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# China's Acquisitions Abroad - Global Ambitions, Domestic Effects

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# China's acquisitions abroad— global ambitions, domestic effects

By Nicholas C. Howson

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In the past year or so, the world has observed with seeming trepidation what appears to be a new phenomenon—China's "stepping out" into the world economy. This move, labeled the "Going Out Strategy" by Chinese policy makers, sees China acting in the world not just as a trader of commodities and raw materials, or the provider of inexpensively-produced consumer goods for every corner of the globe, but as a driven and sophisticated acquirer of foreign *assets* and the *equity interests* in the legal entities that control such assets. *The New Yorker* magazine, ever topical and appropriately humorous, highlighted this attention with a cartoon in its October 17, 2005 edition. That drawing shows two prosperous and no doubt Upper East Side-dwelling matrons holding cocktails before a fireplace. Above the fireplace hangs the formal portrait of a balding, well-fed, elderly, man. Looking at the portrait, one lady says matter-of-factly to the other: "That's Karl, before he was purchased by the Chinese."

## The CNOOC bid for Unocal

This concern, and the slightly nervous humor it engendered, was inflamed by a Chinese oil company's summer bid for the control of an iconic American oil company, in direct competition with a U.S. oil company suitor. That transaction was of course the Hong Kong-domiciled and listed China National Offshore Oil Corporation Ltd.'s (CNOOC Ltd.) June 2005 all-cash US\$18.5 billion bid for Unocal of California—at a more than 10 percent premium to Chevron's competing stock and cash deal, already the subject of a binding merger agreement.

The anxiety—at least as articulated in the press, the U.S. Congress, and at anxious hearings in Washington—focused on an eclectic but eye-catching range of issues. Some thundered grave warnings about the threat to America's "national security" generally, and U.S. "energy security" specifically (meaning U.S. access to worldwide hydrocarbon production and control of downstream refining, supply, and distribution); others worried vaguely about the transaction as a harbinger of China's increasing economic, political, and military influence; still

others pointed to the phenomenon of a long-feared "China Inc." using Communist-led government funds to finance an all cash deal to better the American champion's cash and stock offer. This latter characterization was fueled by the prospect of huge borrowings—perhaps a third of the cash offer—from a consortium of banks led by the Industrial and Commercial Bank of China (ICBC), a People's Republic of China (PRC) state-owned commercial bank, and from the CNOOC Ltd.'s 70 percent shareholder, state-owned, and PRC-domiciled China National Offshore Oil Corporation (CNOOC). Still others, perhaps trade lawyers sensing a rhetorical or business opportunity, went so far as to cry foul under the World Trade Organization (WTO) accession deal which China completed in November 2001—labeling the proposed financing of the Unocal bid as a breach of WTO prohibitions against state subsidies, and thus actionable under the WTO (and the separate China-specific) countervailing duties regime.

In a different environment, each of these points could have been rebutted fairly easily. The worry about the "takeover" of a U.S. oil company might have been answered by pointing out that more than 70 percent of Unocal's petroleum production, and more than 75 percent of its petroleum reserves, remain *outside of the United States* (ironically, mostly in Asia), and all of the Unocal production is promised to various foreign buyers (again, primarily Asian buyers) under long-term production sharing or production sales contracts. (In fact, Unocal's worldwide oil and natural gas production represented only a measly *one percent* of entire U.S. consumption.) For downstream assets (refining, pipelines, distribution, and retail)—where control issues become marginally more relevant—Unocal has *no* downstream assets whatsoever in the United States (having sold them almost a decade ago). The attack which portrayed CNOOC's soft or government-provided financing as an illegal subsidy was a stretch from any honest international trade lawyer's standpoint, as nothing about the proposed CNOOC acquisition, and its financing, violated WTO rules on *trade* (not

investment)-related subsidies, or the PRC's specific commitments upon its accession to the WTO, or under trade-related investment measures (TRIMS) norms. The focus on Chinese providers of finance, whether state run banks, or the 70 percent state-owned shareholder of the bidder, somehow uniformly failed to identify the critical bridge financing provided by such all-American financial institutions as Goldman Sachs and JP Morgan, to be refinanced with CNOOC with debt issuances (and significant underwriting fees for the same financiers) soon after completion of the deal. Clearly something else, something rather pernicious, was at work given the hostile reception that greeted CNOOC's effort to act on the world stage.

### **The new/old rallying cry— “China isn't playing by the rules!”**

The CNOOC bid for Unocal also gave renewed voice to what already seems a tired refrain: “*China doesn't play by the rules.*” Peter Robinson, the vice chairman of Chevron who led the public relations effort for the CNOOC competitor, remained “on [this] message.” Whereas formerly the refrain had been heard on international trade matters and intellectual property rights protection and enforcement, it was now suddenly part of a heated chorus framing the far more sensitive sphere of cross-border acquisitions of controlling interests in U.S.-domiciled mega-corporations.

The truth is that the CNOOC bid signaled something rather different, and given China's reforms over the past two decades, something more profound. Not only did the CNOOC effort represent another significant step in China's complex and broad-ranging interaction with the world generally, but far more critically, it signaled a striking new phase of the PRC's behavior-changing entanglement with foreign and international legal, commercial, and governance norms, all with *direct* reform effects inside China. Thus, the CNOOC bid implicated precisely the *opposite* of a critique which accuses the PRC of “not playing by the rules.” With the Unocal bid, China, its government, and various Chinese commercial instruments were forced for the first time to take cognizance of, and play by, internationally-accepted rules—not merely in their business operations and external contracting, public disclosure, accounting practices, or the conventions of international M&A, but even with respect to internal corporate governance at the firms themselves. In this way, we might see China's new acquisition activity outside of its borders rather more grandly—as an important mechanism for

the encounter with, and absorption of, bedrock “rule of law” concepts and practices.

