

RESTRICTIONS ON FOREIGN INVESTMENT:  
DEVELOPMENTS IN UNITED STATES LAW

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MR. HELENIAK: The topic of restrictions on foreign investments in the U.S. is obviously something that cannot be dealt with in any detailed manner in this presentation, but I think it is essential in a conference devoted to discussing the liberalization and increasing internationalization of capital flows that we remind ourselves that there remain, and indeed in the future may be more, restrictions on flows of capital between countries.

My comments will be directed almost exclusively at one type of investment. Unlike our earlier speakers, I will be principally focusing on the consequences of direct foreign investment, that is, the acquisition of controlling equity interests in U.S. corporations or property. This topic has been of great interest throughout the seventies and into the early eighties in international economic planning on the part of the U.S. government. My former Treasury colleagues on today's panel and that of yesterday, a number of you in the audience, and I spent a certain amount of our time during the previous Administration worrying about the consequences of foreign investment in the U.S. and whether or not those consequences were such that one should be doing something different in the policy area.

Bob Mundheim pointed out to me in the corridor yesterday that the imposition of restrictions on foreign investment remains an idea of great currency, citing the Canadian-Pacific-Hobart tender offer which promptly led to Congressional hearings and the Seagram bid for St. Josephs. Had he had a little more time yesterday morning to read the *New York Times*, he would have noted that it has been alleged that the Prudential bid for Bache was an effort to preclude the Belzberg brothers of Canada from acquiring the same target. Two years ago, when Bob and I first talked about this subject, he was concerned about the proposed acquisition of the neighborhood Woolworth's by Canadian interests. I wonder what the Canadians would make of this great concern in the U.S. over control of our productive resources by Canadians.

## 1. TRADITIONAL POLICY OF LIBERALISM

Although the direction of our policy may be undergoing re-assessment in light of these acquisitions, the essential fact to remember is that our country remains relatively open to foreign investment. Foreign investment has been attracted to the U.S. by the inherent strength of the U.S. economy, the breadth and resiliency of U.S. capital markets, and the fundamental protections of our legal system. These attractions were enhanced in the 1970s by the relative decline of the dollar and the stagnation of U.S. equity prices. Foreign investors have benefited from an essentially open-door policy for investment in the U.S. and, in some instances, from comparative advantages over competing U.S. domestic suitors of investment

opportunities.

#### A. Foundations of the Open Door

The historical liberalism of U.S. government policy toward foreign investment is rooted in two fundamental premises. First, the investment process is likely to work most efficiently in the absence of direct government intervention. Second, investors should be accorded national or neutral treatment in making investment decisions, receiving neither preferential nor discriminatory treatment. Once an investment is made here it should be treated on equal footing with other enterprises.

This policy has enjoyed bipartisan support which has been based on a pragmatic assessment of the national interest as well as on philosophic premises. U.S. investment abroad, which far exceeds foreign investment in the U.S., might be adversely affected by restrictions on foreign investment here. As Michael Coles noted earlier, restrictive policies here can lead to reciprocal treatment abroad. In addition, foreign capital can play an important role in increasing productive capacity, competition, and jobs. Many state governments have found these attractions so appealing that, despite efforts of the federal government to discourage the practice, they have competed with one another to attract foreign investment with various tax and other incentives.

Because of the open door policy, when foreign clients come to their American lawyers to seek advice on U.S. acquisitions, the advice generally consists--with a few exceptions that I will mention shortly--of the same advice that is given to a U.S. purchaser considering making an acquisition. In the case of a foreign client unfamiliar with U.S. securities laws, the advice is laced with educational materials trying to explain the vagaries of Mr. Friedman's Commission. We do not, however, have to concern ourselves with any national entity that will pass on whether or not a foreign investor should be allowed to make a particular U.S. acquisition.

#### B. The Power to Regulate

Although the U.S. has generally pursued a policy of neutrality with respect to foreign investment, the Congress and the executive branch have broad powers to regulate such investment under the commerce clause of the federal Constitution and under the constitutional provisions relating to the maintenance of national defense and the conduct of foreign policy. To a lesser degree the states also have power to regulate and restrict foreign investment. These powers have been exercised sparingly, but to the extent they have been exercised, they represent pitfalls for the unwary.

