

## Exon-Florio Changes Broaden and Intensify Scrutiny of Foreign Direct Investment in the United States

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### INTRODUCTION AND SUMMARY

On October 24, 2007, a comprehensive re-write of the “Exon-Florio Amendment” becomes effective. Exon-Florio authorizes the President to disrupt foreign acquisitions of and mergers with U.S. businesses for national security reasons. Coupled with administrative changes already implemented by the Bush Administration, these modifications substantially alter how the U.S. government treats foreign direct investment in the United States.

Sparked largely by concerns regarding efforts by a Dubai company to acquire U.S. port operations and a Chinese company to acquire Unocal, the “Foreign Investment and National Security Act of 2007” imposes a variety of new requirements on the Committee on Foreign Investment in the United States (the “CFIUS”), which is charged with screening foreign investment for national security threats.<sup>1</sup> These modifications include:

- Direction to the CFIUS to include in national security screening an assessment of the transaction’s impact on critical infrastructure, energy assets and critical technologies.
- A general requirement that transactions involving state-owned or controlled foreign entities or critical infrastructure be subjected to special examination.
- Establishment of a statutory basis for “mitigation agreements” between the government and transaction parties, for penalties for violating a mitigation agreement, and for retroactively disturbing transactions if there is a purposeful, material breach of a mitigation agreement.
- Mandatory analysis of screened transactions by the Director of National Intelligence (“DNI”).
- A system of congressional notification to expand the Congress’s oversight of Exon-Florio screening.
- Special restrictions when transaction parties withdraw notifications to and thereby suspend screening by the CFIUS.

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Apart from the new legislation, the CFIUS has changed its Exon-Florio screening practices in ways that have yielded a more formal and complex review process. The CFIUS has:

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<sup>1</sup> Foreign Investment and National Security Act of 2007, Pub. L. No. 110-49, 121 Stat. 246.

- Established that an increasingly broad range of transaction types -- such as those involving energy or transportation infrastructure -- merit Exon-Florio screening.
- Become much more proactive in ensuring that what it considers to be relevant transactions are examined, notwithstanding that notification by transaction parties remains voluntary.
- Begun relying to a far greater extent on government-private party mitigation agreements to address perceived national security concerns in ways that could call into question the finality of Exon-Florio clearance.
- Begun incorporating into its examination an expanding array of corporate compliance issues.
- Increased *ad hoc* participation by other Executive branch agencies in Exon-Florio screenings.

Although these legislative and administrative modifications may increase the predictability and transparency of the Exon-Florio screening process, they are also introducing new challenges for transaction parties. First, transactions formerly not considered to have national security implications -- such as those involving an oil refinery or toll road -- now attract Exon-Florio examination (sometimes at the CFIUS's insistence). Second, administrative and legislative changes regarding U.S. government-private party mitigation agreements are generating complications, including less certainty about the finality of Exon-Florio clearances. Third, the government's practice of making a greater effort to identify and investigate compliance issues in the context of Exon-Florio screening brings greater risk of screening delays and liability for transaction parties and increases the need for due diligence. Fourth, congressional officials and other persons, such as competitors to transaction parties, now have more opportunity to affect screening outcomes. Finally, the Congress's broadened role in the Exon-Florio review process may result in greater political intervention at the expense of resolving national security issues.

The full measure of the statutory changes will emerge as administrative practice, congressional oversight and precedent emerge. In any event, as transaction screening becomes more extensive, there is an increasing premium on informed, sophisticated Exon-Florio guidance.

## **BACKGROUND**

Originally enacted in 1988, the Exon-Florio Amendment authorizes the President to block a transaction that gives a foreign entity control over U.S. business operations -- or order divestment of completed transactions -- if there is credible evidence that a foreign entity "might take action that threatens to impair the national security of the United States" and existing provisions of law do not provide "adequate and appropriate" authority to protect the national security. The

statute was intended to provide residual authority for what were expected to be highly unusual instances in which there is no other legal basis (apart from special emergency authority) to protect the national security.

The President has delegated responsibility under Exon-Florio to the CFIUS, a 13-member inter-agency committee chaired by the Secretary of the Treasury.<sup>2</sup> The CFIUS is responsible for reviewing proposed foreign investment transactions and making recommendations to the President. While not required by U.S. law, many parties seek CFIUS screening to obtain assurance that a proposed foreign investment transaction will not be subject to action under Exon-Florio.

### **CURRENT EXON-FLORIO TRANSACTION-SCREENING PROCESS**

Presently, Exon-Florio screening of proposed foreign investment transactions can entail as many as four steps.

First, parties to a transaction may file a voluntary notification with the CFIUS to begin the screening process.<sup>3</sup> In some cases, CFIUS officials may informally suggest to the parties that they file a notification. Although the CFIUS may only make recommendations to the President, parties who successfully complete CFIUS screening can generally obtain assurance that their proposed transaction will not be considered to threaten to impair U.S. national security.

