



Portfolio Media, Inc. | 648 Broadway, Suite 200 | New York, NY 10012 | www.law360.com
Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | customerservice@portfoliomedia.com

Effects Of CFIUS Rules On Minority Investments

Law360, New York (April 23, 2009) -- Recently enacted regulations issued by the U.S. Department of Treasury on behalf of the Committee on Foreign Investment in the United States affect a wide variety of minority investments in transactions by foreign investors, including joint ventures and private investment in public equity (PIPE) transactions that have become more prevalent as traditional merger and acquisition transactions have dried up as a result of the crisis in the financial markets.

In addition to these new rules, which went into effect Dec. 22, 2008, the Treasury Department also released guidance on the various transactions that CFIUS has reviewed, and identified the factors used in determining whether such transactions presented national security concerns.

Taken together, the new rules and the guidance provide practitioners with a practical roadmap on how to address the requirements of the Exon-Florio amendment to the Defense Production Act of 1950, as amended by the Foreign Investment and National Security Act of 2007 (FISIA), most importantly in nontakeover minority investments where an unsuspecting investor may unintentionally enter into a transaction subject to review and potential suspension by CFIUS.

Under Exon-Florio, only transactions that could result in the control of a U.S. business by a foreign person are deemed "covered transactions" and subject to CFIUS review.

Covered Transactions and Control

Joint Ventures

The rules clarify that a foreign person may be deemed to control a joint venture which includes a U.S. business by virtue of the contractual rights of the foreign person in the joint venture, and that CFIUS will analyze the factors that determine control as they would in connection with a takeover or merger.

The new regulations further clarify that control means “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[.]”

Emphasizing that all relevant facts and circumstances are taken into account and that no single factor is determinative of control, the rules provide an expanded list of examples of “important matters” that affect an entity.

Negative controls or “veto rights” over these matters, many of which are typical rights granted an investor or partner in a joint venture agreement, are deemed to indicate a level of control. These matters include the right to control the following:

- 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 nonfulfillment by the entity of significant contracts;
- The policies or procedures of the entity governing the treatment of nonpublic technical, financial or other proprietary information of the entity;
- The appointment or dismissal of officers or senior managers;
- The appointment or dismissal of employees with access to sensitive technology or classified U.S. government information;
- The amendment of the articles of incorporation, constituent agreement or other organizational documents of the entity with respect to the foregoing items.

Furthermore, if two joint venture partners hold equal interests in a U.S. business, and each partner has veto rights with respect to important matters affecting the U.S. business, each partner may be deemed to control the U.S. business.

But not all minority investor protections or veto rights rise to the level of control under the new rules. Certain rights that do not affect the strategic direction of the U.S. business or its day-to-day management are not deemed to provide the recipient of these rights with control over the U.S. business. Under the new rules, these noncontrol protections include the following:

- 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;
- The power to prevent the amendment of the articles of incorporation, constituent agreement or other organizational documents of an entity with respect to the foregoing matters.

Additionally, the rules clarify that when determining control where more than one foreign person has an ownership interest in an entity, CFIUS will consider factors such as the relationship among the foreign persons and any formal or informal arrangements to act in concert, whether the foreign persons are agencies or instrumentalities of a single foreign government, and whether a given foreign person and another person that has an ownership interest in the entity are both controlled by a single foreign government.

PIPE Transactions

Private placement or private investment in public equity (PIPE) transactions, even if structured as investments in convertible non-voting securities or for less than 10 percent of the voting rights of the U.S. business, may be deemed to be covered transactions under the new rules.

An investment in nonvoting securities or other instruments that are convertible into voting securities may be a covered transaction regardless of the fact that at the time of investment the foreign person will not have such voting rights.

In its analysis of the transaction, CFIUS will consider the imminence of the conversion, whether the ability to convert depends on factors within the control of the acquiring party, and whether the amount of voting interest and the rights that would be acquired upon conversion can be reasonably determined at the time of acquisition.

Even if the securities are not immediately convertible, the fact that they may be converted at the option of the acquiring party may be taken into consideration by CFIUS in its assessment of the transaction.

With some of the recent high-profile investments by foreign entities in the United States made through convertible securities such as convertible preferred stock, convertible debt instruments and warrants to purchase common stock, both foreign investors and U.S. companies must consider the conversion mechanisms in light of the CFIUS rules.

Accordingly, if the negative control rights over “important matters” as set forth above are present in a convertible securities transaction, the investment may be deemed to give such investor control over the U.S. business as determined by CFIUS.

Similarly, even a transaction in which the foreign person acquires less than 10 percent of the voting interests of a U.S. business may still be a covered transaction.

A “safe harbor” exists only for transactions in which the foreign person acquires 10 percent or less of the outstanding voting interest in a U.S. business and the transaction is solely for the purpose of passive investment.

The rules expand the meaning of “solely for the purpose of passive investment” by providing that “[o]wnership interests are held or acquired solely for the purpose of passive investment if the person holding or acquiring such interests 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.”

Acquisitions that are of less than 10 percent of the voting interest of a U.S. business but are not solely for the purpose of passive investment, such as where the investor obtains control over important matters affecting the U.S. business, are subject to CFIUS review.

Finally, the rules clarify that although representation on the board of directors of a U.S. business is a factor that may indicate control, absent the foreign investor obtaining other veto rights over important matters affecting the U.S. business, such board representation alone will not cause the foreign investor to control the U.S. business, even if such investor acquires more than 10 percent of the voting interests of the U.S. business.

Conclusion

Foreign persons or entities seeking to make investments or acquisitions in the United States, and companies in the United States seeking foreign capital or foreign buyers must consider the implications of the structure and the nature of the party opposite them early on in the proposed transaction in order to make a determination as to whether a voluntary notice filing should be made.

The new rules encourage parties to engage in prefiling consultations in advance of filing the formal notice.

Under the rules, CFIUS review of covered transactions must be completed within 30 days, except that CFIUS must conduct an additional investigation, which must be completed within 45 days, where the transaction threatens to impair U.S. national security, where the transaction involves a foreign-government controlled entity or foreign control over critical infrastructure, or where CFIUS recommends further investigations.

Given the expanded information about the parties and the transaction the new rules require to be included in the notice, parties should budget additional time for the preparation of the filing and potential subsequent requests for additional information with respect to the notice.

--By Thomas Sauermilch and Meir A. Lewittes, McDermott Will & Emery LLP

Thomas Sauermilch is a partner with McDermott Will & Emery in the firm's New York office and co-chair of the firm's mergers and acquisitions practice group. Meir Lewittes is a partner with the firm in the New York office.

The opinions expressed are those of the authors and do not necessarily reflect the views of Portfolio Media, publisher of Law360.