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## Focus

### ¶ 342

### FEATURE COMMENT: The Impact Of Foreign Buyers On Mergers And Acquisitions Involving Government Contractors: Preserving The Facility Security Clearance (Part I)

Not every potential buyer of a business involved in Government contracting is a U.S. corporation controlled by U.S. interests. It is important, both for the buyer and the seller, to understand the implications of foreign ownership, control or influence (FOCI) on the feasibility of a sale to foreign interests, and the processes that apply to such sales. As the title of this FEATURE COMMENT makes clear, foreign buyers do, in fact, make a difference.

Two basic sets of rules must be considered in the FOCI context. *First*, to the extent the target has classified contracts and operates under a facility security clearance (FCL), the parties must understand the limitations imposed by the Department of Defense National Industrial Security Program Operating Manual (NISPOM), DOD 5220.22-M. *Second*, irrespective of whether the target performs classified work, the parties must consider the role of the Committee on Foreign Investment in the United States (CFIUS). The CFIUS process is voluntary, and it affords the parties an opportunity to have the transaction reviewed in advance for national security purposes and to avoid the possible need to unravel the transaction post hoc in the event CFIUS or the president finds the deal objectionable.

The NISPOM FOCI review and the CFIUS process run in parallel, with different time constraints and different considerations; but they focus on one common factor—the impact on national security of foreign ownership of a U.S. business.

This FEATURE COMMENT focuses on the FOCI process. In part II, we will discuss CFIUS.

Let's start with some basics on the FOCI front—

- An FCL is a determination that a company is eligible for access to classified information or award of a classified contract.
- To be eligible for an FCL, a company "must not be under FOCI to such a degree that the granting of the FCL would be inconsistent with the national interest." NISPOM ¶ 2-102(d).
- Generally, a parent corporation must have an FCL at the same level or higher than a cleared subsidiary. NISPOM ¶ 2-109. Obviously, this is a potential problem for a company that, upon consummation of a merger or acquisition, would become a U.S. subsidiary of a foreign parent.

The NISPOM has one overriding objective in assessing the eligibility of a U.S. company under FOCI for an FCL, i.e., ensuring that the foreign owners cannot undermine domestic security and export controls to obtain unauthorized access to critical technology, classified information generally, or special classes of classified information in particular. In a transactional context, the Government seeks to achieve this objective via a two-step process that involves (1) a determination with respect to the degree of FOCI that would result from the transaction, and (2) the mitigation of the FOCI to an acceptable level, if possible.

"FOCI" is defined as the power of a foreign interest:

- whether direct or indirect,
- whether or not exercised,
- whether exercisable through ownership, contractual arrangement, or other means,
- to direct or decide matters affecting the management or operations of the company in a manner that may:
- result in unauthorized access to classified information, or

- adversely affect the performance of classified contracts. NISPOM ¶ 2-300(a).

The Government focuses on several "big picture" issues in evaluating the degree of FOCI under which a company may be operating. These include ownership of five percent or more of any class of the company's securities; ownership of 10 percent or more of the voting interests; a record of economic and government espionage against U.S. targets; its history relating to unauthorized technology transfers; and the types and sensitivity of the information that might be accessed by the foreign interest. NISPOM ¶ 2-301.

The most detailed delineation of the organizational and financial factors that the Government will consider in its evaluation of FOCI can be found in the "Certificate Pertaining to Foreign Interests," or Standard Form 328. This form is required when applying for an FCL "or when significant changes occur to information previously submitted." NISPOM ¶ 2-302. Such "significant changes" include:

- ownership of the company, directly or indirectly, by 10 percent or more of any foreign interest;
- service of non-U.S. citizens on the company's board of directors, or as officers, partners or senior management personnel;
- the ability of foreign interests, directly or indirectly, to control the election, appointment or tenure of the members of the board of directors;
- the ability of foreign interests, directly or indirectly, to control the decisions or activities of the company;
- contracts and agreements with foreign interests;
- indebtedness to foreign persons;
- five percent or more of the company's annual revenues or net income derived from any one foreign interest;
- 30 percent or more of the company's annual revenues or net income, in the aggregate, derived from foreign interests;
- 10 percent or more of the company's voting interest in "nominee shares" or "street names"; and
- directors, officers, executive personnel and senior management personnel who hold positions with or serve as a consultant to foreign interests.

Although an updated SF 328 is not required in advance of closing, the current holder of an FCL (i.e., the target or seller) has an obligation to notify its cognizant security agency at the "commencement" of "negotiations for the proposed merger, acquisition, or takeover by a foreign interest." NISPOM ¶ 2-302(b). Extensive information is required as part of this notification, including a plan to mitigate the resulting FOCI.

There are five techniques for the mitigation of FOCI. Some of these techniques may be acceptable only to a foreign buyer that has a "passive investor" interest in the target. Each of these could be an independent subject of a separate article, but they are succinctly described below.

Three of the five FOCI mitigation techniques allow the foreign interest to continue participating in the management of the cleared company:

- A "board resolution" that effectively precludes access by the foreign interest to classified information may be used when the foreign ownership does not allow the foreign interest to elect or appoint a representative to the company's board of directors.
- A "security control agreement" may be used when the cleared company *is not* effectively controlled by a foreign interest, but a foreign interest *does* have the ability to elect or appoint a representative to the company's board of directors.
- A "special security agreement" may be used when the cleared company *is* effectively controlled by a foreign interest.

The security control agreement and special security agreement are detailed multi-party agreements that impose stringent industrial security procedures; require active involvement of senior personnel, who must be U.S. citizens with personnel security clearances in security matters; establish a Government security committee composed of cleared personnel; and allow the foreign interest to be represented on the board and to have a direct voice in business management, but with no access to classified information. Companies cleared under special security agreements require a national interest determination (NID) by a Government contracting activity in order to perform contracts requiring access to certain "proscribed information," which includes top secret, Communications Security, special access programs, and sensitive compartmented information. These NIDs can be program-, project- or contract-specific in scope.

The final two mitigation techniques are the "voting trust" and "proxy agreement." These mechanisms

 

effectively deprive the foreign owner of all day-to-day management of the cleared company, placing that responsibility in the hands of three cleared U.S. citizen trustees or proxies who must have no prior relationship with the cleared company, the foreign interest or any affiliates, and who must be approved by the Government. The trustees and proxies run the cleared company independently, and are subject to the foreign owners' control only in relation to the following "life or death" corporate decisions: (a) the sale or disposal of all or a substantial part of the company's assets; (b) pledges, mortgages or encumbrances on the capital stock; (c) corporate mergers, consolidations or reorganizations; (d) dissolution; or (e) a declaration of bankruptcy. Plainly, these two techniques will have limited appeal to a foreign investor interested in technological synergies and an active management role. Because voting trusts and proxy agreements place greater restrictions on the prerogatives of the foreign owner, they usually can be more easily processed with the Government than a special security agreement or a security control agreement.

As noted at the outset of this article, foreign buyers *do* make a difference.

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