

UNITED STATES COUNCIL FOUNDATION

Investment Subsidies for Cross-Border M&A: Trends and Policy Implications

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United States Council Foundation
Occasional Paper No. 2
April 2008

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Executive summary

Headline takeover bids made by subsidized foreign firms, coupled with the rise of sovereign wealth funds (SWFs), have excited public sensitivity to cross-border M&A. In addition to raising fears over “stealth” acquisition of U.S. assets, these transactions can also have adverse consequences for non-subsidized home firms that are outbid by subsidized rivals abroad. When confronted with both pressures from domestic firms that have been outbid and constituents alerted by the increasing number of foreign takeovers, Congress is prone to enact legislation that unnecessarily restricts the free flow of investment into the United States.

During the past few years, threats to the open U.S. regime for foreign investment surfaced in response to acquisitions proposed by the China National Overseas Oil Corporation (CNOOC) and Dubai Ports World. Invoking broad “national security” concerns some members of Congress made misguided attempts to expand the oversight mandate of the Committee on Foreign Investment in the United States (CFIUS) beyond the core realm of national security to include economic criteria. Currently, the open U.S. investment climate is under scrutiny due to the recent string of investments made by sovereign wealth funds (SWFs). Concerned that SWFs may deploy government capital for non-commercial means, Congress and the Treasury are now exploring whether the U.S. government should play a role in screening transactions. In this paper we consider what measures can be taken to avoid the temptation of broad-brush, protectionist legislation in response to subsidized M&A or SWF activity.

We begin by analyzing recent trends in cross-border investments and present three case studies of contentious M&A bids. We then explore a range of possible public responses to subsidized M&A bids and SWF activity, and the merits of addressing these issues through existing mechanisms at the OECD, the IMF, the WTO, and the European Union. We conclude that a multilateral compact would best avert not only the possibility of widespread, indiscriminate investment protection legislation but also the danger that M&A subsidies offered by one country would spark a round of competitive subsidy emulation by other countries. We also recommend disclosure by sovereign wealth funds when they acquire equity shares outside their home countries. We realize that pressure for protectionist legislation will likely increase before a multilateral compact on investment subsidies can be agreed. Therefore we also suggest a set of interim measures to begin addressing investment subsidies in a manner that preserves an open investment climate, both in the United States and globally. To be clear: we do not contend that subsidized M&A or non-transparent SWF dealings pose a “clear and present danger.” We do suggest, however, that these issues merit thoughtful consideration well before a political confrontation occurs.

While subsidized M&A or non-transparent sovereign wealth dealings do not pose a “clear and present danger,” they merit thoughtful consideration well before a political confrontation occurs.

Introduction

Fear of “invasion” by “advantaged” foreign investors is an old concern. During the 1960s, French President Charles de Gaulle complained of the dollar’s “exorbitant privilege,” a criticism partly directed against American multinationals that expanded their operations in Europe after World War II.¹ As well, between the 1950s and 1970s, many developing countries rejected multinational firms and direct investment. By the 1980s, however, most countries had changed their stance to welcome multinational enterprises (MNEs) and FDI.

More recently, another nuance has emerged. Some governments have extended policies that were typically used to stimulate domestic industry – e.g., interest rate subsidies and corporate tax relief² – to encourage overseas expansion by “their” MNEs. Domestic firms whose bids were topped by foreign rivals have objected to subsidized M&A activity. In some cases, the general populace has objected to the foreign acquisition of natural resource firms, especially petroleum companies. The official response has been a limited backlash against foreign takeovers in the countries that are home to acquired companies.

While the number of contentious deals has so far been very small, even a single contested acquisition might trigger an impulsive Congressional response.

American tensions flared in the context of the bid by China National Overseas Oil Corporation (CNOOC) for the U.S. oil firm Unocal. Chevron, the rival and ultimately successful bidder, contended that subsidized finance supplied by the Chinese government enabled CNOOC to offer an artificially high price for Unocal. The M&A subsidy issue has also erupted in other high-profile cases: the European Commission’s ruling against the French government’s subsidy of Électricité de France (EDF) and a bid by the Korean firm Doosan for the Bobcat subsidiary of Ingersoll Rand in a contest with the U.S. firm Terex.

While the number of contentious deals has so far been very small, we think the question of subsidized M&A merits attention. Even a single contested acquisition might trigger an impulsive Congressional response that damages the U.S. reputation for welcoming foreign investors. During the 2007 debate over rules governing inward foreign investment, some members of Congress advocated broad economic criteria when the Committee on Foreign Investment in the United States (CFIUS) screens proposed transactions. This approach, if adopted, would have carried CFIUS far from its traditional role as guardian of national security. If these proposals had not been defeated, Congress would have clouded the U.S. reputation and established a strong precedent for investment restrictions abroad.

Legislation proposed in the wake of the Dubai Ports World controversy highlights the risk that hasty reactions on Capitol Hill can harbor protectionist sentiments.³ Congressman Duncan Hunter (R-CA) was joined by 15 other members of the House of Representatives in introducing a bill that would prohibit foreign ownership of numerous assets deemed part of the

¹ For an account of French concerns in the 1960s, see the classic book by Servan-Schreiber (1968).

² For a discussion of government measures used worldwide to stimulate domestic investment, see Thomas (2007).

³ See Appendix A for a full account of the Dubai Ports World controversy.

nation's "critical infrastructure." Had this bill passed, it might have blocked foreign investment in more than 24% of the American economy.⁴

Current conditions presage a rise in foreign acquisitions of U.S. companies. While this phenomenon should be welcomed on economic grounds, it could set the stage for a protectionist backlash. Already the world's largest recipient of FDI, the United States will very likely attract even more foreign investment owing to the dollar's falling value in foreign exchange terms.⁵ If foreign governments quietly urge national firms to take aim on overseas targets – whether in the name of procuring advanced technology, improving market access, or buying natural resources – the acquisition prices for U.S. firms may be bid higher. This would, of course, be welcomed by U.S. shareholders. But just as Chevron complained about CNOOC's bid for Unocal,⁶ American firms that are rival bidders will protest foreign competition, especially if publicly sponsored.

Likewise, the rapid growth of sovereign wealth funds (SWFs) plays a useful role in recycling foreign current account surpluses into investments in the U.S. securities markets, but the secrecy surrounding SWF holdings excites attention in the press and on Capitol Hill. On the sidelines of this year's World Economic Forum, U.S. Treasury officials tried to persuade representatives of sovereign wealth funds to increase their transparency, a major theme of reports

The rapid growth of sovereign wealth funds plays a useful role in recycling foreign current account surpluses into investments in the U.S. securities markets.

from the Davos summit.⁷ As acknowledged by Tony Tan, deputy chairman of the Government of Singapore Investment Corporation, "The right thing to do is to move to a path of more disclosure...[because] the greatest danger...[is that] some form of financial protectionism will arise and barriers will be raised to hinder the flow of funds."⁸

Add to these conditions a dash of public skepticism towards globalization, and the U.S. policy of open investment could face a perfect storm in the years ahead.

The central question we raise is whether, from a public policy perspective, the U.S. government should worry about M&A activity that entails subsidized finance. After outlining the overall trends in FDI and M&A activity, we summarize three major M&A case studies and the characteristics of SWFs. We then turn to an analysis of investment subsidies and put forward a rationale for a public U.S. (or EU) response to subsidized M&A bids. Finally, we evaluate possible frameworks for addressing subsidized M&A transactions, and the secrecy surrounding SWF holdings. To be clear: we do not contend that subsidized M&A or non-transparent SWF dealings pose a "clear and present danger." We do suggest, however, that these issues merit thoughtful consideration well before a political confrontation occurs.

⁴ Graham and Marchick (2006, 147).

⁵ Graham and Krugman (1995) find that FDI in the United States tends to increase when the dollar weakens. Their empirical examples include the surge of FDI during the late 1970s and early 1980s, when the dollar was relatively weak, the slower growth rate of FDI during the mid-1980s, a period of dollar appreciation, and the resurgence in FDI beginning in 1986, when the dollar again fell. For a discussion of this effect on recent investment flows, see "Overseas Investors Buying U.S. Holdings at Record Pace," *New York Times*, 20 January 2008.