### **American perceptions of China and the Chinese, Chinese perceptions of foreign capital in China**

In the 1950s, American journalist and historian Harold Isaacs published an important book on American perceptions of China and India titled *Scratches On Our Minds*. The book synthesized the results of numerous surveys of Americans with respect to common ideas of those two great civilizations. Importantly, the surveys were directed to an “elite” population in America—diplomats, academics, well-traveled writers and intellectuals, and multinational business leaders. Isaacs' idea was that the perceptions of this group were in some ways more important than those of the American “everyman.” First, the elite group had in many ways encountered the reality of China and India, and might be thought to have realistic, nuanced impressions arising from such experience. Second, such persons would—by virtue of their leadership positions—have an ongoing involvement in dealings with those societies and making or implementing U.S. policy towards China and India. Isaacs' sad conclusion was that even these notionally well-educated, informed, and experienced policy makers and leaders operated with heads literally stuffed with damaging and simplistic clichés about China and India. In the Chinese case, these deep-seated attitudes swung between wildly divergent images of the “good” and “bad” Chinese, with no nuanced middle ground. On the good side: Pearl Buck's on-the-cusp Christians, or cheerful, diligent, poor, innocent, peasants, and Charlie Chan—benign, humble, problem-solving, intelligent, and deferential; on the bad side, the diabolical, mysterious, shadowy, cannibalistic, sinister, Dr. Fu Manchu, or, collectively, the rampaging hordes constituting a “Yellow Peril” threatening to swamp and overrun American “civilization,” or at least the American order. While the dichotomy that Isaacs identified may seem absurd or anachronistically racist in what we assure ourselves is a more enlightened age, it does seem to track nicely the dizzying swings in U.S. perceptions over the three decades between President Nixon's visits to Beijing and Shanghai in 1972, and current ideas about China as a distinct military, economic (commercial), and ideological “threat” or “strategic competitor.” It does not seem an exaggeration to identify these deeply-ingrained and easily processed ideas as one set of views informing American approaches to China's accelerating investigation of overseas acquisitions.

Turning the mirror, we might also point out that Chinese elites have long had equally negative perceptions of foreign (and particularly Western) involvement in China—politically, militarily, and of course commercially. This is a very long story, not easily elaborated in this kind of presentation. Suffice to say that this shared attitude was (and is) determined equally by xenophobia and the bitter experience of Western incursions into Qing Dynasty China from the early 19th century, and through the Opium Wars and the “unequal treaties” which pried treaty ports and sovereignty over Hong Kong Island from China, which in turn served in large measure to de-legitimize and topple the last Imperial dynasty. Even people in China who regret the abuses and chaos of the Maoist era approve of how the Communist victory in 1948-49 forced out of China the “imperialist-colonialist” powers, the United States included. So it is not surprising then that on the eve of China’s 1979 history-changing “Reform and Opening to the Outside World” strategy, China’s premier foreign language propaganda organ would proclaim: “*We do not allow foreign capital to exploit China’s resources nor do we run joint enterprises with foreign enterprises, still less beg them for foreign loans*” (from a 1977 *Beijing Review*). And yet, even before this statement was contradicted by thousands of Sino-foreign joint ventures, and China’s rise to the status as the World Bank’s largest borrower, there was an exception. Chinese policy makers had in fact started very early in the 1970s to set the groundwork for cooperation with foreign oil companies. This cooperation, focusing on hard-to-exploit “offshore” oil and gas fields (i.e., within China’s sovereign seas, but not onshore or dry land), started in the late 1970s, yet only after very significant Chinese internal disputes about a potential loss of sovereignty, China’s control of a strategic energy assets, and hidden foreign agendas seeking economic and political (and military) control. In fact, Chinese Communist Party elites in 1977 were saying exactly the same things about foreign participation in Chinese oil and gas production sharing arrangements as Senator Chuck Schumer, Chevron, and a large part of the U.S. House of Representatives were saying about a Chinese company’s bid for control of Unocal almost three decades later. That is one irony revealed in this particular corner of history; the other is that the commercial entity the Chinese government set up to bargain with and enter into production sharing contracts with the likes of Exxon, Mobil, Chevron, and others for the exploration, development, and production of these *Chinese* offshore oil and gas resources was none other than the China National Offshore Oil Corporation, then as now known by its acronym, CNOOC.

### **Acquisitive China— not falling “dominoes” but “falling icons”**

Some of the uglier visions conjured by the Isaacs survey in the 1950s seem to have been reanimated in 2004-05 by the spectacle of China’s global ambitions. For Americans of a certain age, the present climate recalls U.S. attitudes towards Japanese ambitions in the late 1970s and early 1980s, which were hostile even though Japan was a political and military *ally* for the United States. The signal transaction in those days was the acquisition by Japanese interests of an American icon—Rockefeller Center in New York City (perhaps closely followed by the Japanese takeover of the most American of businesses—Hollywood’s Columbia Pictures.) Today, Chinese companies also seem to be chasing America’s icons, with the ready help of America’s own financial institutions acting as lenders, bridge lenders, or private equity co-investors. At the same time, many American companies, iconic or not, are actively seeking to be bailed out by Chinese capital—another interesting and ironic reversal on China’s own use of foreign multinationals to finance or save bankrupt state-owned enterprises in China in the very earliest days of the Chinese reform. And what icons they are: CNOOC’s bid for Unocal, one of the original Standard Oil petroleum companies (the Rockefellers again); Shandong Hai’er’s US\$2.5 billion bid for Maytag (the defenseless Maytag repairman); Beijing Lenovo’s US\$1.75 billion acquisition of IBM’s personal computer business (for Wolverine fans, a lesser “Blue”). And the falling “icons” are not only American. In recent years, the world has witnessed other developed economy properties coming under PRC control: TCL’s acquisition of Thomson France’s TV business (RCA); Shanghai Automotive’s purchase of Korea’s number four auto-maker (Ssangyong Motors); the Minmetals bid to take over Canada’s Noranda (also owner of Falconbridge); Nanjing Auto’s takeover of the MG Rover assets in the United Kingdom; Huawei Technology of Shenzhen’s stalking of Marconi. . . . The list seems to go on and on, and worryingly for some outside China, seems to get longer.

### **How we got here from there**

These acquisitions of iconic foreign industrial properties are in fact the culmination of a 25-year process of investment and financing-related interaction between China and the outside world. China’s “Reform and Opening to the Outside World” policy of the late 1970s featured, among other things, domestic economic reform (and the slow march to a semi-marketized

economy), construction of a legal system (promulgation of substantive law and recovery of legal institutions), increased trade with foreign nations, and the attraction of foreign direct investment (FDI) into the PRC.

