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China as a "National Strategic Buyer": Towards a Multilateral Regime for Cross-Border M&A

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Introduction

The current trade dispute with China, framed in terms of the US-China balance-of-trade deficit, causes us to reflect once again on the liberal global economic regime that has been the premise for the post-World War II global order. Economic theory makes it clear that the global welfare-maximizing trade regime would seek to lower trade barriers to permit the pursuit of national comparative advantage in both goods and services. National governments, however, face on-going political and economic pressure from local losers as well as the consequences of local adjustment costs from the global trade regime. Governments may thus incline toward protectionist measures that over time would undo initial commitments to an open trade regime. The on-going maintenance of this liberal global order therefore requires a structure that creates a binding rules-of-the-game framework to constrain national defection and a dispute resolution procedure for settling grievances. Enter the WTO.

The regime for the global movement of capital has been less well developed. The general framework has been permissive and facilitative. At times nations have imposed general capital controls, either outbound (to foster in-country investment; to reduce exchange rate deterioration) or in-bound (to avoid boom/bust economic cycles; to minimize inflation). A somewhat different question arises when the form of global capital flow takes the form of a cross-border acquisition, when an acquirer domiciled or headquartered in one country acquires a company domiciled or headquartered in another.

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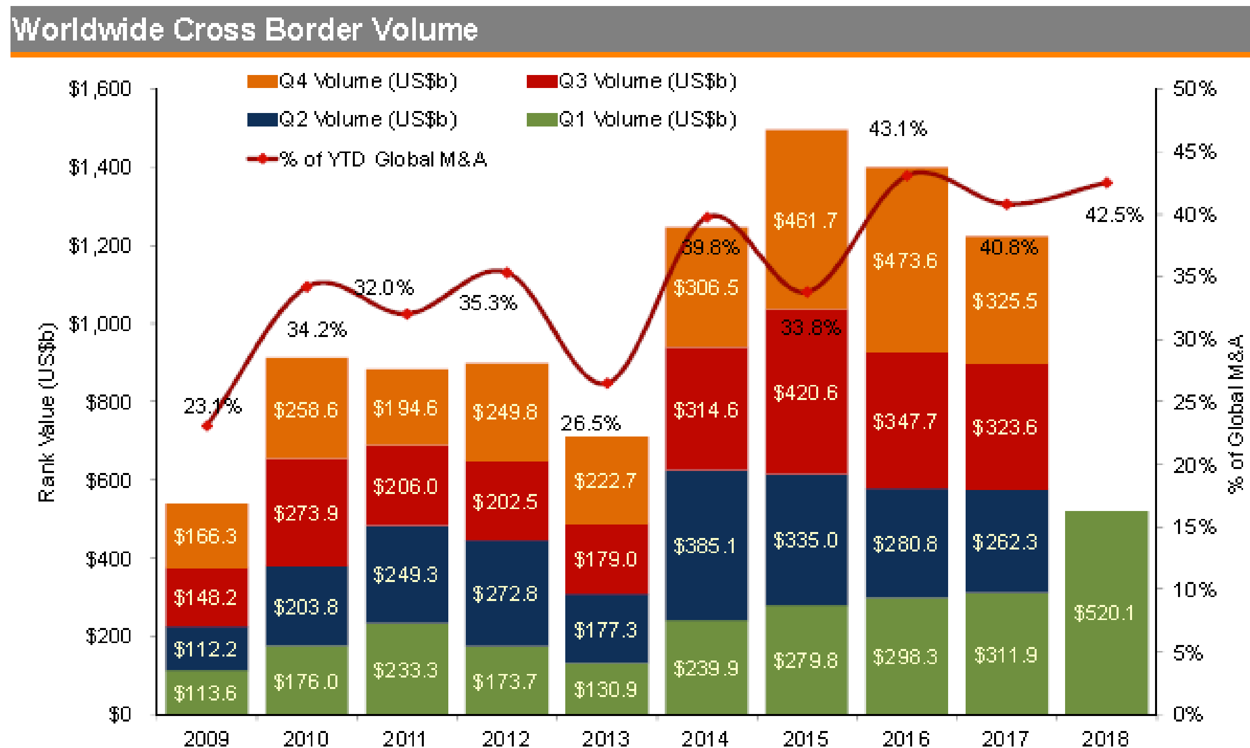
As figure 1 indicates, cross-border mergers and acquisition activity is becoming an increasing consequential form of global economy activity. In the post-financial crisis recovery years (2014-2017), the annual level of cross-border m&a activity has exceeded $1 trillion, and the cross-border share of global m&a activity has exceeded 40 percent.