⁶ O'Reilly, David. "Chevron's Pitch," *Wall Street Journal*, 12 July 2005.

⁷ "Suspicion over sovereign fund investments," *Financial Times*, 26 January 2008. Also see several articles in the Corporate Finance, Davos Edition section of the *Financial Times* on 24 January 2008.

⁸ "Singapore sovereign wealth fund promises greater transparency," *Financial Times*, 28 January 2008.

Recent trends in FDI flows and cross-border M&A transactions

Cross-border M&A constitutes a significant portion of inward FDI, both for the United States and other popular destinations.⁹ Table 1 shows that the M&A share of U.S. inward FDI typically hovers above 80%. In absolute terms, M&A transactions peaked at nearly \$325 billion in 2000, declined for several years, and have now resumed their climb, approaching \$150 billion in 2006. Table 2 (*see page 4*) shows that, as a share of worldwide FDI inflows, M&A transactions averaged 61% during the period 2002 to 2006. In absolute terms, worldwide M&A transactions have nearly tripled since 2003, approaching \$900 billion in 2006. The United States frequently tops the list of countries in terms of inward FDI and M&A activity, while other G7 and European countries typically constitute the top five.

Table 1: Inward FDI in the United States: greenfield vs. M&A^a, 1994-2006 (\$ billions)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Total inward FDI	45.6	57.2	79.9	69.7	215.3	275.0	335.6	147.1	54.5	63.6	86.2	91.4	161.5
Greenfield investment	6.9	10.0	11.2	9.0	32.9	9.8	12.9	9.0	11.1	13.4	13.5	17.4	13.7
(as % of total)	(15)	(18)	(14)	(13)	(15)	(4)	(4)	(6)	(20)	(21)	(16)	(19)	(8)
M&A investment	38.8	47.2	68.7	60.7	182.4	265.1	322.7	138.1	43.4	50.2	72.7	74.0	147.8
(as % of total)	(85)	(82)	(86)	(87)	(85)	(96)	(96)	(94)	(80)	(79)	(84)	(81)	(92)

Notes:

a. Greenfield FDI is approximated by using the BEA statistics for inward FDI for "U.S. businesses established." However, not all businesses that are "established" fall into the greenfield category, and not all greenfield investments are included in the measure of "U.S. businesses established."

FDI characterized as "M&A investment" is estimated by using the BEA statistics for inward FDI for "U.S. businesses acquired."

See McNeil (2007) p.48 for further explanation of the data used in this chart. See UNCTAD's *World Investment Report 2000* (p. xix, 105) for the difficulty of distinguishing between greenfield and M&A investment.

Sources: McNeil, Lawrence R. 2007. "Foreign Direct Investment in the United States: New Investment in 2006," *Survey of Current Business*. Washington: Bureau of Economic Analysis (June).

M&A subsidy cases

*CNOOC's bid for Unocal*¹⁰

In June 2005, CNOOC issued a bid of \$18.5 billion for Unocal, a U.S.-based oil and gas company with significant operations in Central Asia. The offer topped Chevron's \$16.4 billion bid that Unocal had already accepted, more than a year earlier. Accusations of CNOOC's reliance on subsidized loans to beat Chevron's offer – coupled with Chevron's interest in

⁹ FDI can be disaggregated into M&A and greenfield investment. M&A transactions involve the purchase of more than a 10% ownership stake in an existing company, while greenfield transactions entail the establishment of a new company. The share of FDI derived from M&A activity can be determined by dividing the total value of inward M&A transactions ("M&A sales") by the total amount of inward FDI.

¹⁰ Sources consulted for this section:

Graham and Marchick (2006).

Letter from Senators Grassley (R-IA) and Baucus (D-MT) to President Bush on 13 July 2005 (See Appendix B). Sloan, Allan. "Deals: Don't Count 'Baby CNOOC' Out," *Newsweek*, 1 August 2005.

preserving its agreement with Unocal and rising anti-China sentiments in Congress – spurred a heated debate about whether the U.S. government should block CNOOC's offer. In a letter to President Bush, Senators Grassley (R-IA) and Baucus (D-MT) expressed concern that CNOOC was relying on no-interest or below-market-rate loans. CNOOC documents given to Unocal revealed that \$7 billion of the offer came in the form of subsidized loans from CNOOC's government-owned parent company (also known as CNOOC): \$2.5 billion was interest-free for two years with the potential to remain that way for up to 30 years; interest on the remaining \$4.5 billion could be waived by the parent company in the event that CNOOC's credit rating dropped below investment grade. Amid a firestorm on Capitol Hill and sharply-worded cautions from Chinese officials, CNOOC Chairman Fu Chengyu rescinded CNOOC's offer, preventing the Unocal board of directors from voting on the proposal.

Table 2: Worldwide M&A and FDI trends (\$ billions, current)^a

	M&A purchases ^b					Outward FDI					M&A purchases as a share of outward FDI (%)				
	2002	2003	2004	2005	2006	2002	2003	2004	2005	2006	2002	2003	2004	2005	2006
World	369.8	297.0	380.6	716.3	880.5	540.7	580.1	877.3	837.2	1,215.8	68.4	53.0	43.4	85.6	72.4
United States	78.4	82.4	110.0	147.6	171.3	134.9	129.4	258.0	-27.7	216.6	58.1	63.7	42.6	-532.0	79.1
United Kingdom	69.2	57.0	47.3	90.5	91.7	50.3	62.2	91.0	83.7	79.5	137.6	91.6	52.0	108.2	115.4
Spain	6.3	5.5	32.5	23.5	77.5	32.7	28.7	60.5	41.8	89.7	19.2	19.3	53.7	56.2	86.4
France	33.9	8.8	15.0	46.3	73.7	50.4	53.1	56.7	121.0	115.0	67.1	16.5	26.4	38.3	64.1
Netherlands	14.9	8.5	9.1	95.0	63.2	32.0	44.0	26.6	142.9	22.7	46.7	19.3	34.4	66.5	234.5
Germany	45.1	19.7	18.6	41.6	47.5	18.9	5.8	14.8	55.5	79.4	238.1	337.9	125.5	74.9	59.8
Switzerland	9.6	7.0	5.6	16.4	43.8	8.2	15.4	26.3	54.3	81.5	116.7	45.3	21.2	30.3	53.8
Canada	13.0	16.0	34.0	22.5	37.0	26.8	22.9	43.7	33.5	45.2	48.5	70.0	77.9	67.1	81.8
Australia	8.8	14.5	10.5	32.3	31.4	7.9	16.3	10.8	-33.2	22.3	111.9	89.5	97.0	-97.3	140.3
United Arab Emirates	0.0	0.1	0.0	4.8	21.6	0.4	1.0	2.2	3.8	2.3	2.5	6.2	1.8	127.5	932.6

	M&A sales ^b					Inward FDI					M&A sales as a share of inward FDI (%)				
	2002	2003	2004	2005	2006	2002	2003	2004	2005	2006	2002	2003	2004	2005	2006
World	369.8	297.0	380.6	716.3	880.5	622.0	584.1	742.1	946.8	1,305.9	59.5	52.7	51.3	75.7	67.4
United States	73.2	69.7	81.9	105.6	172.2	74.5	53.1	135.8	101.0	175.4	98.4	131.1	60.3	104.5	98.2
United Kingdom	53.0	31.4	58.1	171.7	150.5	24.0	16.8	56.0	193.7	139.5	220.4	187.1	103.8	88.6	107.9
Canada	16.3	5.2	19.6	27.0	70.5	22.2	7.5	-0.4	28.9	69.0	73.6	68.9	-5,389.9	93.4	102.1
Germany	46.6	25.2	35.9	63.1	55.3	53.5	32.4	-9.2	35.9	42.9	87.1	77.7	-380.1	176.0	128.9
France	30.1	17.5	20.1	32.2	39.9	49.0	42.5	32.6	81.1	81.1	61.4	41.2	61.8	39.7	49.3
Italy	11.6	15.3	11.0	41.1	35.5	14.5	16.4	16.8	20.0	39.2	79.8	93.0	65.1	205.7	90.6
Luxembourg	3.0	1.0	0.1	8.0	35.5	4.1	2.9	5.8	7.2	29.3	72.1	32.9	1.2	110.6	121.0
Netherlands	11.0	9.2	13.3	29.0	32.0	25.0	21.0	2.1	41.5	4.4	44.1	43.8	627.4	70.0	731.7
Sweden	7.6	4.3	10.9	10.1	22.6	12.2	5.0	11.5	10.2	27.2	62.6	86.7	95.2	98.9	83.1
Australia	10.7	9.7	15.1	12.1	16.4	17.0	8.0	36.0	-35.2	24.0	62.6	121.1	42.0	-34.3	68.2

Notes:

^aDue to varying definitions of M&A transactions, comparisons between M&A and FDI data are sometimes problematic. A common issue is that some definitions of M&A include transactions that are not classified as FDI. M&A data can therefore serve as an upper bound for FDI-related M&A activity. See p.297 of UNCTAD World Investment Report 2006 and p.105 of UNCTAD World Investment Report 2000 for detailed explanations.

