

BY MIKE KAPLAN, BRIAN BUCKHAM AND KARA BOMBACH

Deals Can Be Derailed by Security Concerns

Given the weak U.S. dollar and historically low valuations of defense contractors, commentators expect even greater mergers-and-acquisitions activity from foreign buyers in the U.S. defense industry. Defense companies considering a transaction that could result in a foreign person acquiring control of the business should prepare for close regulatory scrutiny.

The U.S. president has authority to review and ultimately prevent any transaction that could result in control of a U.S. business by a foreign person if it threatens national security under the so-called Exon-Florio Amendment. The Committee on Foreign Investment in the United States (CFIUS), an inter-agency committee chaired by the secretary of Treasury, is charged with administering Exon-Florio.

As enticing as an acquisition proposal with a lofty valuation may be, CFIUS implications mandate that U.S. defense contractors thoroughly analyze the structure, source, motives of foreign investment and nature of the business to determine whether CFIUS review is needed. The analysis will turn on three key questions: Will the transaction transfer control of a U.S. business to a foreign person? Does the transaction involve a foreign national or any entity controlled by a foreign national, foreign government or foreign entity? Does the transaction raise national security concerns?

On the question of control, the seller should conduct due diligence on the buyer early, including evaluating the structure and ownership of the buyer and the extent of all foreign government interests in the buyer. The regulatory definition of a "foreign person" turns not on where the company does business but on whether it is controlled by a foreign



interest. CFIUS review may apply to the acquisition of a U.S. company by the U.S. subsidiary of a foreign company. Thus, determining that a potential purchaser is domiciled in the U.S. does not complete the CFIUS analysis. The seller must investigate the buyer and its affiliates.

As for transactions, those that implicate CFIUS scrutiny include ones that result, or could result, in foreign control of a U.S. business. Transactions less obvious than mergers and acquisitions, such as joint ventures with a foreign-controlled entity and minority equity investments by foreign entities, potentially implicate CFIUS as well. Transactions resulting in the conversion of non-voting securities into voting securities, or the acquisition of voting proxies, may also be ripe for CFIUS review. Given the broad forms of transactions that may implicate CFIUS review, sellers should carefully consider whether the transaction, as structured, transfers or could transfer control to a foreign investor.

"Control" is defined functionally as the power, direct or indirect, to make decisions in such areas such as the sale of principal assets; dissolution; the closing or relocation of facilities; the termination of contracts; or the amendment of articles of incorporation or bylaws. Control may even be exercised through ownership of a dominant minority of the shares, through contractual arrangements, and by virtue of board seats and veto rights.

The determination of control turns on the allocation of decision-making power,

not simply the percentage of equity ownership. There are no strict quantitative guidelines for determining whether a foreign interest exercises control. But an acquisition of 10 percent or less of the voting securities of a U.S. company is exempt if the securities are held solely for the purpose of passive investment.

The term "national security" is left undefined for CFIUS. Whether national security concerns are implicated is determined on a case-by-case basis. Since Sept. 11, 2001, national security has been interpreted broadly to include businesses involved not only in defense, security and law enforcement, but also those that involve critical infrastructure such as energy, transportation, telecommunications, information technology and a range of goods and services that create vulnerability to sabotage or espionage. CFIUS scrutiny may also apply to businesses that directly affect the U.S. financial system, that involve advanced technologies with potential military applications and that involve products subject to U.S. export controls.

CFIUS notification is not required in advance of a proposed transaction. However, a voluntary filing should be considered in transactions that may be subject to CFIUS review to obtain the benefits of safe-harbor from ex-post review; framing dialogue with CFIUS, rather than being on the defensive; and holding pre-filing discussions and consultations with CFIUS. The president may unwind a completed transaction, but once cleared by CFIUS or the president, it will not be subject to reinvestigation, giving the parties and other stakeholders comfort that the transaction is not vulnerable to challenge.

Michael L. Kaplan (kaplanm@gtlaw.com) is a shareholder in the corporate and defense and homeland security practice groups of the international law firm of Greenberg Traurig LLP in the Phoenix office. Brian R. Buckham (buckhamb@gtlaw.com) is an associate in the corporate practice group in Phoenix and Kara M. Bombach (bombachk@gtlaw.com) is a senior associate in the government contracts and export controls practice group in the firm's Washington, D.C. office. The views expressed are solely those of the authors.