Figure 1



Unlike the case of cross-border trade, there is no explicit international governance regime for cross-border M&A; rather, there is a shared understanding that publicly traded companies are generally available for purchase to any bidder--domestic or foreign – willing to offer a sufficiently large premium over a target's stock market price. This expectation is of course limited by the shifting boundaries of host country protectionism and the prevailing patterns of corporate ownership in different countries.   But the unspoken premise that undergirds the system is that the prospective buyer is motivated by private economic gain-seeking. Some buyers may be "strategic," seeking economies of scale or scope; and others may be "financial," looking to maximize immediate cash flows. These differences, which may elicit different target and host country responses, are nevertheless similar in their overarching *private* objectives:

Firms and management teams are seeking to advance the economic interests of their private "owners."

A particular aspect of this implicit cross-border M&A regime bears emphasis. The state enters the picture on the target-side only, the "sell side." That is, the laissez-faire system is subject to state-level decisions that a particular target is not for sale, perhaps because (i) the follow-on business strategy is anticipated to cost jobs in the target's home country, (ii) the target provides "strategic" infrastructure (like a port or public utility), or (iii) the target is important for "national security" reasons. The state, however, does not play a directive role in the acquirer's decision-making, the "buy side." Protectionism and other forms of mercantilism enter as *constraints* on the pecuniary motives of target shareholders, not as *imperatives* that overcome the pecuniary motives of the acquirers. The bounded nature of state action has meant that the permissive international cross-border M&A regime can survive and even thrive without the law-making and enforcement apparatus of a multilateral regime like the WTO.

The entry of China into the global M&A market threatens the fundamental assumptions of the current permissive international regime. The rise of China-related M&A reflects not only consolidation in its domestic economy but, most important, China's increasing share of cross-border transactions. In 2016, for example, China accounted for $92 billion of net purchases in cross-border acquisitions, 10 percent of the worldwide total and more than the U.S., with $78 billion.[1] A significant fraction of these transactions related to advanced physical and digital technology, domains of an articulated Chinese state objective to become a world leader.

The central claim of this article is that the cross-border M&A regime will require a new rules-of-the game structure to take account of China's ascension. This is because cross-border M&A with a Chinese acquirer adds a new dimension: what we will call the "national strategic buyer" (NSB), whose objective is to further the interests of a nation state in the pursuit of national industrial policy or perhaps national security concerns. Thus, China presents a problem of "asymmetric motives" in the global M&A market: sellers to Chinese firms have private motives for pursuing transactions, while at least some Chinese acquirers have non-economic motivations; they are NSBs. Yet distinguishing commercial and financial motives from national strategic motives with a given Chinese acquirer is difficult: high levels of state ownership, the murkiness of corporate ownership in many cases, and the Communist Party's extensive levers of

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[1] UNCTAD, World Investment Report (2017), Annex table 3.

influence over all firms, whether "state-owned" (SOE) or "private" (POE), creates the potential for national strategic motives to be involved in many transactions. Moreover, the Chinese government's recent clampdown on outbound M&A to stem capital flight[2] demonstrates that the government perceives outbound M&A as closely linked to its overall economic strategy, and the administrative procedures associated with outbound M&A as an important tool of government economic control.

A comparison with France may be useful in illustrating the dilemma raised by an NSB: While it may be difficult for a foreign acquirer to gain control of a French firm due to the relatively statist orientation of that country's economy, the French government is not pursuing a national industrial strategy of targeting foreign firms in order to obtain advanced technologies[3] or regulating the volume of outbound deal flow in service of national economic policy.

To date, the only mechanisms for addressing the NSB problem are national security review mechanisms for cross-border acquisitions of domestic targets at the level of separate nation states. In the United States, this mechanism is the so-called CFIUS process.[4] Although the precise mechanisms differ, Australia, Canada and a number of other countries have adopted similar screening regimes. Concern over Chinese acquisitions has prompted recent legislative proposals to reform the CFIUS process. These proposals focus particularly on the need to expand the range of transactions covered by the screening mechanism to include not simply foreign acquisitions of "control," but joint ventures and other deal structures through which a foreign participant might potentially extract sensitive technology or otherwise exert influence in ways that could harm U.S. national interests. Similar concerns have led to a proposal to adopt a national security screening mechanism at the EU level, where none currently exists.

In our view, this approach, legitimate in the moment, fails to take on the crucial long-term concern of assimilating China as a "normal" actor in the global economic system. A cross-border M&A regime featuring acquirers with asymmetric motives is not stable over the long

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[2] See Don Weinland, Capital Crackdown Threatens Wave of Overseas Buyouts, Financial Times, https://www.ft.com/content/091677dc-f8ec-11e6-bd4e-68d53499ed71

[3] [Compare China 2025]

[4] See infra. For the origins of the "Committee on Foreign Investments in the United States" in 1975 and its activities for the first 30 years, see George S. Georgiev, The Reformed CFIS Regulatory Framework: Mediating Between Continued Openness to Foreign Investment and National Security, 25 Yale J. Reg 125 (2008).

term. As noted, amendments to the CFIUS regime and comparable initiatives at the EU and member state level are a likely response. But the national approaches differ in their details, have gaps in coverage, and operate as an on-off switch: a deal is either blocked or cleared, and once cleared, there is no follow-up to monitor the behavior of the acquirer. Eventually, the presence of actors in the global M&A market with asymmetric motives will lead to a backlash that could disrupt global capital markets. Indeed, there are already signs of backlash against China building.[5]

The problem of asymmetric motives could be eliminated through a multilateral regime of mutual contestability – i.e., a requirement that every acquirer in a cross-border deal must itself be susceptible to takeover by a foreign buyer. In such a regime, value-reducing acquisitions to serve national strategic objectives could elicit a hostile bid; this would serve as a check on such state insistence. Such a regime is not politically feasible, however, as demonstrated by the collapse of an effort to agree to such a regime at the EU level almost two decades ago. But a second-best solution is available.

