

The Foreign Investment and National Security Act of 2007

By Edward M. Lebow

On July 26, 2007 President Bush signed the Foreign Investment and National Security Act of 2007 (FINSA), which reforms and codifies the activities of the Committee on Foreign Investment in the United States (CFIUS). FINSA became effective in October, with regulations due to be published by April, 2008. Although much of FINSA comprises a codification of changes to CFIUS practice since September 11, 2001, there are a number of as yet vague provisions requiring scrutiny by the bar.

CFIUS is an interagency body created by presidential order and chaired by the Secretary of the Treasury. Since 1988 CFIUS has operated under powers granted to the president by the “Exon-Florio” amendments to the Defense Production Act, which authorize the president to suspend or prohibit any foreign merger or acquisition of a U.S. company that the president determines threatens or impairs U.S. national security.

Parties may receive a “safe harbor” by voluntarily filing a notification to CFIUS. This notification begins a 90-day process during which the U.S. government has an opportunity to review the proposed transaction and address any potential national security concerns. Companies submit to this process to ensure that, once vetted, any approved transaction cannot later be prohibited or altered, unless a material misstatement or omission in the notification is discovered.

The FINSA reforms include statutory authorization of CFIUS, broadening the scope of investments reviewable by CFIUS, tightening the rules application to transactions involving acquisitions by foreign government-controlled entities, and increasing the post-review powers of the government to monitor and control the activities of foreign investors. However, FINSA presents a number of key issues for practitioners that will affect not only the law but also the attractiveness of the United States as a recipient of foreign investment. Chief among these concerns will be the scope of “critical infrastructure” in the national security context and the intrusiveness of government-ordered mitigation agreements required of parties to obtain CFIUS approval. The regulations published next April will shed some light on these issues, but it will take several years to evaluate the true import of the FINSA reforms.

During the summer of 2005, CFIUS gained national prominence during the controversy surrounding the attempt by the Chinese National Offshore Oil Corporation (CNOOC) to outbid Chevron for the shares of Unocal. Around that time there had been several Chinese acquisitions of natural resources companies elsewhere in the world. The high price offered by CNOOC, and the sense that the investment was motivated as much by strategic as by commercial concerns, contributed to an uproar that led to Unocal’s acceptance of a different offer and CNOOC’s decision to withdraw its bid rather than undergo a full CFIUS review.

The heightened public awareness of the CFIUS process that came out of the CNOOC controversy was soon overtaken by a firestorm of criticism when, in the winter of 2006, it

became apparent that CFIUS had approved the acquisition by Dubai Ports World of a British company that held leases to manage a number of U.S. ports. Members of Congress seized on the incident to lambaste allegedly weak and ineffectual bureaucratic oversight of vital national security interests.

The supporters of a balanced approach to investment review also knew that the case for foreign direct investment (FDI) is iron-clad. Affiliates of foreign companies employ in excess of five million Americans, about one-third of whom work in manufacturing. That is more than triple the rate of other U.S. workers. They pay in excess of \$325 billion in wages each year. That is about \$65,000 per worker, which is a third higher than the national average. In 2005, U.S. subsidiaries of foreign corporations reinvested nearly \$60 billion in their U.S. operations and paid many billions in taxes. Their research and development spending alone totaled \$30 billion. They also account for about one-fifth of U.S. exports. FDI inflows now comprise nearly \$100 billion annually, with a total foreign FDI stock of almost \$2 trillion.

And as is also often pointed out, the FDI street runs profitably in two directions. The United States is the world's largest foreign investor, with a combined portfolio of over \$2.5 trillion. Only by carefully balancing national security with free and open investment can the U.S. take a strong stand against other nations' justifying their own more stringent limitations on FDI by pointing to tightened U.S. controls. For example, in August 2006, China promulgated rules to review the impact of foreign investment on economic security. Russia has even tougher restrictions, protecting 39 industries from foreign control. Mexico and India are also considering their own barriers to FDI. These restrictions not only hurt U.S. investors, but also will slow worldwide economic growth. In short, while some limited restrictions on foreign control of truly vital U.S. national assets is prudent, overly tight regulations would slow economic growth in the United States and thus have, at least indirectly, a negative impact on U.S. security. And controls that are too stringent would provide a pretext for illiberal forces elsewhere, which would more directly harm U.S. national security interests. It is in this context that FINSA can be seen in a favorable light.

