity;
- the power to prevent the change of existing

legal rights or preferences of the particular class of stock held by minority investors, as provided in the relevant corporate documents governing such shares; and

- the power to prevent the amendment of the Articles of Incorporation, constituent agreement, or other organizational documents of an entity with respect to such matters.

Furthermore, the final regulations also set forth a number of other minority shareholder protections that CFIUS will "consider favorably" in the context of specific notified transactions.

Although the final regulations retain the definition of control set for in the proposed regulations, the final regulations now incorporate additional examples demonstrating that, although an investor might have influence within a U.S. business, such as through a board seat or by exercising pro rata voting rights attendant with share ownership, such investor does not have control unless it is able to determine, direct, take, reach, or cause decisions regarding the types of "important matters affecting an entity" enumerated above. Among these are a scenario whereby a foreign person acquires a thirteen percent interest in the shares of a U.S. business and the right to appoint one director. The foreign person receives minority shareholder protections, but does not receive any other positive or negative rights. Under these circumstances, the foreign person does not have the ability to exercise control over the U.S. business.

Treasury further clarified that in private equity structures CFIUS will direct its attention only toward the general partner to the extent such entity has the sole authority to determine, direct, and decide important matters affecting the partnership and any fund operated by the partnership. This issue is especially relevant when, for example, a fund's limited partnerships are organized outside the United States.

D. "Critical Infrastructure"

FINSA specifically directs CFIUS to analyze foreign acquisitions in light of "the potential national security-related effects on United States critical infrastructure, including major energy assets" and the "long-term projection of United States requirements for sources of energy and other critical resources and material." Indeed, unless the Treasury Secretary and the head of any lead agency certify that the transaction will not impair the national security of the United States, FINSA and the final regulations direct that CFIUS undertake a full 45-day investigation to determine the effects on national security of any covered transaction that would result in the control by a foreign person of critical infrastructure of or within the United States, if CFIUS determines that the transaction could impair the national security and such impairment has not been mitigated.

The final regulations define "critical infrastructure" to mean "in the context of a particular covered transaction, a system or asset, whether physical or virtual, so vital to the United States that the incapacity or destruction of the particular system or asset of the entity over which control is acquired pursuant to that covered transaction would have a debilitating impact on national security." Consistent with the approach enunciated in FINSA and to the chagrin of many in the trade and investment community, Treasury specifically declined to designate certain classes of systems or assets as critical infrastructure or to provide illustrative examples, preferring instead to make a case-by-case assessment of whether (i) a particular transaction constitutes a covered transaction; (ii) that particular transaction would result in foreign control of critical infrastructure of or within the United States; and (iii) that particular covered transaction has potential national security effects.

II. Procedural Issues

A. Pre-Filing Consultations

Consistent with the proposed regulations, the final regulations explicitly encourage, but do not require, the parties to a proposed transaction to engage CFIUS, including by submitting a draft joint voluntary notice, prior to the formal submission of a joint voluntary notice. Furthermore, Treasury specifically assured the public that any information or documentary material supplied to CFIUS prior to the formal submission of a joint voluntary notice would be exempt from disclosure, even if the parties ultimately elect not to file.

B. Contents of Joint Voluntary Notice

The final regulations somewhat ease the burden on the parties to a proposed transaction by narrowing the scope of the information required to be submitted to CFIUS. For example, Treasury had proposed that the parties identify each contract in effect during the three years prior to filing between the U.S. business that is the subject of the proposed transaction and any U.S. Government agency. The final regulations now require the identification of such contracts with any U.S. Government agency or component with national defense, homeland security, or other national security responsibilities, including law enforcement agencies insofar as their activities relate to defense, homeland security, or national security.

In addition, Treasury has established a process whereby the parties to a proposed transaction may request that the CFIUS Staff Chairperson modify an existing information requirement. Treasury has made clear, however, that the information requirement at issue must place an extraordinary burden on the parties and that the modification of such requirement must not impair the full and efficient consideration of the transaction.

C. Post-Filing Communications

Treasury had proposed allowing parties only two business days to provide follow-up information requested by the CFIUS Staff Chairperson, unless a written request for an additional grant of time has been granted by the CFIUS Staff Chairperson, or risk the rejection of a joint voluntary notice. To the dismay of many practitioners, the final regulations allow parties only three business days to provide any requested follow-up information. We note, however, that the final regulations require joint voluntary notices to include information that traditionally was requested after the submission of a joint voluntary notice. As a result, there may be fewer requests for follow-up information.

D. Penalties

The final regulations maintain that civil penalties not to exceed $250,000 per violation could be imposed for intentional or grossly negligent misstatements or omissions in a joint voluntary notice, or for making a false certification. In addition, the final regulations maintain that the intentional or grossly negligent violation of a material provision of a mitigation agreement could result in a civil penalty not to exceed $250,000 per violation or the value of the transaction, whichever is greater. Many practitioners expected that Treasury would set an upper limit on the imposition of civil penalties in the context of a breach of a mitigation agreement. In this regard, Treasury only commented that CFIUS retains the discretion to impose less than the maximum penalty. The final regulations also affords parties the opportunity to submit a petition for reconsideration of any decision to impose a penalty.

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1 For a more detailed discussion of the proposed regulations and the CFIUS process, please refer to our May 2008 Alert at http://www.kirkland.com/siteFiles/Publications/F95B3D2B83E28C32CEB3097E1334DD46.pdf.

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