This article argues that the problem of asymmetric motives can be mitigated through adoption of a multilateral regime under which firms (whether SOE or POE) subject to the potential for direct government influence in their corporate decision-making must demonstrate "eligibility" to engage in outbound M&A. Our proposal would require state-owned-enterprises, firms subject to a golden share held by a governmental body, or privately-owned enterprises with governing-party-based internal governance organs to meet agreed-upon eligibility standards before they could undertake acquisitions of foreign firms. These eligibility rules could be developed as part of the G20 Guiding Principles for Global Investment Policymaking, agreed to in 2016 during China's presidency of the G20. Those rules, which we outline in detail below, could be implemented on an opt-in basis at the national level, for example as a new discipline added to an existing national security screening regime. An eligibility regime would provide incentives for governments to reduce the number of firms subject to its requirements (by eliminating government/political party involvement in corporate governance) and provide

[5] See, e.g., Jonathan Sterns, Amid China M&A Drive, EU Rushes for Investment-Screening Deal, Bloomberg, March 5, 2018 (quoting a French member of the European Parliament who is leading the body's deliberations over adoption of an EU-wide screening mechanism, prompted concerns over China: "It's the end of European naiveté. We have to have the courage to change things.").

meaningful discipline against a state's efforts to advance national-strategic motives in cross-border M&A for firms subject to its requirements.

Part I surveys evidence of China's rise as a serious player in the global M&A market. Part II explains the role of China's firms as "national strategic buyers" and illustrates the way this undermines the basic assumption of *symmetric private motivations* on which the global M&A market is based. Part III examines the existing regimes at the national level for dealing with national security concerns and the proposals for reforming them. It explains why these regimes do not fully address the problem of the NSB.

Part IV contains our proposal for a coordinated regime for cross-border M&A based on the concept of "eligibility." The "eligibility" criteria are designed to make it possible for an acquirer to make a credible commitment that its cross-border acquisition proposal is motivated by private commercial objectives rather than "national strategic" objectives. The elements are:

> (i) the company commits in its charter or other constitutive documents to undertake foreign acquisitions solely for own-firm financial or commercial objectives and not at the behest of any government;
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> (ii) a significant portion, 25 percent, of the company's cash flow rights are available for purchase by foreign shareholders;
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> (iii) the company's governance structure provides for independent directors, at least 25 percent of the board (but no less than two), who will be nominated by foreign shareholders;
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> (iv) in advance of a public acquisition proposal, the independent directors are required under the acquirer's governance documents to prepare a report for subsequent public release that attests to the own-firm financial or commercial motivation and absence of government involvement in the acquisition decision; and
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> (v) the company provides full disclosure of the sources of funding for the transaction before the transaction is final.

Enforcement of the regime would consist of two elements: first, a secretariat that can evaluate whether a would-be acquirer satisfies the eligibility criteria both as a general matter (the company's governance set-up) and as to the specific transaction; second, national legislation that would permit rejection of the acquisition of a local target by an acquirer that does not meet the eligibility criteria.

In Part V, we address two likely objections to our proposal: first, that it is itself "protectionist" and second, that China, or any other regime that imposes on its firms an NSB obligation, would never subject itself to such discipline. As to the first potential objection, a regime creating eligibility standards for the conduct of outbound acquisitions is designed to protect the integrity of the global system, not to advance the interests of domestic economic actors of any particular national economy. As to the second, we have no illusions that China's political leadership would find the loss of this lever of influence over the economy attractive. But as the national security screening mechanisms in advanced western economies proliferate and tighten, it will be in China's national interest to accede to a harmonized M&A regime that minimizes the "suspicion tax" under which many Chinese firms currently operate in global markets.

At the 2017 World Economic Forum in Davos, President Xi Jinping called for an open global economy and projected himself as a chief statesman on behalf of global governance. He explained China's decision to join the WTO as reflecting "the conclusion that integration into the global economy is a historical trend. To grow its economy, China must have the courage to swim in the vast ocean of the global market."[6] Agreement to a multilateral regime that constrains mercantilist M&A is the next important step for China.

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[6] See World Economic Forum, https://www.weforum.org/agenda/2017/01/full-text-of-xi-jinpin-keynote-at-the-world-economic-form.