At least from the Chinese side, FDI was understood from its earliest days as a way to attract hard currency financing for China's bankrupt state-owned or controlled assets, and gain additional benefits like foreign technology, management know-how, distribution and marketing skills, and foreign sales channels for hard currency-earning exports. Foreign capital seemed happy to do its part, by donating capital, technology, and management expertise into China, all for a chance—however tightly restricted—at the rumored *nirvana* of one billion Chinese consumers. Regardless of the motivations on either side of the equation, the FDI program did serve as the exclusive vehicle for early introduction of great areas of commercial, corporate, and financial law into China, including items as basic as corporate legal personality, transferable equity interests, separation of owners and management (and in management, between a board and an executive corps), and a market for equity interests in enterprises.

In the early 1990s, China began to look to another mechanism to raise finance for the same moribund state assets—the domestic and then international capital markets. These ambitions spurred “corporatization” of asset groupings in China, and the issuance of stock by such new corporations to both domestic and foreign investors buying on China's new stock exchanges, and very quickly, foreign investors buying on foreign exchanges—in Hong Kong, then New York, then London, then Tokyo, and so on. Overall, this second interaction with the international capital markets—again, featuring Chinese issuers raising funds from foreign capital providers—proved beneficial for Chinese commercial legal developments, by introducing foreign securities laws and exchange regulation, a new world of disclosure and legal enforcement (both administrative and through private rights of action), international accounting standards, and internal governance requirements.

And yet, even as China saw the establishment of ever greater numbers of in-country FDI projects, or listings of China- or Hong Kong-domiciled issuers on the New York Stock Exchange (NYSE) via Securities and Exchange Commission-registered offerings, the Chinese government proved positively shy in calling Chinese enterprises to fulfill their destiny outside of the embrace of the PRC—allowing only tentative forays first into Hong Kong, and then in Southeast Asia. While large Chinese

companies established offices and sometimes subsidiaries throughout the West beginning in the mid 1990s, these were almost uniformly shell companies used to facilitate simple trading activities with foreign purchasers or vendors. That situation changed radically in the late 1990s, when individual Chinese enterprises—some old-style state-owned or controlled actors, others fiercely independent Chinese companies—began to look actively for investment deals abroad, a set of ambitions only subsequently sanctioned and supported by central policy makers under the so-called “Going Out” strategy. It is again beyond the scope of this presentation to speculate in detail on what is behind the now acknowledged fact of the “Going Out” strategy, or what high policy aims call for its rhetorical support by the central government. Here, one might point to the need of these companies to procure stable access to certain kinds of resources, and/or technology. Other, more manufacturing oriented companies are clearly after foreign distribution channels and thus access to foreign markets, better profit margins in better-developed product markets, and use of established “global” brand names. And certainly many bold and rather far-seeing Chinese managers believe they need to “Go Out” to test and strengthen their companies in a truly competitive, and global market, far removed from the cozy monopoly-based market that remains a substantial part of China's industrial economy.

For present purposes, it is most important to recognize that the “Going Out” strategy is in most cases being led by Chinese enterprises themselves, rather than the central government. (For instance, in late 2005, it was revealed that the CNOOC bid for Unocal was undertaken almost entirely at the initiative of CNOOC, and over the fierce objections and stubborn hesitations of PRC central government actors. This may have lulled CNOOC executives [and their advisors] into a false sense of achievement. Perhaps they thought if they had managed to convince their political masters to allow them to proceed with the bid, it would be so much easier to convince Unocal shareholders to accept the higher price offered.) In addition, the Chinese government has in the last two years also created or ameliorated the legal basis for such outbound investment activity, and thus conformed the law (or removed legal restrictions) which had previously worked to restrain such activity. (Here, most of the restrictions were sourced in foreign exchange regulation and government permissions for offshore holdings.) Most important, this outbound push has caused the

## Initial contest

### UNOCAL and its suitors (to April 4, 2005)

#### 2004

- **End of 2004**—Unocal is “shopped”—discussions with both Chevron and CNOOC;
- **December 26**—Unocal and CNOOC Chairman meet to discuss a possible deal (CNOOC Ltd. board not advised of the meeting);

#### 2005

- **January 6**—*Financial Times* reports that CNOOC is considering making a bid for Unocal; *Los Angeles Times* reports a CNOOC bid of US\$13 billion;
- **January 6**—Chevron delivers a letter to Unocal, indicating strong interest in purchasing Unocal;
- **January–early February**—CNOOC lobbies PRC government departments in preparation for a possible bid for Unocal;
- **February 26**—Chevron’s initial bid: all share deal, 0.94 Chevron shares for each share of Unocal;
- **February 26**—Unocal board determines that Chevron’s offer is insufficient;
- **March 1**—Unocal notifies Chevron that the February 26 Chevron bid is refused;
- **March 1**—Unocal in contact with CNOOC and ENI (Italy) as alternative bidders, and gives each until March 7 to offer a price;
- **March 7**—CNOOC Ltd. communicates preliminary bid range of US\$59.00–62.00 per Unocal share (US\$16.0–16.8 billion)—immediately rejected by Unocal;
- **March 29**—Chevron raises its February 26 bid 10 percent—still an all share deal, 1.03 Chevron shares for each share of Unocal;
- **March 29–30**—two-day meeting of CNOOC Ltd. board; foreign, non-executive, directors are informed of a potential bid for the first time, and vote to block CNOOC Ltd. bid; CNOOC signals to Unocal that a bid will not be forthcoming on March 30;
- **March 30**—Unocal board, upon receiving Chevron’s revised offer of March 29, decides to terminate negotiations with ENI, and gives CNOOC until April 2 to make an offer;
- **March 31**—CNOOC Ltd. board meets, but is still unable to agree on the making of an offer, or a price; one foreign, non-executive, director resigns for “health reasons”;
- **April 1**—CNOOC board in disarray, not even able to convene a board meeting;
- **April 1**—the day before an anticipated bid from CNOOC Ltd., Chevron agrees to sweeten its bid again, by giving Unocal shareholders a choice of an all share deal, cash and share deal, or all cash deal: (i) 0.7725 Chevron shares plus US\$16.25 for each Unocal share; (ii) 1.03 Chevron shares for each Unocal share; or (iii) US\$65.00 per Unocal share;
- **April 2**—Unocal board meets, decides to make a final decision on April 3;
- **April 3**—CNOOC Ltd. board meets again, but is still unable to make an offer;
- **April 4**—Unocal and Chevron sign a definitive merger agreement for combined cash/stock deal with Unocal, at value of US\$60.65 per share (US\$16.5 billion) (this includes “force-the-vote” clause [Chevron as acquirer can force Unocal board to put the Chevron bid to a Unocal shareholder vote] and US\$500 million “break up” fee).

full range of Chinese actors—from government departments to enterprises to individual managers and investors—to encounter a whole menu of laws, regulations, institutions, customs, and more, that govern and shape investment and commercial activity in political economies outside of China.

