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A Slalom Course for Foreign Investors

Selling an aerospace or defense company to a buyer outside the U.S.? It's tricky, but it can be done.

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The aerospace and defense industry is in a boom cycle. Profits are at historic highs. Stock prices are rising. Growth rates are projected at 2-3 percent per year. And companies' values are increasing as the sector continues to benefit from strong balance sheets and cash flows. This trend should continue over the next few years, and acquisitions will continue to be the key component driving the industry's growth.

CORPORATE COUNSEL
A SPECIAL REPORT

Sellers have a strong incentive to capitalize on their companies' relatively high valuations. Buyers have been scouring the market to find attractive investment opportunities. Prime contractors like Lockheed Martin and SAIC have been on an acquisition binge in recent years to consolidate their businesses and reinvest earnings. They have been joined by private-equity players—such as the Carlyle Group and Arlington Capital Partners—that are similarly flush with cash and eager to invest in appreciating assets.

And now foreign buyers are seeing opportunity. The devaluation of the dollar has created significant international interest in U.S.-based companies. Many market analysts believe that, in order to compete globally, foreign private-equity firms and strategic players will have to take advantage of attractive opportunities in the United States.

Although there are advantages in the exchange rates, there are also significant legal and regulatory hurdles in the United States for any foreign investor wanting to own some or all of any U.S. government contractor involved in the aerospace, defense, or national-security sphere. What should in-house counsel with an eye on a merger or acquisition know to avoid the land mines in an arena that favors domestic U.S. buyers?

Regulatory Slalom Course

First, keep in mind some of the unique ownership restrictions that could apply to a cross-border merger or acquisition. These peculiar rules restrict foreign investors from purchasing contractors that engage in classified activities or produce high-technology or defense products. Although the limitations serve to keep the U.S. national-security industry in American corporate hands, they also have more flexibility to them than some observers might realize.

Here's an example of one hurdle. The Exon-Florio amendment to the Defense Production Act of 1950 authorizes the president to suspend or prohibit any acquisition, merger, or takeover of a U.S. company by a foreign entity if the transaction will impair "national security" interests. To avoid the risk of future divestitures, Exon-Florio requires the parties to an M&A transaction involving a foreign investor to notify the Committee on Foreign Investment in the United States, an interagency committee composed of 12 Cabinet-level members and chaired by the secretary of the Treasury.

That doesn't mean a sale can't go through. But a company looking for a sale to a foreign company would be smart to disclose the transaction to the government and initiate the CFIUS review process. Despite the politicization of foreign investment in the United States due to the recent Dubai Ports World controversy, most insiders agree that the review process effectively balances an open investment climate with national-security considerations.

The review process starts with a 90-day review period in which parties renegotiate the terms and conditions to comply with national-security imperatives. They can, for example, agree to include U.S. citizens on the board of directors, conduct research in the United States, or even grant company access to law-enforcement agencies. Actual investigations by the committee are rare: More than 1,500 notices have been filed to date, but only 25 required an investigation. Of those, only 12 were sent to the president for a decision about whether to block the transaction.

The Defense Department must grant security clearance to foreign companies seeking to merge with or acquire a domestic company with facilities engaged in classified activities. At the same time, even these kinds of security regulations allow some flexibility to accommodate a foreign investment.

If the buyer is only interested in a minority or noncontrolling position and not in electing a director, the company can simply amend its bylaws and issue a board resolution that excludes the foreign investor from access to any classified information. Alternatively, if the foreign investor is interested in a purely passive investment, the parties can establish a voting proxy or voting trust arrangement in which the foreign buyer retains the right to approve certain extraordinary transactions, such as a sale of assets or a merger, and the proxy holder or trustee is empowered to make day-to-day management decisions.

Other structuring options are available if the foreign investor wants more control over the target. If the foreign ownership interests are less than 50 percent but are nonetheless sufficient to elect a board representative, the foreign investor may be able to get a clearance under a "security control agreement." This arrangement requires the active involvement of senior management and outside directors (all of whom must be cleared U.S. citizens) in security matters, as well as a government security committee to oversee classified and export-control matters, but allows the foreign owner a direct voice in the management of the business through its board representative. When the company is effectively owned and controlled by foreign interests that wish to have a voice in day-to-day operation and management, a "special security agreement" provides maximum flexibility. Under these agreements, representatives of the foreign owner can be on the board of directors as long as the Defense Department approves them and they are also U.S. citizens.