^bM&A is defined as a transaction in which the buyer acquires an equity stake greater than 10% in an existing company.

Source: UNCTAD World Investment Report, 2007.

Doosan Infracore's purchase of Ingersoll Rand divisions¹¹

In July 2007, Korea-based Doosan Infracore announced its agreement to purchase the Bobcat machinery business and two other units from U.S. industrial conglomerate Ingersoll Rand. The purchase price of \$4.9 billion exceeded Wall Street expectations by 20%, leading

¹¹ Sources consulted for this section:

“Doosan to Buy Ingersoll Units for \$4.9 Billion,” *Reuters*, 30 July 2007.

“Doosan to Buy Ingersoll Unit for \$4.9 Billion,” *Wall Street Journal*, 30 July 2007.

“KDB fund to aid S Korea's global growth,” *FT.com*, 30 September 2007.

some observers to speculate that the price was inflated by Doosan's access to public support. Terex Corporation, a Connecticut-based rival bidder for the Ingersoll Rand divisions, complained that Doosan's financing was subsidized by the Korean Development Bank (KDB), a government-owned institution that also owns a partial interest in Doosan.

The specific terms of KDB's \$4.2 billion loan have not been revealed, but KDB has a history of using cheap lines of credit to fuel the expansion of favored Korean industries. Terex lodged a complaint with the United States Trade Representative (USTR) and members of Congress, but there was no official reaction in the United States. However, the issue could gain traction when Congress begins debating the Korea-U.S. free trade agreement, especially in light of KDB's planned launch of a \$1 billion private equity fund to help Korean companies expand overseas. The Korea-U.S. FTA states that neither party is obligated to extend national treatment or most-favored-nation status to companies based in the other party when it grants subsidies to its own domestic firms.¹² Nor is there any prohibition on the use of such subsidies for acquisitions abroad.

*EDF's expansion abroad*¹³

The national champion of the French power industry, EDF, has long held a monopoly position on electricity generation and distribution. In 2000, France began to deregulate the industry and allow competition, partly in response to urgings from the European Commission. Yet reforms in France progressed more slowly than in other EU countries.

Facing little competition in its home market, EDF announced it would spend 19 billion euros on foreign acquisitions between 2001 and 2003. As the company rapidly acquired stakes in the newly liberalized electricity markets of Italy, Spain, Britain, and Germany, resentment mounted against the slow pace of liberalization in France. Italy and Spain passed "golden share" laws specifically intended to prevent EDF from acquiring privatized electric companies.¹⁴ In addition to complaints about EDF's privileged position in France, criticisms were voiced about the subsidized financing EDF received from the French government. With its bonds guaranteed by the government, EDF's triple-A credit rating allowed the firm to raise capital on more favorable terms its foreign competitors.

In October 2002, the European Commission announced that the French government's treatment of EDF was incompatible with EU subsidy rules. The Commission launched formal investigations regarding EDF's government-backed debt and tax relief that the company had

¹² Article 11.12.5 of the Korea-U.S. FTA states that national treatment and most-favored-nation status for foreign investments "do not apply to...subsidies or grants provided by a Party, including government-supported loans, guarantees, and insurance."

¹³ See Appendix C ("EC Rules") for an explanation of the three main issues covered by EC rules: State aid control, merger control, and internal market activities.

Sources consulted for this section:

"French Aid to State Utility May Come Under Scrutiny," *New York Times*, 16 October 2002.

"Europe Inquiry on French Aid to Big Utility," *New York Times*, 3 April 2003.

"The French state hastens the end of its industrial empire-builders," *Financial Times*, 19 July 2003.

"Commission tells EDF to pay back Euros 1bn government guarantees," *Financial Times*, 15 December 2003.

"French Aid to State Utility May Come Under Scrutiny," *New York Times*, 16 October 2002.

¹⁴ See Appendix C ("EC Rules") for an exposition of the Italian case.

previously been granted which could have been used to partly finance acquisitions abroad. In December 2003, the Commission ruled against EDF on both counts. The French government was ordered to stop guaranteeing the company's debt, and EDF was told to repay \$1.2 billion to the French government in order to reverse tax breaks Paris had given EDF in the late 1980s and early 1990s.

The growing role of sovereign wealth funds¹⁵

In each of the three M&A cases just cited, governments *indirectly* influenced the types of foreign investments made by national firms. During recent years, some governments have increased their *direct* control over foreign investments by channeling official foreign exchange reserves into SWFs. Projected trends in the growth of SWFs could create new concerns about the state's role in foreign equity investment.

SWFs are not new – the Kuwait Investment Authority, the first SWF, was created in 1953 – but their recent growth in size and usage has led to new policy questions. The worldwide total of assets under SWF management approaches \$2 trillion, or roughly 1.6% of the global stock of financial assets (stocks, bonds, and bank deposits). Estimates of their future growth predict SWFs will control more than \$7 trillion by 2012. SWFs already control roughly the same amount of capital as private equity firms and hedge funds combined. Today, however, they control little more than 5% of the assets under management by institutional investors such as UBS and Barclays.

As Table 3 shows, most SWFs derive their investment capital either from government ownership of commodity wealth (notably, petroleum exporting countries) or from the current account surpluses enjoyed by countries with export-oriented economies (e.g., China, Singapore, and Malaysia). Given the high price of oil and the likelihood of continued trade surpluses in Asia, the value of assets managed by SWFs will likely mushroom in the future.

Countries have traditionally stored their foreign exchange reserves in passive assets, such as gold, U.S. Treasury bills, or CDs issued by large banks. Global foreign exchange reserves held in these forms still exceed SWF-managed assets by a factor of around two. However, recent trends suggest that an increasing share of officially-controlled external assets will be managed by SWFs. For example, China recently announced that a new SWF, the China Investment Corporation, will be allocated \$200 billion (nearly 15% of China's foreign exchange reserves). Korea, Taiwan, Singapore, and Malaysia have also multiplied their reserves in the last decade, and these countries also sponsor SWFs. Such developments will contribute to the growth of

¹⁵ Sources consulted for this section:

Truman (2006).

Truman (2008).

Lyons (2007).

Wolf, Martin. "The brave new world of state capitalism" *Financial Times*, 16 October 2007.

European Commission's Report on Competition Policy 2003 (p. 235-237) and Report on Competition Policy 2002 (p. 349).

Francis, David R. "Will Sovereign Wealth Funds Rule the World?" *Christian Science Monitor*, 26 November 2007.

Kimmit, Robert M. 2008. "Public Footprints in Private Markets: Sovereign Wealth Funds and the World Economy," *Foreign Affairs* 87(1): 119-30.

SWFs, due in part to the low rate of return on traditional reserve assets such as U.S. Treasury bills.