#### The CNOOC bid for Unocal—the facts

We now turn briefly to the very specific situation which caused so much worry in the United States, the CNOOC Ltd.

bid for Unocal during the summer of 2005. As it developed, the proposed transaction involved CNOOC Ltd.—the Hong Kong-domiciled, 70 percent-controlled, subsidiary of Beijing’s purely state-owned enterprise, China National Offshore Oil Corporation or “CNOOC”—making an *all cash* bid for Unocal, that bid supported by proposed financing of more than US\$7 billion from CNOOC (to be swapped for shares in CNOOC Ltd. within two years) and US\$6 billion from a syndicate led by

the Industrial and Commercial Bank of China (ICBC), but with JP Morgan Chase and Goldman Sachs participating with bridge financing (to be taken out with the issuance of debt by CNOOC Ltd. after completion of the acquisition of Unocal).

The major points timeline for the rise and fall of CNOOC's efforts may be recited as follows: At the end of 2004, Unocal was being "shopped" in America and internationally. In December of 2004, CNOOC was approached by Unocal, with Unocal executives asking CNOOC if the Chinese company would be interested in acquiring the American company. At the beginning of 2005, the *Financial Times* reported (falsely as it turned out) an imminent bid for Unocal from CNOOC. This, perhaps by design, conjured an immediate indication of "strong interest" from Chevron on January 6, and then a formal all stock bid from Chevron on February 26, valuing Unocal at over US\$16 billion. All through this period, and then March, CNOOC was not able to make a bid—the bid requested of it by Unocal—because independent directors on the board of CNOOC Ltd. could not be persuaded to vote in favor of such an action. (Their formally articulated concerns focused on the crushing debt load CNOOC Ltd. would have to take on to complete the purchase, and the hugely dilutive effects for non-CNOOC shareholders of future, necessary, issuances of stock by CNOOC Hong Kong. These outside directors may in truth have been alienated by the way in which the proposal was brought to them by CNOOC executives and CNOOC Ltd. executive board members at the last minute, and seeking a "rubber stamp.") Insiders also report real battles between CNOOC executives and the highest-level Chinese central government actors, many fiercely opposed to the proposed takeover bid by a Chinese company for an American oil company. Unocal finally gave CNOOC Ltd. until April 2 to post a bid, which caused Chevron to raise its own offer on April 1. CNOOC Ltd. remained stymied at the board level, and thus with no Chinese bid forthcoming over the night of April 2-3, Unocal signed a binding merger agreement with Chevron on April 3, 2005, valuing Unocal at approximately US\$16.5 billion. In an example of skilled lawyering, the Chevron lawyers included in the merger agreement a "force the vote" clause, which contractually obligated Unocal, at Chevron's direction, to convene a shareholders' meeting to approve the sale to Chevron. (This made the Chevron strategy going forward rather simple—if and when a competing Chinese bid was forthcoming, Chevron needed only to introduce doubt into the minds of Unocal shareholders about eventual U.S. govern-

## Revised contest CNOOC re-enters the fray

(June 1 to August 10, 2005)

- **June 1**—Fu Chengyu, Chairman of CNOOC and CNOOC Ltd., works to convince CNOOC Ltd. board that CNOOC Ltd. should make offer for Unocal;
- **June 10**—U.S. Federal Trade Commission raises no objection to Chevron-Unocal merger;
- **Early June**—Continued resistance on CNOOC Ltd. board from foreign-citizen independent directors—they articulate concern about the crushing debt load CNOOC Ltd. would have, and the dilutive impact on minority shareholders, etc.;
- **June 22**—CNOOC Ltd. board votes unanimously to make bid (Goldman Sachs-employed independent director abstaining to avoid "conflict of interest");
- **June 22-3**—CNOOC Ltd. makes bid for Unocal—US\$67.00 per share or US\$18.5 billion, all cash (11 percent higher than Chevron's signed US\$16.5 billion offer);
- **June 22-mid July**—CNOOC Ltd. and Unocal negotiate draft Merger Agreement in New York;
- **June 24**—41 members of U.S. Congress send letter to President Bush urging a "thorough review" of the CNOOC Ltd. offer;
- **June 30**—U.S. House of Representatives votes 333-92 to bar the U.S. Treasury from using any of its funds to "recommend approval" of the CNOOC Ltd. bid per the CFIUS process; and 398-15 non-binding resolution, expressing concern that the CNOOC Ltd. bid, if completed, could "threaten to impair national security" (CFIUS standard);
- **June 30**—U.S. Securities and Exchange Commission approves proxy and tender offer materials for Chevron-Unocal deal;
- **July 1**—CNOOC Ltd. makes pre-emptive request of CFIUS to commence investigation of announced CNOOC Ltd. bid and proposed transaction;

ment approval, force a shareholders' meeting, and allow the Unocal shareholders to approve the bid in hand (Chevron's lower-priced deal) over a possibly unstable but richer option [CNOOC's higher bid].) Soon thereafter, the shareholders' meeting required under the governing merger agreement was set for later in the same summer—August 10, 2005.