FINSA makes certain significant changes to the CFIUS review process, including:

- Heightening the scrutiny of any transaction where a foreign government or an entity controlled by a foreign government is a party, or whenever a transaction would result in the foreign control of "critical infrastructure."
- Defining "critical infrastructure" broadly to include "systems or assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems or assets would have a debilitating impact on national security." This definition expands the types of transactions subject to CFIUS review to include energy generation and transportation.
- Including an "evergreen" provision. Under the new law, if the investigation of a transaction results in a mitigation agreement, and at some later date, a party to the mitigation agreement intentionally commits a material breach of the agreement, either CFIUS or the President may reopen the review if "there are no other remedies or enforcement tools available to address such breach." A reopened

review can result in additional mitigation agreements or even the unwinding of the transaction. Previously, CFIUS could reopen a review only when it discovered a material omission or misstatement by one or more of the parties to the transaction made during the initial review period.

- Codifying the role of CFIUS in the review process.
- Designating a lead agency, depending on subject matter expertise, to review each transaction. The lead agency is granted the authority to negotiate, monitor, modify, and enforce mitigation agreements.
- Appointing the director of national intelligence as an *ex officio* member of CFIUS. The director must perform a national security threat analysis for all proposed transactions.
- Requiring a full 45 day review for transactions by companies owned or controlled by foreign governments unless the treasury secretary or deputy and the head of the lead agency determine that the transaction will not impair national security.
- Increasing the role of congressional oversight by requiring CFIUS to provide an annual report to Congress as well as a certified notice to Congress specifying its determinations, decision-making rationales, and actions taken.

Foreign businesses seeking to acquire U.S. assets, and U.S. companies courting foreign investment, will find that the above-listed and other provisions significantly tighten the formal CFIUS legal process. In fact, however, much of this tightening had already been adopted in practice by CFIUS and by the business community itself during the past two years.

For example, on paper the act greatly increases the number of transactions that will be subject to review, from toll roads to energy generation to ports. However, there had been a sharp upswing in notifications to CFIUS of just such projects after CNOOC and Dubai Ports World. Similarly, while the new law also expands CFIUS' *ex post facto* review powers through an enlarged "evergreen" provision, the increase in mitigation agreements with post-review obligations has already subjected parties to ongoing oversight and threat of sanctions for failure to comply. Since CNOOC and Dubai Ports World, CFIUS filings are up by about 75 percent, investigations have more than tripled and the number of companies withdrawing filings to gain more time in the review process has more than doubled. There were more second stage investigations during 2006 than during the previous five years combined and more than during the entire decade of the 90s. The number of mitigation agreements also tripled during 2006. These mitigation agreements typically require periodic reports to the U.S. government of any events or activities that might constitute a threat to U.S. security interests.

It is thus not surprising that the U.S. business interests are pleased and that Financial Services Forum, the Business Roundtable, the Organization for International Investment and the U.S. Chamber of Commerce issued a joint statement endorsing the Act, stating "We applaud the... passage of the Foreign Investment and National Security Act of 2007. This action... will protect

our national security while keeping America open for business and restore predictability and certainty to the CFIUS process.”

Notwithstanding the sound basis for CFIUS reform as enacted and the satisfaction expressed by the business community, actual implementation of FINSAs, both by regulation and by practice, will bear watching. In recent years the Department of Homeland Security (DHS) has become an increasingly active member of CFIUS. As that agency has ramped up its activities, some have observed a tendency to use the CFIUS process to demonstrate its displeasure with companies arising from prior events or transactions and to impose inordinately strict mitigation provisions in subsequently reviewed acquisitions. There have also been reports of instances of the government using a specific transaction to apply to a single company standards that it would like, but is not legally permitted, to impose on an entire industry. For example, it has been suggested that a component of DHS that feels strongly about cyber security has used a CFIUS filing to acquire control over the activities of the parties, even though the actual link to national security is at best tenuous and such controls would not otherwise be permissible.

Another area of concern is whether CFIUS will interpret “critical infrastructure” to comprise wide swatches of the economy. And how will CFIUS decide which energy assets are “major” and which technologies are “critical”? Perhaps most interestingly, will acquisitions by Chinese entities attract a special level of scrutiny?

Certainly the number of CFIUS filings will continue at or above the current increased level, and counsel involved with foreign investment may come to see CFIUS notification as rather routine, perhaps on a par with Hart-Scott-Rodino antitrust clearance. How the government interprets its new mandate, and how hard the bar pushes back, will do much to shape the ultimate costs and benefits of FINSAs for U.S. national security and U.S. legal norms.

This tension between necessary secrecy and abused discretion is, of course, neither new nor unique. In the 1991 Preamble to the regulations at 31 CFR Part 800 implementing the Exon-Florio amendments, the treasury department summarized its resistance to comments calling for greater specificity and detail by stating, “Ultimately under section 721 and the Constitution the judgment as to whether a transaction threatens national security rests within the president’s discretion.” Today, even more than in the early 1990s, this flexibility that must be respected, but also closely monitored.

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