Table 3: Sovereign wealth funds

Country	Current Name	Date Established	Current Size ^a (billions of US dollars)
United Arab Emirates	Abu Dhabi Investment Authority and Corporation	1976	536 – 911 ^e (500 – 875 ^e)
	Dubai International Capital ^b	2004	(13 ^e)
	Istithmar (Dubai) ^b	2003	(12 ^e)
	Mubadala Development Company (Abu Dhabi) ^b	2002	(10 ^e)
	International Petroleum Investment Company (Abu Dhabi) ^b	1984	(1 ^e)
	Dubai International Financial Centre Investments ^b	2006	n.a.
	Emirates Investment Authority	2007	n.a.
Norway	Government Pension Fund – Global	1990	357
Singapore			208 – 438 ^{e,r} (100 – 330 ^{e,r})
	Government of Singapore Investment Corporation	1981	
	Temasek Holdings ^b	1974	(108)
Saudi Arabia	Saudi Arabian Monetary Agency	n.a.	275
Kuwait	Kuwait Investment Authority	1953	213
China			201
	China Investment Corporation ^b	2003	(200)
	Shanghai Financial Holdings	2007	(1 ^e)
Russia	Stabilization Fund of the Russian Federation	2004	144 ^f
Hong Kong	Exchange Fund Investment Portfolio	1998	127 ^{e,r}
Qatar	Qatar Investment Authority	2005	60 ^e
United States			48
	Alaska Permanent Fund ^b	1976	(39)
	Severance Tax Permanent Fund (New Mexico) ^b	1973	(5)
	Permanent Mineral Trust Fund (Wyoming) ^b	1974	(4)
	Revenue Regulation Fund	2000	46 ^e
Algeria			40 ^e
Libya	Libyan Investment Authority ^b	2006	40 ^e
Brunei	Brunei Investment Agency	1983	35 ^e
Kazakhstan	National Oil Fund	2000	21
Korea	Korea Investment Corporation	2005	20 ^f
Malaysia	Khazanah Nasional ^b	1993	18
Canada	Alberta Heritage Savings Trust Fund ^b	1976	16
Venezuela			15
	National Development Fund ^c	2005	(14)
	Macroeconomic Stabilization Fund	1998	(1)
Chile	Economic and Social Stabilization Fund	2006	13
Nigeria	Excess Crude Account	2003	12 ^e
Oman	State General Reserve Fund	1980	10 ^e
Iran	Oil Stabilization Fund	2000	8 ^e
Botswana	Pula Fund	1997	7
Mexico	Oil Income Stabilization Fund	2000	5
Azerbaijan	State Oil Fund of the Republic of Azerbaijan	2000	2
Trinidad and Tobago	Heritage and Stabilization Fund	2007	2 ^e
Timor-Leste	Petroleum Fund	2005	2
Kiribati	Revenue Equalization Reserve Fund	1956	<1 ^e
Gabon	Fund for Future Generations	1998	<1
São Tomé and Príncipe	National Oil Account	2004	<1
Sudan	Oil Revenue Stabilization Account	2002	<1
Total^d			2,745

e = estimate, r = some or all assets are included in reserves

a. Data are from the end of 2006 or the most recent date available.

b. A portion of the holdings is in domestic assets.

c. A portion of these holdings is intended for domestic investment.

d. Total uses the midpoint of the range of estimates.

Source: Truman (2008).

On Wall Street, capital injections from SWFs have recently been obtained by Citigroup, Merrill Lynch, Morgan Stanley, and other banks that are eager to repair their balance sheets in the wake of the 2007 subprime crisis.¹⁶ Aware of the potential for a Congressional firestorm reminiscent of the Dubai Ports World controversy, SWFs have limited the size of their investments to avoid CFIUS review.¹⁷ Nonetheless, recent SWF investments have begun to draw attention from lawmakers concerned about the potential for sovereign shareholder activism. Senator Chris Dodd (D-CT), chairman of the Senate Committee on Banking, Housing, and Urban Affairs, has asked the Government Accountability Office to investigate SWF activities, and Congressman Barney Frank (D-MA) is expected to lead SWF oversight hearings in the House Financial Services Committee later this year.¹⁸

The rationale for an international compact on investment subsidies

In their home countries, politicians often debate what kinds of investment should be subsidized, and whether the cost of public subsidies is justified. Indeed, the history of the United States is littered with investment subsidies, from canals and railroads in the 19th century, to aircraft in the 20th century, and now to energy in the 21st century. Given such widespread practices,¹⁹ one might ask why the international community at large, or an individual country, should concern itself with the M&A subsidy policies of a foreign nation. After all, if a nation unwisely subsidizes its national firms in their overseas M&A activities, isn't the economic distortion principally the misfortune of the subsidizing nation? And why should a target country be concerned if a foreign company pays above the market price to acquire one of its domestic firms?

Gresham's Law in the realm of investment policy

The arguments for ignoring the M&A subsidy policy of a foreign nation may well be compelling in a context of isolated bids. If the subsidy policy is a mistake, at worst it will lead the country to overpay for the foreign acquisition. But we may not be dealing with isolated events. The Great Depression showed that misguided protectionist policies can metastasize from nation to nation. Responding to pressure from concentrated interest groups, governments in that period embraced the vices of protection rather than defending the virtues of free trade. Gresham's Law was at work: bad policy drove out the good. Aware of such systemic dangers, governments have used multilateral agreements to "tie their own hands" against various forms of destructive retaliation and emulation. In the realm of trade subsidies, from the formation of the GATT in 1947 to the Agreement on Subsidies and Countervailing Measures (ASCM) in the Uruguay Round (1994), countries have made commitments to limit many forms of commercial subsidies.²⁰

¹⁶ "Asia, Mideast to the Rescue of Citi, Merrill," *Wall Street Journal Asia*, 11 January 2008.

¹⁷ "Lobbyists Smoothed the Way For a Spate of Foreign Deals," *Wall Street Journal*, 25 January 2008.

¹⁸ "U.S. Lawmakers Request Probe into Sovereign Wealth Funds," *Dow Jones Capital Markets Report*, 11 January 2008.

¹⁹ See Thomas (2007) for a global account of investment subsidies.

²⁰ See Ray (1995, 36) for the evolution of GATT rules on trade subsidies.

From the standpoint of classic economics, a country should welcome subsidized imports: after all, its citizens can then buy cheaper merchandise from abroad. But if the political response from affected domestic producers subsequently forces the importing country into offering its own subsidies, the story changes. The country could be better off signing an international pact limiting all trade subsidies. And if the political response leads to a round of protectionist tariffs, the argument for limiting subsidies in the first place becomes that much stronger.

In some sectors where multilateral agreements limiting trade subsidies could not be reached, bad policies have worked to pollute free markets. A lead example involves the maritime shipping industry. Most ports are open to vessels of all flags, meaning that there is a nominally free market for international shipping services. However, in order to protect and enlarge their own merchant fleets and shipyards, several nations subsidize shipbuilding and maritime operations. They also protect their own merchant fleets, by requiring certain cargo to be carried on domestic flag vessels, and prohibiting foreign vessels from entering the cabotage trade between domestic ports. These policies have led to chronic conditions of overtonnage, punctuated by occasional episodes of inadequate capacity (such as in 2007). The auto, steel, and aircraft industries furnish other examples of investment subsidy emulation that has not been effectively disciplined by international rules.

Such examples suggest that subsidized M&A activity, if not restrained by agreed international rules, might breed costly and often wasteful emulation. It can also breed a protectionist sentiment, which can prove even more damaging. If Gresham's Law is triggered in the M&A realm, free market policies toward takeovers could be supplanted as more countries adopt policies to subsidize outward foreign investment or to screen a wide array of inward foreign investment.

Subsidized M&A, if not restrained by agreed international rules, might breed costly, wasteful emulation as well as protectionist sentiment.

Public budget constraints should dampen the effects of Gresham's Law. However, the recent history of government subsidies – e.g., U.S. and EU agriculture subsidies; European aerospace subsidies; and state-level subsidies in North Carolina (research) and Alabama (automobile manufacturing) – illustrate the softness of budget constraints. The same logic applies in the context of M&A subsidies: private companies are more constrained from “overpaying” than are governments that subsidize acquisitions. Just as governments justify export subsidies in the name of employment, so can governments justify investment subsidies in the name of creating national champions or securing access to scarce resources abroad. For example, Gazprom Chairman Dmitry Medvedev, Russia's most likely next president, recently urged Russian companies to follow China's lead by acquiring overseas firms.²¹

Economic nationalism

Nationalism is an outcome equally if not more plausible than emulation in the United States. Subsidized M&A activity could lead to policies designed to impose stiff screening requirements on all foreign takeovers, whether or not subsidized. If that were to happen in the

²¹ “Copy China, says Medvedev,” *Financial Times*, 1 February 2008.