More than two months later, CNOOC management finally cajoled the dissenting CNOOC Ltd. board members into place,

- **July 7**—NSC Director Steven Hadley indicates that CFIUS review will only occur once the deal is “finalized in some way” (contradicting U.S. Department of Treasury, which had indicated review could start before);
- **Mid-July**—PLA General Zhu Chenghu quoted as saying that the PRC might use nuclear weapons against the United States if the United States intervenes over Taiwan;
- **July 13**—CNOOC Ltd. board authorizes CNOOC Ltd. Chairman Fu Chengyu to increase all cash offer, from US\$67.00 to US\$69.00 per share, but not exceeding US\$70.00 per share;
- **July 13**—U.S. House of Representatives Armed Services Committee holds hearings at which the CNOOC bid is uniformly denounced;
- **July 14**—CNOOC does not raise its bid;
- **July 14**—Unocal board meets to consider competing Chevron and CNOOC Ltd. offers;
- **July 15**—Unocal board continues to meet—it does not recommend CNOOC Ltd.’s higher all cash offer over existing Chevron cash/stock offer, but resolves to continue looking at a CNOOC Ltd. offer, certain conditions being met (promise of Unocal divestitures in the United States to get government approval, and some kind of escrow fund to assure CNOOC performance and funding of Unocal-Chevron “break up” fee);
- **July 15**—CEO of Unocal calls Chairman of CNOOC Ltd., asks for CNOOC Ltd.’s “best offer”;
- **July 16**—Chairman of CNOOC Ltd. responds: CNOOC Ltd. agrees to raise its offer to US\$69.00 per share, but only if Unocal pays the Unocal-Chevron “break up” fee (US\$5 million) and works with CNOOC to convince the U.S. government to approve the deal;
- **July 19**—Chevron formally increases its offer to US\$63.00 per share;
- **July 19–20**—CNOOC Ltd. does not raise its bid;
- **July 20**—U.S. Congress passes Schumer amendment to the foreign operations spending bill; amendment holds that the President may not approve proposed acquisitions by foreign government-controlled entities in the United States until the U.S. State Department reports to Congress on whether or not the foreign government permits U.S. firms to “purchase, acquire, merge or otherwise establish a joint relationship” with a company based in the country, such report to be delivered 30 days prior to the proposed acquisition;
- **July 25**—U.S. Congress adds amendment to the proposed energy bill, authorizing the Department of Energy, the Department of Defense, and the Department of Homeland Security to undertake a four-month investigation of the effects of China’s worldwide energy demand, and providing for a three-week period after delivery of this report before which CFIUS would be permitted to submit a recommendation to the President (lengthening the CFIUS review period from a maximum of 90 days to 141 days);
- **Late July**—rumors on Capitol Hill that the Department of Defense, not the Department of Commerce, will undertake CFIUS investigations;
- **Late July**—U.S. Senate asks Secretary of Commerce to investigate whether or not CNOOC Ltd. proposed financing violates WTO rules on subsidies;
- **August 2**—CNOOC Ltd. formally withdraws its tender offer for the stock of Unocal (only eight days from the Unocal vote on the Chevron transaction). In its withdrawal statement, CNOOC Ltd. said that it would have considered raising its bid for Unocal prior to the Unocal board vote, but for the fact of the “impact of the U.S. political environment” (*meiguo zhengzhi huanjing de yinxiang*);
- **August 2**—six percent rise in CNOOC Ltd.’s share price on the NYSE;
- **August 10**—Unocal shareholders vote, accepting Chevron’s amended offer.

and on June 22 CNOOC Ltd. announced a much higher bid for Unocal (US\$18.5 billion), and an *all cash* one at that. Chevron immediately went into action, conjuring the anxiety, fear, and concerns alluded to at the start of this presentation. At this point, CNOOC’s only hope was that the political uncertainty immediately rumored for the Chinese bid could be made a non-issue by early, *hypothetical*, approval of the Chinese acquisition by the Commission on Foreign Investment in the United States

(CFIUS), the U.S. government interagency group tasked with analyzing foreign bids for American assets or equity interests under Exon-Florio. (If Unocal shareholders were permitted to believe that the acquisition would be approved by the U.S. government, they would likely have rejected the lower Chevron bid to take more value [and all in cash] under the CNOOC offer.) Those hopes were dashed when, on July 7, the Bush administration’s National Security Advisor let it be known

publicly that CFIUS would not make a pre-transaction review of the bid or CNOOC's pre-filed Exxon-Florio submission. Unocal directors were still required to fulfill their fiduciary duty to Unocal shareholders however, and so on July 15 refused to recommend either the agreed Chevron deal or the higher CNOOC bid, but asked CNOOC for its final "best offer." That was forthcoming a day later, when CNOOC raised its bid to US\$69.00 per share. Three days later, Chevron raised its own agreed offer—albeit to a level still lower than the Chinese bid, or US\$63.00 per share. In these couple of weeks, the anti-China and "China threat" rhetoric in the American Congress grew almost unbearably over-heated, with several legislators introducing bills specifically targeting CNOOC's proposed acquisition of a U.S. energy company. CNOOC decision makers saw that no bid from a Chinese company, no matter how stable, or how rich, would be allowed to pass over the significant political hurdles now in place. Accordingly, CNOOC formally withdrew its offer for Unocal on August 2, 2005. On August 10, 2005, Unocal shareholders approved the merger of Unocal with Chevron.

### **CNOOC specifically— poster child of enmeshment with "the rules"**

In many ways, the critiques and fear-mongering targeted on CNOOC proved almost cruelly ironic. For CNOOC is not the mere agent of a newly rapacious Chinese superpower, or the servant of its insatiable appetite for energy resources. Instead, CNOOC represents one of the first and best examples of a significantly independent modern Chinese enterprise, exposed very early in China's "Opening to the Outside World" to commercial and investment activity under law, and fully implemented notions of transparency, disclosure, and internal firm governance.