Second, following receipt of the parties' notification or a CFIUS self-initiation determination, the CFIUS conducts a "review" for up to 30 days to evaluate whether the transaction raises national security concerns.

Third, if at least one member of the CFIUS determines that there are national security issues that warrant further examination, the CFIUS prosecutes an additional 45-day "investigation" of the transaction. Exon-Florio investigations have traditionally been relatively rare; most transactions have been cleared after the initial review.

Finally, if the CFIUS does not clear a transaction at the end of an investigation, the decision on whether to take action against the transaction is in

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<sup>2</sup> Prior to the 2007 Exon-Florio re-write, the CFIUS agencies included the: (1) Department of the Treasury; (2) Department of Commerce; (3) Department of Defense; (4) Department of State; (5) Department of Justice; (6) Department of Homeland Security; (7) Office of Management and Budget; (8) Council of Economic Advisors; (9) Office of the U.S. Trade Representative; (10) National Security Council; (11) National Economic Council; and (12) Office of Science and Technology Policy. The new statute added the Department of Energy and, on a non-voting basis, the Department of Labor and the federal intelligence community.

<sup>3</sup> Alternatively, the CFIUS may issue a notice of review and thereby self-initiate screening if it has reason to believe that a transaction may raise national security concerns.

the hands of the President, who must act within 15 days. Transactions have rarely been presented formally to the President, and the President has formally disapproved of only one transaction.

Exon-Florio screening is designed to take no more than 90 days. In practice, it can take longer. Parties often pursue informal consultation with government officials in advance of initiating a formal screening by submitting a notification. In addition, parties sometimes feel compelled to withdraw and re-file notifications -- thus "restarting the clock" -- because they believe that CFIUS agencies will not issue a clearance unless given more time to examine the transaction.

Although the President has formally blocked only one transaction under Exon-Florio, the government sometimes induces parties to alter transactions in substantial ways to address perceived national security concerns. Furthermore, parties have sometimes voluntarily terminated or withdrawn from transactions based on an expectation that Exon-Florio clearance would not be forthcoming (as was the case with CNOOC's 2005 effort to acquire Unocal).

#### **LEGISLATIVE CHANGES**

The Foreign Investment and National Security Act of 2007 (the "FINSA") modifies the Exon-Florio screening structure and processes in several significant ways.

For the first time, the FINSA provides a statutory basis for the CFIUS and codifies its membership (prior to the FINSA, the committee was a creature of executive order). The FINSA also expands the committee to include the Secretary of Energy as a voting member and the Secretary of Labor and the DNI as non-voting members. The statute reinforces that other executive agencies may participate in Exon-Florio examinations by invitation and may be made permanent CFIUS agencies at the President's discretion. The Secretary of the Treasury continues as chair of the committee. But depending on the particular transaction, a CFIUS agency other than the Treasury Department may be appointed the lead agency for purposes of, among other things, negotiation and enforcement of mitigation agreements.

Congressional oversight of Exon-Florio screening is expanded, clarified, and codified through a "system of Congressional notification."<sup>4</sup> The FINSA requires the CFIUS to submit a certified report to the Congress regarding every examined transaction. The report must contain a description of the actions taken by the CFIUS with respect to the transaction, as well as identification of the

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<sup>4</sup> S. Report 110-80, 110th Congr., 1st Session (June 13, 2007).

determinative factors considered by the committee. The CFIUS is required to certify that there are no unresolved national security concerns with the examined transaction. In addition, the CFIUS is required to submit an annual report to the Congress detailing all of the proposed transactions examined by the CFIUS that year.

If the foreign acquiring entity is owned or controlled by a foreign government or if the transaction implicates critical infrastructure, the FINSA compels the CFIUS to pursue a 45-day “investigation.”<sup>5</sup> The “investigation” can be avoided only if the Secretary of the Treasury and the lead agency jointly determine that the transaction will not impair national security. For all transactions involving foreign state-owned companies, the CFIUS is required to undertake an assessment of the acquiring country’s compliance with U.S. and multilateral counter-terrorism, non-proliferation, and export control regimes.

The FINSA extends the list of statutory factors to be considered by the CFIUS. It is now required to consider the impact of the transaction on critical infrastructure, energy assets and critical technologies. For each screened transaction, the FINSA must instruct the DNI to analyze any threats to national security that the transaction could pose.

The FINSA provides the first express statutory basis for government-private party mitigation agreements and for addressing noncompliance with such agreements. For any given transaction, the lead CFIUS agency has primary responsibility for negotiating and enforcing mitigation agreements. An FINSA provision with potentially far-reaching implications authorizes the government to impose civil penalties for violations of mitigation agreements. The government is also authorized to reopen Exon-Florio screening after clearance of a transaction and even order divestiture if a transaction party is found purposefully to have violated a mitigation agreement.<sup>6</sup>

Parties wishing to withdraw and resubmit transaction notifications are now subject to a system for tracking the transaction. They may be required to enter into interim agreements, which can restrict the ability of the parties to conclude the transaction.