United States, a wave of similar takeover restrictions could spread from country to country, in much the same manner as tariff retaliation in the 1930s.²² Among large countries, China, Russia, and India are already skeptical of foreign M&A bids aimed at their domestic firms. A more recent harbinger is the European Union's response as Russia's government-owned Gazprom has expanded its European operations. After a string of foreign acquisitions, long-term supply contracts, and agreements to participate in distribution projects, Gazprom now supplies 27% of Europe's gas.²³ The European Commission has now drafted legislation that would restrict ownership of energy assets by all foreign companies. If approved by a majority of Member States, the plan would give the EU the power to prevent companies from non-member countries from acquiring a majority stake in gas distribution networks. These proposals have been put forth in response both to fears that Gazprom's operations could be manipulated by the Russian government and to concerns about the lack of reciprocal investment opportunities in Russia, which has closely guarded its majority stake in Gazprom.²⁴

In our view, the best public response is not country-by-country action, but rather an international agreement that would curb M&A subsidies and forestall a destructive wave of investment protectionism. Such an agreement would also mitigate the likelihood of welfare losses for both shareholders and consumers in the target country. Before exploring the venue and content of an agreement, we outline several different types of investment subsidies.

Types of investment subsidies

Investment subsidies can take different and sometimes exotic forms. In the context of cross-border M&A, the core characteristic of investment subsidies is their design to encourage national firms to bid higher than they otherwise would. Governments do this by reducing the cost of capital to a national firm through concessional interest rates on borrowed funds, loan guarantees, or public subscription of equity at an inflated price. Governments can also use less obvious subsidies such as exchange rate guarantees and corporate tax relief.

Interest rate subsidies are the most straightforward. Acting through a lender which it controls, a government can offer preferential credit terms to a national company that needs capital for an international acquisition. In beating Chevron's bid for Unocal, CNOOC was assisted by an interest rate subsidy from its parent company, a fully government-owned entity.

Public loan guarantees are another common technique. The interest rate at which a company can borrow in private capital markets is typically determined by the company's bond rating. A government can artificially improve the firm's bond rating by guaranteeing corporate debt. EDF's foreign acquisitions were facilitated by the French government's guarantee of the company's debt, leading to a triple-A credit rating. This sequence of events prompted the European Commission to require the French government to stop guaranteeing EDF's debt.

²² On the EU's effort to keep capital markets open to liberalization and on its treatment of defensive measures against takeovers see Appendix C ("EC Rules").

²³ "Gazprom eyes downstream assets to boost margins: Gas giant has more leverage in the U.K. than in other European countries," *MarketWatch*, 11 June 2007.

²⁴ "Unbundling at Forefront of Latest EU Energy Market Proposals – but with Foreign Ownership Restrictions," *Global Insight Daily Analysis*, 20 September 2007.

Another obvious subsidy occurs when a government purchases a firm's shares at an inflated price. The firm can then use the funds to make foreign acquisitions or it can rely on its larger equity base to tap private capital markets at a lower interest rate.

Turning to less obvious subsidies, a government exchange rate guarantee can relieve the acquiring firm from the risk of adverse exchange rate movements or the need to pay the cost of a hedging strategy.

Another less obvious form of subsidy is corporate tax relief. By easing the tax burden on national companies that make overseas acquisitions, the government can reduce the cost of capital for the acquiring firm. A recent example came when the Korean government announced a plan to exempt certain taxes on firms that invest in natural resource projects abroad.²⁵

The Appropriate Response to Investment Subsidies

Any proposal to address M&A subsidies should foremost emphasize the benefits of an open investment climate. As President Bush recently affirmed, the tendency to restrict foreign investment in the name of national security must be weighed against the benefits of such investment, namely "stimulating growth, creating jobs, enhancing productivity, and fostering competitiveness."²⁶ As we argue in detail below, a multilateral compact on M&A subsidies would address these goals by providing a bulwark against the risks of emulation or economic nationalism. Negotiating such a compact would offer a pragmatic strategy compatible with the preservation of an open investment climate by providing a shield against emulation or protectionist backlash.²⁷

Proposals to address M&A subsidies should emphasize the benefits of an open investment climate.

In this paper we explore existing approaches for addressing investment subsidies and then suggest benchmark principles that the executive branch might adopt in launching the negotiation of a multilateral compact. These benchmark principles would help foreign investors by identifying "do not cross" red lines in the M&A arena. Just as foreign governments have already reminded the United States in the context of CFIUS reform legislation, potential investors need the confidence of clear rules when making M&A bids for U.S. firms.

Existing ideas

In response to CNOOC's bid for Unocal, the question came up whether the WTO's dispute settlement panel could be used to prevent the alleged subsidies. However, as Appendix C describes, existing WTO rules do not easily cover this type of subsidy. The existing rules are

²⁵ *Maeil Business Newspaper*, 5 September 2007.

²⁶ "President Bush's Statement on Open Economies," White House press release on 10 May 2007.

²⁷ The logic behind our proposal to negotiate a multilateral compact to guard against protectionist backlash against subsidized M&A transactions has already been acknowledged in the SWF context by an emerging consensus of U.S. Treasury officials and academic economists. See "How Trade Talks Could Tame Sovereign-Wealth Funds," *Wall Street Journal*, 29 October 2007.

designed to curtail subsidies that affect merchandise trade flows, not subsidies that affect investment. There is also a time dimension problem: M&A transactions usually survive or die in a period of months, whereas WTO disputes usually take one or two years to resolve. Finally, in trade disputes, WTO remedies are prospective, not retrospective. Prospective remedies (“don’t do it again”) would not afford much comfort to losing bidders in an M&A context.

Thus, some members of Congress argued that CFIUS should block subsidized takeovers by foreign companies. The Committee’s mandate for reviewing investments was enlarged when CFIUS was reviewed by Congress in 2006 and 2007. However, as Appendix A summarizes, and as Treasury officials have recently confirmed, CFIUS remains focused on the national security implications of inward foreign investments. Expanding this mandate to cover debates over investment subsidies and competition/antitrust issues would take the CFIUS into terrain far better covered by expertise in other agencies.²⁸

U.S. trade policy is another avenue through which M&A subsidies can be addressed. In the investment chapters of its free trade agreements, the United States typically excludes public subsidies from the requirement that they comply with national treatment and most-favored-nation principles. In the Korea-U.S. free trade agreement, this exemption was partially motivated by the Korean Development Bank’s history of subsidizing favored industries.²⁹ Moreover, U.S. FTAs do not proscribe or penalize the use of subsidies to advance M&A transactions abroad.

Private solutions

Publicly traded companies can take action to prevent unwanted acquisitions by implementing “poison pills” in order to make the target firm less attractive to its bidder. Tactics include diluting the bidder’s potential ownership stake by expanding the number of shares owned by other investors, selling assets to friendly companies, and extending employment contracts of key officers for long periods, frustrating the potential bidder’s ability to restructure. In theory, many of the undesirable effects from investment subsidies – which governments have an interest in preventing – might lead a few companies to adopt one or more of these poison pills to prevent an acquisition. But in practice, if a target company is willing to be acquired, it will almost always welcome the highest bidder, regardless whether the buyer is a foreign or domestic firm, or whether the acquisition price is supported by subsidized financing.

Benchmark principles for a multilateral compact on M&A subsidies

- *Increase government transparency.*

Increasing the transparency of government involvement in M&A financing would seem to be the first priority for any multilateral compact. Unless acquiring firms are obligated to disclose the means by which their government may have given them preferential access to capital, any corrective measures will be shooting in the dark. Hence, we suggest that the burden should be placed on the acquiring firm to show that its access to capital was not preferentially increased by its home government in the recent past, say the last three years. Otherwise, “hide

²⁸ David McCormick, Treasury Department Undersecretary for International Affairs. 2007. Testimony before the Senate Banking Committee on 14 November.

²⁹ Korea-United States Free Trade Agreement, Article 11.12.5.