CNOOC's development path provides a perfect example of why observers simply *must* differentiate between the origins and control of the Chinese players now stepping onto the world stage. For instance, Lenovo, which acquired IBM's PC business, is uniformly referred to as a "PRC state-owned" or "government controlled" entity in the press and business literature. This is a reference to the fact that the Chinese Academy of Sciences—a Chinese social academic unit under the State Council—was one of the original promoters of Lenovo (then "Legend") when it became the first successful low cost producer of computer hardware in China. (The Chinese Academy of Sciences acted in much the same way by providing seed funding and technical expertise to the Stone Corporation, which has not achieved

## **The CNOOC Unocal bid discourse**

- "One of the reasons your price of gasoline is going up is . . . economies like China and India are demanding more oil in a limited supply—in a market that's of limited supply." (President George Bush)
- "They're not playing by commercial rules; it's not fair trading. . . . Clearly this is not a commercial competition. We are competing with the Chinese government, and I think that is wrong. . . . We [Chevron] will produce more oil and gas, and put it into the world supply. . . . We'll put oil on the market in a commercial way and it'll be sold to the highest bidder. [CNOOC will use the oil it produces for domestic consumption, which will yield] less oil on the world market, which means higher prices for U.S. consumers and all consumers." (Peter Robinson, Vice Chair of Chevron)
- "My biggest concern is the preservation of Unocal's energy assets in friendly hands. If a company is owned by a foreign government, its loyalty is going to be to that government." (Rep. Richard Pombo, Republican, California)
- "Should we work with China? Yes. Should we turn over our government, our business to China? No, we shouldn't." (Rep. Carolyn Kilpatrick, Democrat, Michigan)
- "Do we want a foreign power, whose military intentions in the long term are not clear, to own energy assets inside our border?" (Larry Wortzel, U.S. China Economic and Security Review Commission)
- "I'm a free trader, but being a free trader isn't synonymous with being a chump. He [U.S. Secretary of the Treasury John W. Snow, making no comment on the CNOOC bid] should have said, 'You bet we're going to look at it.'" (Sen. Ron Wyden, Democrat, Oregon)
- "Remember, to the Chinese everything is related: the economics, the diplomacy, the military posture. It's all one." (Senior Administration Official, *The New York Times*)

the success of Lenovo.) How different Lenovo—even with the participation of a government-run academic think tank—is from Air France or PetroCanada or any entity that is traditionally conceived of as "state owned." Similarly, Hai'er, which made a run at Maytag in partnership with U.S. private equity funds, is government financed and promoted, but the "government" in this case is a provincial level government in China which has

- “[CNOOC is] an organ, effectively, of the world’s largest communist dictatorship. [This transaction] should be beyond the pale, given the nature of the Chinese government.” (James Woolsey, former director, CIA)

- “Does anybody honestly believe that the Chinese would let an American company take over a Chinese company?” (Sen. Charles Schumer, Democrat, New York)

- “[China] already has too many Treasury [bonds]. So they’re looking to buy assets. Chinese companies are growing, they are ambitious, they want to be global players, they want to have global brands, and in the case of oil they are kind of obsessed with assuring energy security for the long run so they’re buying up all the oil and oil rights they can find.” (Clyde Prestowitz, former U.S. Trade Representative)

- “With China on a buying binge for raw materials to feed its ever-expanding economy, it was inevitable that it would eventually go beyond the more modest corporate purchases it has already begun and make a grab for something the United States really cares about.” (*New York Times* editorial, June 26, 2005)

- “There are a lot of what I call ‘silk purse’ deals, in which multinational companies sold divisions which weren’t profitable, and in many cases Chinese companies were the only logical buyers of these dog divisions. Their owners could not make them profitable, but the Chinese use them to help jump-start their own international presence.” (Jack Lange, Paul, Weiss et al.)

- “[China’s drive to acquire assets] is consistent with government policy to secure long-term supplies. But China is too chaotic and fragmented to think that there is one central coordinator. China does not have a central ministry like Japan’s Ministry of Economics, Trade, and Industry. A lot of what is happening is a bottoms-up [*sic*] phenomenon with companies under pressure from their shareholders to grow, and since they are cash-rich, to deploy that cash efficiently.” (Fred Hu, Goldman Sachs)

- “The assets involved in the Unocal transaction are not on the scale or geographic location to make them of critical importance to U.S. energy security. Many of the important Unocal assets are actually located in Asia, and the energy produced there would never flow to the United States.” (Amy Jaffe, James A. Baker III Institute for Public Policy)

- “. . . Unocal is not ‘an American energy asset’ . . . . The United States does not own or control Unocal and has no claim on the company’s gas and oil reserves, which are dotted across the globe. And Unocal does not reserve its oil for American consumers. Like every other oil company, it sells to the highest bidder. In the end, its responsibility is to its shareholders, not to American national security, as some of Unocal’s recent activities (such as working with the Taliban on a potential pipeline) might indicate.” (James Surowiecki, *The New Yorker* magazine)

- “A lot of politicians are leveraging China bashing. The only thing [CNOOC] can do is bid higher.” (Unocal shareholder, quoted in the *Wall Street Journal*)

- “It’s essential that we not put . . . our future at risk with a step back into protectionism.” (Alan Greenspan, Chairman, Federal Reserve)

- “CNOOC’s bid to take over Unocal of the United States is a normal commercial activity between enterprises and should not fall victim to political interference.” (PRC Foreign Ministry)

- “I think this is a normal business activity. The relevant people should not make a fuss and should not interfere in business deals for political reasons.” (Liu Jianchao, PRC Foreign Ministry)

- “The idea of buying Unocal was purely initiated by our company. The idea did not come from the government, and not one cent of government money is involved in the deal. I don’t think there’s anyone in the government who understands our business.” (Fu Chengyu, Chairman and CEO of CNOOC)

acted to facilitate capital accumulation and investment, and foregone some tax revenues in exchange for a small equity interest, but not kept a strong hand in the running of what is an entrepreneurial business controlled by a charismatic individual. (This of course is not to say that all PRC entities identified as “state-owned” are innocent of state or government control —MinMetals, the proposed acquirer of Noranda in Canada, is

in fact a direct creation [as the name indicates] of the former Ministry of Metallurgy.)