#### C. Exceptions to the Open-Door Policy

The exceptions to our open-door policy, to which I just referred, relate primarily to licensing requirements and limitations on foreign acquisitions of real estate or rights relating to real estate. Foreigners interested in U.S. acquisitions and, more important, their U.S. counsel must remain alert to legal inhibitions in these areas in the context of particular acquisition programs.

##### (i) Federal restrictions in particular industries

The U.S. has a small but important body of law that sharply restricts, precludes, or requires licensing of, foreign ownership

in certain sectors of the economy--the aviation, communications, maritime and nuclear energy industries, and defense contracting activities. The materials listed in the Bibliography appended to this chapter should be consulted for a detailed description of such legislation. Each of these sectors is, or has historically been, heavily regulated; and, in most instances, obvious and compelling national security interests dictate separate treatment for foreign investors. None of the special legislation concerning foreign investment in these sectors appears to have developed in response to a particular acquisition or to be directed against investors of a particular nationality.

The requirements of these statutes are complex, made more abstruse by a labyrinth of implementing regulations and uneven implementation of the regulations. In some matters lawyers have, of necessity, become so cautious that they are unwilling to give legal opinions, directing their clients instead to the more cumbersome process of regulatory rulings. Results appear on occasion to have been completely unintended by the Congress. For example, leveraged lease transactions, unheard of when federal aviation and maritime statutes were enacted, have become a common means of acquisition of commercial aircraft and maritime vessels. In such transactions, a financial institution, as owner-trustee, occupies a normally passive role with respect to the operation of the aircraft or vessels. Nevertheless, in the case of aircraft, for example, the Federal Aviation Act of 1958 and regulations thereunder have been deemed to require the substitution of a new owner-trustee when twenty-five percent of the voting stock of the U.S. corporation acting as owner-trustee has been acquired by foreign persons.

Given the conglomerate nature of much of American enterprise, a foreign investor must carefully examine all of the business activities of a potential acquisition target to determine whether its business depends materially on government licenses or regulatory permits that cannot be issued to foreign-owned enterprises. You will note that most tender offers by foreigners include a preliminary determination as to the material dependence of the business of the target corporation on licenses that might be adversely affected by foreign ownership. If the loss of such licenses as a result of an acquisition might cause material adverse effects on the business of the target, the prospective investor must confront serious issues which will vary according to the means and extent of acquisition. Where restrictions may be applicable, it is imperative to determine before making or abandoning an investment whether such restrictions can be avoided or accommodated (for example, by operating through a U.S. entity, or establishing a voting trust with U.S. trustees) or if post-acquisition divestiture is feasible without incurring penalties or losing the benefits of the acquisition.

Some domestic corporations have taken advantage of this dilemma for prospective foreign suitors in their defensive planning against takeover bids. For example, Section 5-703(b) of the corporation law of the State of Maryland deals with Maryland corporations that conduct business under a federal or Maryland license or grant of authority which may be restricted, limited, or revoked if a specified percentage of its voting interests is owned or controlled by aliens. Such corporations are expressly permitted to adopt a by-law provision restricting the transferability, ownership, or voting rights of shares held or to be held by aliens to comply with such license or grant of authority. Under this statute, corporations have adopted bylaws prohibiting the transfer or voting of shares of

their stock by aliens in an amount that would violate the ownership or control requirements of a particular regulated activity in which the corporation is engaged or even an activity in which the corporation intends to be engaged. Such restraints on alienation of voting securities are not widespread and have not been judicially tested. Presumably the validity of such provisions will be determined by the reasonableness of the restrictions imposed, taking into consideration all of an entity's business activities.