USTR 2007 National Trade Estimate Report on Foreign Trade Barriers, Korea.

the ball” will become the name of the M&A game. Full disclosure has become the normal practice between competing export credit agencies under the terms of the OECD Export Credits Group (ECG),³⁰ and we think this practice should become the norm in cross-border M&A. When it makes a cross-border takeover bid, the foreign firm should publicly disclose all subsidies received in the recent past (we propose three years) or contemplated for the transaction at hand. We suggest building on the law and jurisprudence that has evolved in the WTO and the EU to develop agreed rules for identifying and measuring subsidies (see Appendix C).

- *Limit the number of “actionable” subsidies.*

While public subsidies should be disclosed in all cross-border acquisitions to minimize the twin dangers of emulation and investment protection, we suggest three criteria to define the types of subsidies that would be “actionable” (*i.e.*, governed by the compact). First, we would confine the scope of a compact to those subsidies which facilitate bids that encounter a *bona fide* domestic rival. Expanding the definition of “actionable” investment subsidies to include those that facilitate uncontested bids, while consistent with a broad effort to “stamp out” M&A subsidies, would run the unacceptable risk of fostering “shake-down” litigation. Domestic firms should not be encouraged to pursue rent-seeking lawsuits that infringe on the open investment climate. Additionally, “actionable” M&A subsidies should be limited to those involving the provision of capital at below market terms in traceable anticipation of foreign takeovers. Finally, we would ignore any capital provision made more than three years before the M&A bid. We recognize that these narrow criteria for “actionable” subsidies might allow room for circumvention. However, we are more concerned that a broader test would induce “shake-down” litigation.

Domestic firms should not be encouraged to pursue rent-seeking lawsuits that infringe on the open investment climate.

- *Adopt a per se approach to facilitate expeditious reviews of alleged subsidies.*

Two distinct approaches can be envisaged for deciding whether a subsidy is governed by the compact. Under a *per se* approach, which requires only the existence of a subsidy rather than proof of the subsidy’s effect on the market, action could be taken against a subsidized foreign acquirer, regardless of the connection between the subsidy and the takeover bid. This approach is applied, for example, by the WTO in the case of prohibited export subsidies. Alternatively, an “effects” or “injury” test might be required to authorize action against the subsidized foreign firm. This is the approach applied by the U.S. International Trade Commission (pursuant to WTO rules) when evaluating antidumping and countervailing duty cases. But this framework does not seem suitable in the realm of M&A, since a delayed bid is usually a dead bid. The need for target companies to evaluate rival bids within a period of weeks or months would seem to preclude prolonged litigation over the effects of a subsidy in the context of a specific takeover bid.

³⁰ See Ray (1995, 46).

- *Require a “significant” level of subsidy.*

In light of time constraints in the M&A context, we prefer a *per se* approach for determining whether M&A subsidies call for a public remedy. A central issue, however, is the *level* of subsidy required to trigger public action. In our view, the level should be “significant.” Moreover, we think the aggregate total of subsidies conferred on the acquiring firm in the recent past (plus those contemplated for the transaction at hand) should be related to the size of the takeover bid to determine “significance.” The reason for adding up all subsidies is that, as businessmen know, money and credit are fungible. However, we do not want to preclude cross-border M&A on account of minor subsidies. As a rule of thumb, subsidies totaling less than 5% of the takeover bid would not seem to be “significant.”

Remedies for M&A subsidies

Policymakers should consider rules designed to curtail the most objectionable subsidies while keeping doors open to international investment. A careful scalpel approach today is clearly preferable to impulsive sledgehammer legislation tomorrow – legislation that would likely impede a broad swath of capital flows. It might be argued that a compact to curtail objectionable

A multilateral compact will serve as a bulwark against, rather than an incentive for, protectionist legislation

subsidies can have the unintended consequence of igniting protectionist investment measures. To the contrary, we believe that properly managed and with high level commitment to retain our open investment policy, a multilateral compact will serve as a bulwark against, rather than an incentive for emulation and protectionist legislation. In this section we identify four different alternatives for redressing “actionable” subsidies. The most drastic alternative is simply to block the potential bid altogether when a rival domestic offer has been made. Companies with access to subsidized capital would then think twice before bidding for overseas targets.

Another alternative is to allow the bid to stand as long as the buyer repays its home government the total amount determined to be an “actionable” subsidy. The European Commission adopted this approach, though not in the context of a specific M&A transaction but rather in the direct scrutiny of granted subsidies; ultimately the Commission required EDF to repay the French government for waived taxes. This approach entails the difficult task of measuring the amount of subsidy that should be repaid. Still, if adopted in a multilateral compact, the repayment remedy would be preferable to the risk of emulation and retaliation.

A third possibility is to allow the bid to stand while requiring the buyer to pay a penalty to rival domestic firms that lost out in the bidding war. Giving potential rivals this incentive to police M&A subsidies has both positive and negative ramifications. On the upside, delegating responsibility to domestic firms creates a self-enforcement mechanism that takes part of the burden off government. On the downside, phony rivals may jump into the fray, just to collect a bounty. The Byrd Amendment set a bad precedent for this sort of private reward when it created

a mechanism that enabled U.S. firms to collect antidumping and countervailing duties paid by foreign respondents.³¹

A fourth alternative is to use existing merger control laws to address subsidized M&A. With a mandate that already authorizes the preventive control of planned M&A, the European Commission can block subsidized mergers that create anti-competitive concerns in the relevant product market (see Appendix C). This approach may be well-suited for Europe, where subsidized M&A frequently involves cross-border consolidation of newly privatized industries, such as utilities, which are already scrutinized by competition regulators. In the United States, however, the primary concerns surrounding subsidized M&A – typically one-off purchases of American firms, such as Unocal and Bobcat, to the disadvantage of rival domestic bidders – do not fall within the current purview of the Department of Justice or the Federal Trade Commission, since their jurisdiction focuses on competition in product markets. Hence the merger control remedy does not immediately lend itself to use in the United States.³²

Possible venues to negotiate an international compact on M&A subsidies

The G-8 would be a good venue to lay down a marker that reflects the views of industrial countries toward M&A subsidies. In anticipation of this year's G-8 summit in Japan, finance ministers and central bank governors have already begun to discuss best practices for SWF investments.³³ Broadening the G-8 agenda to include M&A subsidies would give members an outlet for communicating "red lines" to countries such as Korea, China, and Russia, three countries whose subsidies are likely to draw the ire of target countries.³⁴ This approach would set the tone for a multilateral compact on M&A subsidies that might be negotiated over the next few years.

The G-8 would be a good venue to lay down a marker that reflects the views of industrial countries toward M&A subsidies.

Echoing proposals from U.S. Treasury officials, IMF Managing Director Dominique Strauss-Kahn has advocated that the Fund should draft rules to govern the investment practices of SWFs.³⁵ Recently the Fund tapped Singapore, Norway, and Abu Dhabi to take the lead in establishing guidelines for public disclosure of investments, which was the primary focus of earlier IMF proposals (IMF 2007).³⁶ This is certainly desirable in the SWF context. However, broadening the Fund's mandate to cover M&A subsidies outside the SWF realm seems problematic. The IMF's core competency is in the macro realm – fiscal

³¹ The Byrd Amendment, in force from 1999 to 2007, was found inconsistent with WTO rules, and repealed by Congress effective October 2007.

³² A merger control remedy has the potential advantage of considering welfare impacts in all relevant markets, including product markets. This is a plus for a remedial approach constituted around competition law principles.

³³ "Statement of G-7 Finance Ministers and Central Bank Governors," 19 October 2007, available on the internet: www.g8.utoronto.ca/finance/fm071019.htm.

³⁴ Though "red lines" might apply to firms in Russia, a G-8 member, Russian leaders might still support the inclusion of M&A subsidies in the agenda. Russia might have grounds for urging European members of the G-8 to curb retaliatory legislation aimed at firms such as Gazprom.

³⁵ "New IMF chief says he needs to deliver changes quickly," *Reuters*, 3 November 2007. Also see David McCormick, Treasury Department Undersecretary for International Affairs. 2007. Testimony before the Senate Banking Committee on 14 November.

³⁶ "IMF urges action on sovereign wealth," *Financial Times*, 25 January 2008.

policy, monetary policy, and exchange rates. Moreover, any Fund-led effort to draft M&A takeover rules would inevitably be delayed by the conflicting priorities of nearly 200 members.