Each of these examples should prod us to examine closely the genesis and nature of Chinese enterprises increasingly active on a global scale, such as CNOOC specifically. For if CNOOC is representative of anything, it is for identification of domestic and internal firm effects arising from China’s or “China Inc.’s”

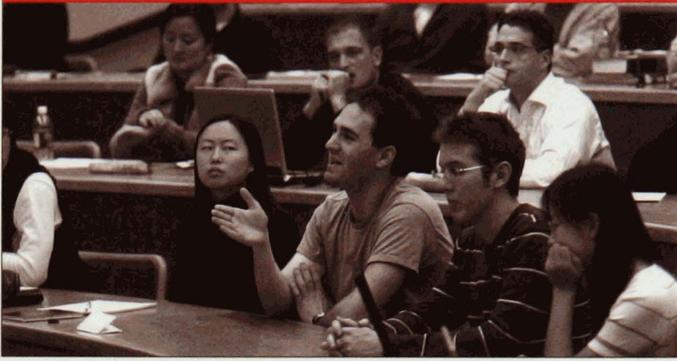
Nicholas C. Howson delivers his lecture ...



participation in the global economy and commercial legal order. CNOOC's path is emblematic of the path future Chinese enterprises will walk as they truly "Go Out" into the world—first, developing their business in an increasingly marketized domestic economy functioning under law; then, after corporatization, pursuing business activities under a host of objectively-rendered commercial, legal, financial, and corporate governance constraints; then raising capital on developed overseas capital markets and encountering the significant demands of foreign securities and exchange regulation; and finally, in the process of making offers for public and private foreign companies, working with and being shaped by a wholly different legal, contractual, and regulatory context, from the negotiation of sophisticated acquisition agreements (enforceable before courts or arbitral bodies) to the complete range of takeover regulation and proxy rules. In addition, there will no doubt be serious and sustained enmeshment with other regulatory systems if and when Chinese companies are successful in gaining control of foreign industrial properties—for example, other than ongoing corporate disclosure and securities regulation (in the post Sarbanes-Oxley [SOX] United States, increasingly pertaining to internal firm governance), environmental, occupational health and safety, labor, pension, etc. stipulations. (Consider the experience of Lenovo as it moved its headquarters to the United States, and suddenly found its operations and work force largely subject to a whole nest of foreign laws and regulations.)

The CNOOC case specifically is highly instructive. CNOOC was conceived in the late 1970s, and formally established in the early 1980s, as a corporate representative of the sovereign, or the People's Republic of China. (This happened even before there was a corporate law in China, much less a law formally governing state-owned enterprises [or "enterprises owned by all the people"].) Having made the politically sensitive decision to invite foreign oil companies into commercial production sharing arrangements to explore, develop, and hopefully produce from China's then untapped offshore oil and gas resources, China needed to create, from whole cloth, an entity which could sign production sharing contracts with interested foreign concerns. CNOOC was thus established, given franchise rights over exploration areas (and contract blocks within those areas), and commenced accepting bids

from foreign parties for the negotiation and implementation of such production sharing arrangements. (Distinguish the other two large national oil companies from the PRC: China National Petroleum Corporation [CNPC], now known as PetroChina, was effectively the encapsulation of the "upstream," onshore-focused, line ministry, the Ministry of Petroleum Industry; Sinopec, the other major Chinese oil company, was the monopoly participant in all "downstream" activities. A reorganization in the late 1990s saw CNPC and Sinopec swapping some [onshore] upstream and downstream assets, while CNOOC aggressively developed greenfield downstream projects but gave up none of its offshore production sharing contracts entered into with foreign concerns). Over more than two decades of work, CNOOC concluded a large number of production sharing deals, entered into with some of the world's most sophisticated oil and gas companies, all focused on finding and extracting hydrocarbons from offshore blocks. In those two decades, many saw CNOOC as the exemplar of a new kind of Chinese concern—admittedly a corporate front for the state, but forced to enter into detailed production sharing contracts (subject to binding international arbitration) modeled closely on contractual forms used by Indonesia and Brazil, with key input from Norway's national oil company. (CNPC, the state-owned enterprise successor to the Ministry of Petroleum Industry, was never forced to do this in its upstream work, and was only permitted to enter into production sharing contracts with foreign oilers in 1994.) While a step forward for the introduction of law and legal instruments into the basic life of one of China's largest concerns, many of these facially sophisticated contracts were not subject to a great deal of negotiation (except for a narrow set of commercial terms, and the negotiable "X factor" which divided up production based on different volumes achieved). And yet, these contracts did provide, for the first time in reform-era China, extremely detailed contractual arrangements governing a joint project's exploration, development, and production phases, sophisticated tracking of expenses and investment to effect cost and then investment recovery, and allocation of revenue sharing (after investment and cost recoveries were fully paid out) very similar to the "waterfalls" seen in U.S.-style partnership agreements. Moreover, these relationships between CNOOC and foreign oilers were implemented as commercial contracts subject to binding dispute resolution



... and the audience members ask questions.

(as opposed to state-to-state relationships or bureaucratic commands), and were (and are) actually contested in several arbitrations or threatened arbitrations over the years.

CNOOC's second major brush with law, and markets operating under some kind of rule of law, was the listing on the Hong Kong Stock Exchange of a newly-created and 70 percent-owned subsidiary—CNOOC Ltd., the summer 2005 suitor for Unocal. (The benefit of many of the better production sharing contracts originally entered into by CNOOC with foreign companies was assigned to this Hong Kong-domiciled listing vehicle.) That phenomenon left CNOOC, *qua* the representative of the PRC on numerous production sharing contracts, learning many of the same hard lessons absorbed by other Chinese state-owned firms seeking finance in developed capital markets. CNOOC went through a difficult period of corporate reorganization, property (contract) rights transfers, and abundant public disclosure, all in the service of capital raising from mostly foreign investors (granted relatively little governance power in exchange for their share investment). The process even allowed CNOOC to encounter the fickle capital markets, with CNOOC Ltd.'s first attempt at an IPO in 1999 pulled back at the last minute and then re-launched in 2001.