(ii) *Restrictions on real property ownership*

The other significant area where foreign investors meet unusual problems relating to their nationality is in the acquisition of U.S. real estate. At the federal level, far-reaching prohibitions, which are no longer meaningful, were imposed in the nineteenth century on land acquisition by aliens in the Western territories. There remain, however, significant restrictions under the Mineral Leasing Act of 1920 and related statutes, which provide that rights of way over federal land for oil pipelines and the acquisition of lease rights or other dispositions of interest with respect to coal, oil, and various other minerals on federal lands may be granted, leased, or sold only to U.S. citizens or corporations. The Federal Land Policy and Management Act of 1976 prohibits the sale of public lands to aliens or corporations not subject to the laws of the U.S. or of any state.

Real property law in the U.S. is generally a matter of state law and is not uniform. Alien land laws, restricting foreign ownership of land, date from the initial reception of the English common law by the colonies and are widespread (a majority of the states have such laws), particularly with respect to agricultural land. Recently, states have been enacting new or further restrictions. The power of the states to impose restrictions on alien land ownership has been upheld in both federal and state courts against attacks under the equal protection clause of the federal Constitution and applicable treaties. Nevertheless, the prohibitions may often be avoided, for example, by operating through a U.S. corporation; and in some instances they may be susceptible to legal challenge.

Foreign investors have been following recent developments in the state of Oklahoma with considerable interest. In September 1979, the Attorney General of Oklahoma withdrew a 1975 opinion of his office and concluded that an alien, including a corporation, could not directly or indirectly acquire title to or own land in Oklahoma under the state constitution, except for limited periods of time in the case of *bona fide* residents or through devise, descent, or foreclosure. Title conveyed in contravention of such law was declared to have escheated to the state. The state then commenced escheat proceedings against certain foreign corporations owning real estate in Oklahoma. A state district court held in February 1980, that that Oklahoma law was inapplicable to domesticated foreign corporations. That case had been pending on expedited appeal before the Oklahoma Supreme Court for more than a year. Recently the Supreme Court of Oklahoma held--I have been told, but have not yet read the opinion--that a foreign corporation that qualifies to do business in Oklahoma will be considered a *bona fide* resident of that state and entitled to enjoy the same benefits as any other resident in terms of real estate ownership.

Those are the principal areas, historically, where the U.S. has imposed restrictions on foreign investment. My topic today

is to concentrate on current developments in U.S. law with respect to foreign ownership.

## 2. POLITICAL CONCERN OVER FOREIGN INVESTMENT

Political concern over foreign investment has increased during the past decade, hand in hand with the rising tide of foreign investment. The decline of the dollar in the new era of floating exchange rates facilitated an acceleration in foreign investment in the U.S. through most of the 1970s. Dollar-denominated assets became relatively inexpensive; and in some instances, competitive, or political necessities dictated that foreign producers establish production facilities in the U.S. to preserve market shares otherwise threatened by the increasing dollar prices of their exports to the U.S. or by proposed trade protectionist measures. The emerging wealth of OPEC countries further contributed to the flow of funds.

This concern reflects, to varying degrees, (1) xenophobic pressures and prejudices against some nationalities, (2) responses to competitive threats or takeover pressures (particularly in the banking industry, where artificial geographic limitations on domestic bank expansion have limited the exposure of medium and large banks and bank holding companies that are potential takeover targets for foreign banks, it has been suggested that some domestic banks want to inhibit acquisitions by foreign banks in order to preserve domestic takeover targets for a time when geographic limitations on bank expansion are liberalized), and (3) grappling with the complex and historically difficult problems of the accommodation of transfers of real wealth between nations without temporary and irrational distortions of international capital markets.

The U.S. Congress and state legislatures have seen a spate of legislative proposals over the past decade designed to respond to these concerns. The prescriptions for the perceived ills of foreign investment have included such varied approaches as (1) imposing direct limits on the percentage of foreign ownership of public companies in general or companies in particular industries, (2) establishing a commission to prohibit or screen certain foreign investments or to review foreign investments in general, (3) attempting to eliminate advantages foreign investors have been accorded inadvertently over domestic competitors, (4) proposing state legislation to enable corporations to restrict the transfer of their voting stock to foreigners where such transfers might adversely affect the ability to compete in certain business activities, (5) imposing further limitations on alien land acquisition at both federal and state levels, (6) implementing investment moratoriums to permit studies on the effects of foreign investment, (7) providing for disclosure and reporting of foreign investment and collection of data with respect thereto, and (8) instituting a reciprocity requirement restricting foreign investors to the same types of investments in the U.S. as U.S. investors may make in their home countries.