The OECD is another possible venue for drafting a compact on M&A subsidies. It brings together a group of countries that would be most interested in promoting a multilateral compact – namely those countries that are potential recipients of subsidized M&A capital. During the 1990s, the OECD facilitated negotiations for a Multilateral Agreement on Investment (although the talks ultimately failed; Graham 2000). Following precedents established in the MAI negotiations, the OECD could invite non-member countries – such as China, Russia, Singapore, and Saudi Arabia – to participate in defining unacceptable investment subsidies, building on WTO and EU precedents (see Appendix C). Over a longer time horizon, the WTO itself might provide a forum for reaching agreement.

To move things along, the new U.S.-EU Transatlantic Economic Council might serve as an initial venue for holding discussions. As destinations for the majority of the world's FDI, the United States and the European Union hold similar views on most investment issues, and a joint U.S.-EU communiqué on acceptable rules could provide a basis for multilateral negotiations.

Once an international agreement has been reached, either the ICC International Court of Arbitration or the International Centre for Settlement of Investment Disputes (ICSID) might serve as the venue for vetting the level and significance of M&A subsidies. Under an international compact that defines inappropriate investment subsidies and delegates enforcement responsibilities to ICSID or the ICC, firms could file complaints when they face rival bids from subsidized competitors. By delegating the responsibility for evaluating M&A subsidies to an independent international body, the risk of politically-motivated rulings would be averted.

Interim measures in the United States

Regardless of the multilateral venue ultimately chosen, the United States may need to implement medium-term policies both to deal with the rise of SWFs and to create meaningful remedies for subsidized M&A bids. The Securities and Exchange Commission (SEC) already has jurisdiction to require SWFs to observe U.S. securities laws, though Chairman Christopher Cox has acknowledged there are difficulties involved with investigating sovereign governments.³⁷ Until the IMF has established its own guidelines for SWFs, the US should continue to monitor foreign investments and insist that SWFs should follow existing SEC guidelines: investors must declare ownership stakes in excess of 5% in publicly traded companies. And until a multilateral compact on subsidized M&A is agreed, the Department of Commerce might review allegedly subsidized transactions. It's a legal stretch, but conceivably disclosure requirements and remedies could be justified under Sections 301 (a)(2) and (a)(3) of the Trade Act of 1974 (P.L. 93-618).³⁸ At the same time, the United States could revise its model free trade agreements and bilateral investment treaties to limit M&A subsidies.

By giving recourse to U.S. firms that face subsidized M&A rivals, an interim approach would reduce the pressure for broad-brushed protectionist legislation aimed at all foreign takeovers. Moreover, by confronting other countries with the possibility of unilateral U.S.

³⁷ Cox, Christopher. "The Role of Government in Markets." Speech made for the Robert R. Glauber Lecture at the John F. Kennedy School of Government on 24 October 2007.

³⁸ Application of Section 301 in the subsidized M&A context is a legal stretch because the historical background and statutory language of Section 301 are both couched in terms of trade flows, not investment.

measures against subsidized M&A bids, the U.S. review procedure would encourage foreign governments to participate in multilateral negotiations.

Conclusion

The U.S. government and the European Commission are likely to face increasing pressure to address the issue of subsidized M&A and to enforce more transparency on SWFs. The rationale for a multilateral compact on M&A subsidies is suggested by the sorry history of other arenas where governments failed to coordinate their response to competitive subsidy practices. The maritime shipping industry is perhaps the worst case, but automobiles, civil aircraft, air transport, and agriculture all illustrate the problem. Bubbling protectionist sentiments – excited by the rise of SWFs as well as the M&A bids issued by CNOOC, Doosan, and Gazprom – demonstrate the contemporary relevance of these issues. In the absence of considered rules, adopted ahead of the political curve, broad-brush investment protection could become the political alternative. Multilateral rules on M&A subsidies and SWF transparency seem like the sensible long-term solution. The G-8 can set the stage. Standards for M&A subsidies and SWF disclosure might be initially agreed between the United States and European Union, and the details worked out in institutions such as the OECD, the IMF, and possibly the WTO.

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Appendix A

The Committee on Foreign Investment in the United States (CFIUS): History and Recent Reforms³⁹

Created by executive order in 1975, CFIUS was designed to monitor and analyze trends in foreign investment in the United States.⁴⁰ The Committee was granted authority to review any investment that “might have major implications for United States national interests.” But in order to block a foreign acquisition, the president had to invoke the International Emergency Economic Powers Act (IEEPA), which required a declaration of a “national emergency” with respect to an “unusual and extraordinary threat” stemming from the investment.⁴¹ As Senator Pete Wilson (R-CA) remarked, preventing a foreign investment under IEEPA’s strong language would be “virtually the equivalent of a declaration of hostilities against the government of the acquirer company” (US Senate 1987, 17, statement by Senator Wilson).⁴²

To expand the president’s authority, Congress adopted the Exon-Florio amendment to the Defense Production Act of 1988. This amendment allowed the president to block an acquisition for which “there is credible evidence that leads the President to believe that the foreign interest exercising control might take action that threatens to impair the national security.”⁴³ CFIUS was then charged with conducting Exon-Florio reviews and recommending whether to prevent or modify the terms of a foreign investment.⁴⁴

While the fundamental relationship between the president and CFIUS remained the same under Exon-Florio – the Committee’s role was still limited to advising the president whether to intervene in a proposed foreign investment – the likelihood of blocking actions escalated after the 1988 legislation. Concerns were then increasing about Japanese investments, but Japan was then (and remains today) a key military ally that could be offended if its investments were thwarted under the IEEPA language. After 1988, the president could use the softer language of Exon-Florio while still achieving the same outcome.

Enacted in 1992, the “Byrd Amendment” *requires* a CFIUS investigation of any proposed merger, acquisition, or takeover in which:

- 1) the acquirer is controlled by or acting on behalf of a foreign government; *and*
- 2) the acquisition results in control of a person engaged in interstate commerce in the United States that could affect the national security of the United States.⁴⁵

³⁹ *Sources consulted for this section:*

Graham and Marchick (2006).

Jackson (2007).

⁴⁰ Executive Order no. 11858 (1975).

⁴¹ *International Emergency Economic Powers Act*, Public Law 95-223, *US Statutes at Large* 91 (1977): 1625-26, codified at *US Code* 50 (2000), § 1701 et seq.

⁴² As far as we can determine, IEEPA was never invoked to block a foreign acquisition.

⁴³ *Omnibus Trade and Competitiveness Act of 1988*, App § 2170(e).

⁴⁴ Executive Order no. 12661 (1988).

⁴⁵ National Defense Authorization Act for Fiscal Year 1993, Public Law 102-484, *US Statutes at Large* 106 (1992): 2315, 2463.

After 9/11, the Congress and the president held differing interpretations of the Byrd Amendment. The Dubai Ports World proposal to acquire Peninsular and Oriental Steam Navigation Company spotlighted the divergence between Congress and the president. After a 30-day review, CFIUS approved the transaction, yet many members of Congress believed that the Dubai Ports World case merited the full 45-day CFIUS investigation due to the company's being "controlled by or acting on behalf of a foreign government." CFIUS members argued that they could use their own discretion in deciding whether to launch a 45-day investigation because the initial 30-day review had produced no "credible evidence" that the transaction would impair national security.

A second issue on which the two branches of government differed was the degree to which CFIUS should keep Congress informed of its activities. During the hearings organized to investigate the CFIUS process, members of Congress complained about the secrecy surrounding the Committee's investigations. As tensions escalated on Capitol Hill, both chambers took steps to enact legislation that would block the transaction proposed by Dubai Ports World. The president, realizing he would not have enough votes to sustain a threatened veto, informed leaders of the United Arab Emirates. On March 15, 2006, Dubai Ports World announced that it would liquidate its U.S. operations within four to six months.⁴⁶

Responding to intense congressional and public pressure in the wake of the Dubai Ports World saga, CFIUS and President Bush expanded their investigative roles before approving French-based Alcatel's acquisition of Lucent Technologies in late 2006. Concerns arose regarding the possibility that Alcatel would gain access to classified work performed by Bell Labs for the Department of Defense. For the first time in its history, CFIUS reserved the right to overturn its decision at any time in the future should Alcatel "materially fail to comply" with the promises it made to mitigate national security concerns. This was the beginning of "evergreen provisions," now a regular feature of CFIUS reviews.