Some may object to any portrayal of the 2001 CNOOC Ltd. listing in Hong Kong as progress in the terms argued here, pointing to the unhealthy phenomenon of an entirely dominated listing subsidiary, and a 30 percent body of passive and disempowered public shareholders positioned alongside an unconstrained and 70 percent controlling (Chinese state) shareholder. This would be wrong, as it fails to take account of the Hong Kong, U.S. and NYSE securities and exchange law and regulation which immediately impacted CNOOC Ltd.'s internal governance (especially after the passage of SOX), the real rights of minority shareholders under those external regulatory systems, and transactional rules which call for disinterested director or shareholder votes, exchange approvals, or the like, prior to implementation. Again, realists might see shareholder votes mandated at any 70 percent single shareholder-controlled company as an empty formality. CNOOC itself disproved this view when in 2004 another of its Hong Kong-listed subsidiaries—China Oilfield Services Inc.—was blocked from diverting 40 percent of its US\$148 million revenue to another CNOOC-controlled PRC-domiciled finance entity. Sixty-three percent

of the China Oilfield Services Inc. shareholders voted to block the diversion of funds from one CNOOC subsidiary to another, that shareholder vote being required by Hong Kong Stock Exchange rules. (It is fascinating to see these same transactional rules, many of which limit the opportunism of controlling shareholders, subsequently imported directly into the domestic Chinese legal system, via China Securities Regulatory Commission and Shanghai Exchange regulation.)

Aspects of the Unocal bid experience itself support the idea that CNOOC and its top management, in seeking to act outside of China, encountered serious constraints on their behavior that they would never have faced were CNOOC acting as a large SOE in a purely Chinese context. CNOOC was forced to engage directly with accepted or mandated corporate governance norms and rules designed to protect real (and minority) shareholders. It is now known that CNOOC executives were intent on having CNOOC Ltd. launch a bid for Unocal in the early part of 2005, but that the transaction was frustrated solely due to the opposition of at least one and perhaps several independent (and all foreign national) board members at the CNOOC Ltd. level. (While various rationales are rumored for the objections, suffice to say that the non-executive CNOOC board members may have harbored resentments over the way in which the parent company and its leaders went to the full CNOOC Ltd. board at the very last minute as a “rubber stamp.”) Observers outside China must recognize what a profound difference this represents: When previously would any Chinese state-run giant, even if “corporatized” (or “reformed” into a corporation with a board of directors, executive management, shareholders, etc.) have been constrained in any way on a proposed acquisition, especially by board-level actors? CNOOC Chairman Fu Chengyu, by June of 2005 forced by his non-executive directors to delay the bid for 6 long months, and then re-enter the battle with an offer for Unocal that was for US\$2 billion higher than the bid CNOOC might originally have made, said tellingly, if rather wistfully, “*Our independent directors believed they needed more time to further evaluate the value of Unocal. This showed the good practice of corporate governance.*” Rarely in the history of China's reform has the “good practice of corporate governance” been so keenly felt—or so costly! Even when the board of CNOOC Ltd. was finally cajoled into launching the bid (and not without some continued resistance

from CNOOC Ltd. board members and aspects of the PRC central government), the Hong Kong-listed company would have been forced to gain the approval of a sufficient number of its public shareholders, as required under Hong Kong corporate law and rules governing issuers listed on the Hong Kong Stock Exchange. And finally, of course, if the bid was to be allowed to go forward, it would have had to comply with the web of U.S. public takeover regulation, including the Williams Act (Section 14(d) of the Securities Exchange Act of 1934 (34 Act)) and the tender offer rules, the notifications required under Section 13(d) of the 34 Act, continuing disclosure by the bidder and *its controlling shareholders*, and been subject to the full scope of U.S. anti-manipulation and anti-fraud rules and jurisprudence, not to mention the rather sobering civil liability provisions implicated.

And ultimately the bid would have required approval by a shareholders' vote of the target, Unocal, with or without the recommendation of the Unocal board. Again, to outside observers, this may seem to be an insignificant process, or at least one where Unocal shareholders could have been bribed with an all cash Chinese offer (that "bribe" being financed, directly and indirectly, by the PRC's treasury). Yet, that understanding does not take into account what has been business as usual for the largest and most privileged Chinese state-owned enterprises in the decade or so that they have grown to their current size and ambition. Never, in the internal Chinese domestic markets, have players of the size and influence of a CNOOC implemented transactions (including large scale corporate M&A or even public markets financing transactions) other than in accordance with the explicit command and say-so of the central government (or its line-ministries), without any real thought of what target shareholders might think, or public rules and regulations, much less contractual constraints, designed to inform participants' behavior and protect owners. By seeking to acquire the shares of Unocal, CNOOC placed itself at the relative mercy of the many shareholders of Unocal who—regardless of the relentless public relations campaigns being fought by both CNOOC and Chevron—had real decision-making power in respect of CNOOC's ambitions.

### **We're all rule abiders now . . .**

CNOOC's bid for Unocal then placed "China Inc." into a brave new world, and entangled a previously unconstrained, state-created, oil giant in a web of laws and regulations governing everything from internal corporate governance to external market transactions. Whether or not people in the United

States recognize this immediately, or understand the deep and abiding effect such constraints and procedures will have on the behavior of Chinese corporations as they step into the world, the fact is certain. It is for this reason that any late-stage denial of a successful offer for Unocal by CFIUS in the United States (were CNOOC to have gained approval of the deal at the Unocal shareholder level)—*on anything other than legitimate and well-considered national security grounds*—would have been a disaster for the ongoing socialization of CNOOC and "China Inc." An unreasoned denial by a supposedly objective U.S. agency would have signaled that the laws and governance rules which CNOOC and other Chinese corporate actors are just coming to terms with do not really matter and—in the style of many Chinese ministries which have in the past denied or limited foreign investment in China on an entirely discretionary (or plainly xenophobic) basis—raw political power, rhetorical heat, and foreign "threat" concepts rule the day. That would be a terrible lesson for China's emergent companies to learn at this time in world history, or more importantly, from such a teacher.

China is changing domestically, and specifically in the way it is being governed by rule of law, as opposed to pure political or bureaucratic power. Of course, much of this change is due to organic development inside China as its economic system comes to resemble more closely a market economy, and participants in that economy demand property and contractual rights, and a stable legal system to protect those rights. However, these domestic legal system changes are also clearly due to China's increasing involvement in the global market for ownership interests and corporate control of industrial and service properties. Without doubt, China has worked hard over more than 20 years to implement "legal construction" at home. However, it is equally certain that the effect of China's "Going Out Strategy," and the resulting entanglement with *external* legal requirements and norms, is having a direct effect in binding China and Chinese actors to radically different ways of acting *inside* China—ways which affect everything from internal boardroom dynamics, the status and powers of the previously ignored minority shareholder, and the individual acting to protect his or her rights "under law."

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