## 3. RESTRICTIONS ON FOREIGN INVESTMENT

I am delighted to report that at the federal level successive Congresses, with the strong encouragement of Republican and Democratic administrations, have resisted the more draconian proposals. The legislation that has been enacted at the federal level during the past few years, I think fits into two broad categories. The

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first category represents an effort to enhance the statistical base available to policy planners; and the second is the area that Bob Carswell referred to previously as trying to make the playing field even--that is, addressing areas of U.S. legislation that have accorded disparate treatment between U.S. and foreign investors with a view to removing the differences.

#### A. Reporting Requirements

The origin of reporting statutes can be traced to the early seventies when dollar-denominated assets began to look increasingly attractive and there was concern within the Congress about possible OPEC acquisitions. The executive branch, in trying to make some intelligent decisions as to whether or not the level of investment was substantial enough to warrant some concern, and to be able to document its views on the subject in a sensible way to the Congress, discovered that we did not have a good statistical base within the U.S. concerning the degree of foreign investment. Beginning with the Foreign Investment Study Act of 1974 the U.S. government commenced the arduous task of compiling a statistical base on foreign investment. The International Investment Survey Act of 1976 [IISA] has established a permanent basis for providing every five years a survey of foreign direct investment (acquisition of ten percent or more of the voting securities of a business enterprise) and portfolio investment in the U.S. The Treasury Department has recently published the results of the first portfolio survey, which was conducted in 1980. In January the Commerce Department published for comment an instruction booklet and regulations for the conduct of the first direct investment survey, which is scheduled for the first half of 1981, together with amendments proposed for quarterly and other reporting forms.

In addition to the reporting requirements imposed under IISA, the Commerce Department has established numerous periodic and extraordinary reporting requirements under IISA applicable to enterprises in which foreigners invest and to persons assisting such investment. The reports that have been required have been criticized because they appear to go beyond the informational needs to which the statute is addressed--this despite the express statutory provision that it is not intended to inhibit foreign investment here in any way. In particular, reporting requirements have in the past required identification of the name of an acquirer, whereas only the home state of the acquirer seems necessary for policy planning purposes. In the regulations proposed for the first IISA survey, the Commerce Department has asked for comments on its ability to dispense with the name requirement in favor of simply a nationality requirement. IISA itself has also been criticized for the detailed reporting information it requires.

Similarly, detailed reporting requirements have been imposed under the Agricultural Foreign Investment Disclosure Act of 1978 [AFIDA] with respect to foreign ownership and acquisition of land used for agricultural, forestry, or timber products. Unlike IISA which effectively limits disclosure of particular acquisitions to the federal government alone, AFIDA permits public disclosure of information filed with respect to particular acquisitions. AFIDA imposes an obligation that, within ten days of the filing of a report of an acquisition, the report must become publicly available not only in Washington, but also within the state in which the acquisition occurred. Accordingly, the ability of foreign investors to assemble significant parcels of land is likely to be adversely

affected by the disclosure of partial acquisitions and their purchase prices, prior to completion of assembly. Substantial penalties, including civil fines of up to twenty-five percent of the fair market value of the interest acquired, may be imposed for failure to report under AFIDA. The results of the first survey under AFIDA, published by the Department of Agriculture in November 1980, indicate that less than one-half of one percent of privately held agricultural land in the U.S. is foreign-owned. The benefits of this information must be weighed in the context of the costs imposed by AFIDA on foreign investors.

The Domestic and Foreign Investment Improved Disclosure Act of 1977, which was enacted with the Foreign Corrupt Practices Act, has also expanded the reporting requirements imposed on foreign and domestic investors by increasing the instances in which reports must be filed with the SEC under the Securities Exchange Act of 1934, disclosing the beneficial ownership of five percent or more of each class of an issuer's equity securities. I will discuss the reporting requirements of the newly enacted Foreign Investment in Real Property Tax Act of 1980 [FIRPTA] in a moment.