Another potential hurdle is the International Traffic in Arms Regulations, promulgated by the State Department, which regulate the import and export of defense articles and services. These regulations impose export controls and restrictions on the foreign acquisition of U.S. defense companies. In general, anyone who intends to "export" a "defense article" must first obtain a license from the State Department. The term "export" is defined broadly to include "[d]isclosing or transferring technical data to a foreign person, whether in the U.S. or abroad." And "defense articles" include specific items, services, and related technical data listed in the U.S. Munitions List, including weapons, military equipment, spacecraft systems, and technical data and defense services. The government has recently shown its seriousness about enforcing these regulations on exporters when it imposed a $100 million fine on ITT Corp. for exporting classified night-vision technology without a proper license.

The State Department also requires that companies disclose foreign ownership interests. This includes situations in which foreign persons own more than 50 percent of the outstanding voting securities of the firm, or in which foreign persons have the authority or ability to establish or direct the general policies or day-to-day operations of the firm (which is generally presumed if the foreign persons own 25 percent or more of the outstanding voting securities).

Patents are another potentially tricky area for foreign investors. The Bayh-Dole Act grants government contractors the first opportunity to file for a patent on a federally funded invention and ensures that the benefits of title to inventions accrue principally to the United States. The right to retain title may be denied to contractors outside the United States, and any contractors that are owned by foreign governments are automatically denied those rights. Any company that holds an exclusive license for sales in the United States must substantially manufacture the product in the United States. And the owner of the invention may not grant exclusive licenses to use or sell the invention unless the recipient of the license agrees that its invention-related products will be manufactured substantially in the United States.

These limitations have important implications for foreign investors. The restrictions requiring the product to be manufactured in the United States, for example, may not be economically or logistically feasible. That, in turn, could have a significant impact on a company's value. The foreign firm can, however, be exempt from the rule if it can show either that it made reasonable but unsuccessful efforts to grant licenses on similar terms to potential licensees that would likely manufacture in the United States or that domestic manufacture is simply not feasible. Alternatively, foreign buyers must seek waivers from the government on a case-by-case basis or otherwise enter into customized research-and-development agreements with the Defense Department that include tailored patent rights meeting the needs of both parties.

Outlook for Foreign Buyers

In our view, current market conditions provide attractive opportunities for the right buyer looking to make a long-term investment in the right target. The general consensus among analysts focused on the industry is that—despite the countercyclical tendencies of the defense and commercial aerospace sectors—the U.S. aerospace and defense market will continue to expand for the next two or three years, spurred on by continued increased defense spending resulting from the wars in Iraq and Afghanistan as well as the proposed relaxation of regulatory restrictions on investment in U.S. airlines.

That said, the market is cyclical, and most experts also agree that a contraction is inevitable, particularly in light of certain indicators: a long industry growth trend spanning more than a decade, current large pockets of overcapacity, an industry that is already largely consolidated, and the realities and pressures of budget reform and federal spending priorities. Once the contraction begins, we expect another wave of market consolidation as prime contractors seek to redefine their markets and shed unwanted assets, similar to the trend of the early 1990s. In the meantime, acquisitions will continue to be a big driver.

This trend presents particular advantages and, of course, hurdles to the right foreign buyer and U.S. target. From the seller's perspective, the market is competitive and valuations are high. From the foreign buyer's perspective, the depreciated dollar and current exchange rates can make an acquisition deal relatively attractive. But for these interests to align, the parties also have to consider the risks related to the peculiar rules governing investments by foreign buyers in U.S. targets that engage in classified, high-technology, defense, or national-security activities.

To avert or mitigate these risks, all of the players must approach and structure the deals appropriately, using seasoned and experienced advisers familiar with the legal and regulatory terrain. Armed with these protections and the right outlook, foreign investors can expect the aerospace and defense market to be full of exciting stories and thrilling opportunities over the next few years.

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