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<sup>5</sup> Legislation enacted in 1992 arguably already mandated a 45-day “investigation” when there is a state-owned or controlled acquirer, but the CFIUS interpreted the statute to require investigations in only some such cases.

<sup>6</sup> The CFIUS has in recent months already begun to negotiate mitigation agreement terms that purport to provide for reopening of screening in response to noncompliance with the agreement.

## ADMINISTRATIVE CHANGES

The CFIUS has made several changes to its transaction screening process in recent years in anticipation of legislative modifications. These administrative changes make the process more formal and complex.

CFIUS agencies have greatly increased staff devoted to Exon-Florio examinations. The committee also introduced more *ad hoc* participation by non-CFIUS executive agencies, some of which have only a tangential connection to national security (e.g., the Department of Health and Human Services). Following addition of the Department of Homeland Security as a CFIUS member, participation by intelligence agencies in screenings has also increased.

The CFIUS has expanded its interaction with the Congress in connection with transaction screening. Following the failed CNOOC/Unocal and Dubai Ports World transactions, officials of CFIUS agencies participated in congressional hearings regarding the adequacy of the committee's screening practices. Consistent with the urgings of many in the Congress, the CFIUS has recently intensified its focus on infrastructure and adopted a broader view of the instances in which foreign control of infrastructure assets could threaten the national security.

Today, the CFIUS is much more proactive in examining transactions, notwithstanding that notification by transaction parties remains voluntary. More and more, the committee is communicating to transaction parties that the committee will self-initiate an Exon-Florio examination if the parties do not initiate screening through a notification.

The CFIUS increasingly entertains agency concerns about corporate compliance issues in the context of Exon-Florio screening. Compliance issues with little connection to national security or no apparent foundation for consideration in this context have begun to play important roles in the examination process. At a minimum, this can elongate screening as the CFIUS will deny clearance until a compliance issue is resolved.

Finally, the CFIUS has begun to rely more and more on mitigation agreements between transaction parties and the U.S. government to address national security concerns. Since 2006, mitigation agreements have been established in approximately 35 percent of the transaction examinations by the CFIUS, a significant increase from 2005. Although each mitigation agreement is specific to the particular transaction, they often establish:

- Reporting requirements for the acquiring foreign entity;

- An obligation to implement specialized corporate compliance programs; and
- Monetary penalties for non-compliance.

Recently, the CFIUS has also insisted on mitigation agreement terms which contemplate that screening can be restarted -- and divestiture is possible -- if a party violates the agreement, notwithstanding that Exon-Florio clearance has been issued.

## **ANALYSIS**

Legislative and administrative changes may, in some respects, make Exon-Florio screening more predictable and transparent. But the changes also present challenges.

First, many transactions previously not considered to have national security implications now attract Exon-Florio screening. There is now a particular focus on perceived connections between foreign control of infrastructure and energy assets and national security. Six years ago, few would have thought an acquisition of an oil pipeline or a toll road by an entity in a neutral foreign country would be worthy of an Exon-Florio notification. Today, it is highly inadvisable to forego a notification for such a transaction.

Second, administrative and legislative changes regarding U.S. government-private party mitigation agreements give rise to new concerns and complications, including less certainty about the finality of Exon-Florio clearances. Parties now must evaluate the extent to which they can accept an agreement clause that would leave a consummated transaction exposed to a divestment order depending on U.S. government views about the parties' compliance with the agreement.

Third, the government's extension of Exon-Florio screening to ever more unknown or dormant compliance issues brings greater risk of liability and screening delays for transaction parties. For example, an Exon-Florio examination can now instigate government consideration of allegations of export, immigration or, potentially, environmental noncompliance, on the basis that these problems go to the integrity of the acquirer and whether it can be trusted to adhere to a mitigation agreement. This threatens to take the review beyond the bounds of the transaction at issue, a risk that is already of concern because of the sheer number of government officials involved. Even if there is no foundation to the allegations, they can postpone an Exon-Florio clearance for weeks or even months.

Fourth, the Congress, and through it other persons such as competitors of the transaction parties, now have a greater opportunity to have an impact on

screening outcomes. Exon-Florio screening can take on pronounced political dimensions, with U.S. competitors using the process as leverage to stop or alter transactions. New approaches to the examinations provide a stronger platform for such intervention by non-transaction parties. Because of increased congressional involvement, transaction parties now have an enhanced stake in building advance support for and understanding of a transaction before formal notification is filed with the CFIUS.

Finally, as transaction screening becomes more intensive, complex and specialized, it is increasingly important for transaction parties to be well prepared. Advisors need to be adept at addressing the breadth of challenges that are presented, such as inquiries by congressional offices, independent screening by law enforcement agencies and trade regulators, evaluations of classified-information issues by intelligence agencies, and public relations issues.

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