## B. New and Proposed Legislation

The other broad area I want to touch on briefly is new legislation designed to make the playing field even: in particular, two recently enacted pieces and one proposed piece of legislation. I will limit my remarks on the first: the International Banking Act of 1978 [IBA] about which you have heard a great deal. Let me underscore the previous comment that in enacting the IBA the Congress passed up the opportunity to be pro-competitive by eliminating artificial restrictions imposed on domestic institutions in this country. Instead, a second dual banking system was created where one is difficult enough to understand.

### (i) Banking

Prior to enactment of the IBA, the vagaries of our bank regulatory system, with separate federal and state bank regulators, presented opportunities to foreign banks operating in the U.S. that were not available to their domestic counterparts. In particular, foreign banks could establish branches or agencies in as many states as permitted such entry and could establish securities affiliates here. Similar activities were not available to U.S. banks because of the McFadden Act and the Glass-Steagall Act. The IBA redressed this imbalance by imposing similar limitations on foreign bank activity here while creating a separate dual banking system for foreign banks, which as a result may now establish either federal or state branches or agencies. Although the IBA fashioned a politically acceptable compromise to some issues surrounding foreign investment in the domestic banking system, controversy continues to rage concerning foreign acquisitions of U.S. banks and even--as has so often been the case with banking regulation in this country--about the scope of authority of federal regulators in granting branch licenses to foreign banks in states with more restrictive legislation, regulation, or lore than appears to be consistent with such licensing on the federal level. A three-month moratorium on the approval by federal bank regulators of applications in connection with takeovers of U.S. banks by foreign persons was enacted as part of the Depository Institutions Deregulation and Monetary Control Act of 1980.

*(ii) Real estate*

In the tax and real estate areas, and in response to the dictates of the Revenue Act of 1978, the Treasury Department completed a study of the federal tax treatment of income from, and gains on the sale of, interests in U.S. property held by non-resident aliens and foreign corporations. The study concluded that such persons, unlike their domestic counterparts, rarely incurred capital gains tax on disposition of their U.S. properties because of various techniques designed to change such property from being "effectively connected" with a U.S. trade or business to not being so connected. Such devices converted capital gains on real estate, which were ordinarily taxable, into gains on other assets which were not. To rectify this apparent inequity, FIRPTA was enacted in the closing days of the 96th Congress. FIRPTA generally provides that any gain or loss realized by a foreign person from the disposition of U.S. real property will be taxed as "effectively connected" with a U.S. trade or business. FIRPTA also imposes significant reporting requirements as to foreign beneficial owners of non-public U.S. companies, which may be avoided if adequate security for tax collections is provided. Congressional efforts to impose a withholding tax on gains from the disposition of U.S. real estate were unsuccessful.

*(iii) Margin requirements*

Legislation has been proposed in the 97th Congress to extend the application of margin regulations to stock acquisitions by foreign entities that are not controlled by U.S. persons. Section 7 of the Securities Act of 1934 does not at present authorize this extension, presumably because of concern over the jurisdictional reach of our laws. Currently, only domestic borrowers and most domestic lenders are subject to Federal Reserve Board Regulations G, T, U and/or X imposing generally a fifty percent margin requirement on secured loans, the proceeds of which are to be used to purchase stock. Accordingly, a foreign borrower may borrow from a foreign lender to make a U.S. acquisition without the imposition of margin requirements. The difficulties of national regulation of an increasingly international capital market exemplified in this instance were perhaps even more strikingly presented during much of 1980, when the Federal Reserve Board attempted through its powers of "moral suasion" over domestic banks to allocate credit away from so-called non-productive uses, such as the acquisition of existing business enterprises. The Board's persuasive powers were, of course, less powerfully employed against foreign lenders.



## APPENDIX X

## A SELECTED BIBLIOGRAPHY

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