The CFIUS reform bill, signed by President Bush in July 2007 and implemented by executive order in 2008, addressed the issue of mitigation agreements ("evergreen provisions") as well as other concerns.⁴⁷ This legislation:

- Allows CFIUS to designate one or more federal departments to negotiate, modify, monitor, and enforce mitigation agreements;
- Enhances congressional oversight and reporting to Congress;
- Requires the Director of National Intelligence to evaluate the national security implications of the transactions and report to CFIUS within 20 days;
- Enumerates the factors that CFIUS must consider, including the degree of ownership by a foreign government, levels of domestic production needed for national defense, potential for transfer of military-related technology, implications for critical infrastructure.⁴⁸

⁴⁶ Christopher S. Rugaber and Heather M. Rothman, "DP World Pledges to Sell U.S. Holdings In 4-6 Months; House Votes to Block Dubai Deal," *BNA International Trade Daily*, 16 March, 2006.

⁴⁷ *Foreign Investment and National Security Act of 2007*, Public Law 110-49, *US Statutes at Large* 246: 121. Implemented by President Bush on 23 January 2008 with an amendment to Executive Order 11858 (1975).

⁴⁸ Marchick (2007); Rivlin, Spiegel, and Stamberger (2007); Jackson (2007).

Appendix B

Letter from Senators Grassley and Baucus to President Bush

July 13, 2005

The Honorable George W. Bush
President of the United States
The White House
Washington, D.C. 20500
Dear Mr. President:

We are writing to apprise you of our concerns with respect to the offer by a subsidiary of the China National Offshore Oil Corporation ("CNOOC") to purchase California-based Unocal Corporation. On April 4, 2005, California-based Chevron Corporation announced it had reached a merger agreement with Unocal. The Federal Trade Commission accepted that merger, pending public comment, on June 10, 2005. Less than two weeks later, CNOOC's subsidiary, i.e. CNOOC Ltd., made an unsolicited offer for Unocal.

We understand that National Security Adviser Stephen Hadley has committed that the Administration's Committee on Foreign Investment in the United States ("CFIUS") will review the proposed transaction for national security implications if Unocal eventually accepts the offer from CNOOC Ltd. We would welcome such a review.

CNOOC is wholly-owned by the Chinese Government. And CNOOC owns 70 percent of CNOOC Ltd. According to at least one press report, the higher offer by CNOOC Ltd. relies upon significant subsidies in the form of low- or no-interest loans from its government-owned parent corporation. It is reported that without those subsidies, the offer from CNOOC Ltd. would be valued lower than Chevron's outstanding offer.

The offer by CNOOC Ltd. for Unocal raises an important question; namely, whether it is appropriate for state-owned enterprises to subsidize investment transactions to acquire scarce natural resources that are in high demand. When government subsidies are directed toward the acquisition and development of scarce resources, any ensuing market distortions should be of particular concern. Such subsidies may facilitate the allocation of scarce resources to inefficient or less-efficient producers. Any review by CFIUS should take into account the impact this type of subsidized acquisition may have on the U.S. economy and its potential threat to our national security interests.

Separately, we hope that any purchase of Unocal by CNOOC Ltd. will be closely scrutinized by the Administration to ensure that it is consistent with China's WTO obligations. During the negotiation of China's accession to the World Trade Organization, there were extensive discussions with China on the role of state-owned enterprises. The Working Party report on China's accession states that the representative of China emphasized the evolving nature of China's economy and that decisions by state-owned and state-invested enterprises had to be based on commercial considerations as provided in the WTO Agreement. The Administration should undertake a review of the structure of any final transaction in the context of the representations and commitments China made when joining the WTO.

Thank you for considering our concerns, both in the context of the offer by CNOOC Ltd. for Unocal as well as with respect to any similar transactions in the future.

Sincerely,

Charles E. Grassley
Chairman

Max Baucus
Ranking Member

Appendix C

WTO, EC, and OECD Rules that Might Relate to M&A Subsidies⁴⁹

Introduction

This appendix explores whether M&A subsidy scenarios might be regulated by WTO subsidy rules, EU law, or OECD practice. The WTO law on subsidies will be analyzed first. Secondly, the EU experience at surveillance of takeover bids will be addressed. Finally, the appendix briefly describes a relevant OECD experience at disciplining export credit practices. The goal of this appendix is to provide a basis for comparing the recommendations on ways to deal with M&A subsidies that are advanced in the main text with rules and practices that have already been agreed in related economic contexts.

WTO Rules

Commencing with WTO law, the rules on export subsidies are the most obvious candidate for regulating a subsidy that facilitates a foreign acquisition.⁵⁰

We start by asking whether the relevant WTO rules cover investment into enterprises, or other forms of financial support such as tax incentives, that may facilitate a subsequent M&A (see the main text discussion on “types of investment subsidies”).

The Agreement on Subsidies and Countervailing Measures (ASCM) provides that a “financial contribution” by a government (which includes “any public body”) should be deemed to be a subsidy in so far as it confers a “benefit” to the recipient and is “specific,” i.e., it is granted, in law or in fact, only to certain enterprises or groups of enterprises.⁵¹

The ASCM expressly states that a financial contribution may take the form of various equity and debt investment into enterprises, in particular direct transfers of funds (such as grants, loans, and equity infusions) and potential transfers (such as loan guarantees).⁵² Considering the express language of the ASCM, there is little doubt that even exotic forms of public financial support are covered by the definition of subsidy. For example, the disputes between Canada and Brazil in the aircraft sector enabled the relevant Panels and Appellate Body to consider various and complex examples of support (such as different kinds of grants; equity infusions; debt financing; loans; bonds; guarantees for equity, loans, export sales, residual value and first-loss-deficiencies; interest rate support; and the preferential sale of shares). Although the Geneva authorities were not always presented with sufficient evidence to support the relevant claims, in light of the clear language of WTO law, all these forms of financial support would constitute a financial contribution under WTO subsidy rules.⁵³ The Appellate Body has very recently

⁴⁹ This appendix was principally authored by Luca Rubini.

⁵⁰ These rules only apply to subsidization to enterprises in the manufacturing sector. Currently there is no discipline on subsidies to the service sector, since the GATS only calls for negotiations on the subsidy issue. With respect to agriculture, conclusions similar to those provided in the text are applicable to export subsidies, as provided in the WTO Agreement on Agriculture. For an analysis of WTO subsidy rules, in particular in a comparative perspective with EC subsidy rules, see Rubini (2008).

⁵¹ See Articles 1 and 2 SCM.

⁵² Article 1.1(a)(1)(i) SCM.

⁵³ See *Canada – Aircraft*, WT/DS70; *Canada – Export Credits and Loan Guarantees*, WT/DS222; *Brazil – Export Financing*, WT/DS46.

confirmed that the category of forms of corporate investment that can be captured by the rules should be construed broadly. In its 28th November 2007 report in the *Japan – DRAMS* dispute,⁵⁴ it has held that the examples of transactions reported in Article 1.1(a)(1) ASCM as “direct transfer[s] of funds” should be considered as illustrative. ‘Transactions that are similar to those expressly listed are also covered by the provision’, such as, in that case, those involved in the modification of the terms of pre-existing loans (e.g. debt forgiveness, extension of a loan maturity, interest rate reduction, and debt-to-equity swaps). Finally, as the controversial *US – FSC* dispute has shown, tax incentives (such as corporate tax relief), may well constitute a form of subsidy when it is concluded that “government revenue that is otherwise due is foregone or not collected.”⁵⁵

It should also be noted that a government can grant a financial contribution indirectly by requiring one private party to support another private party. In such a case, there is no legal requirement that the government backs the granting party and consequently the public fisc incurs a cost.⁵⁶

Crucially, all these enumerated forms of public financial support for enterprises are not considered as prohibited or objectionable subsidies *per se*. What should additionally be proved is that they confer an economic advantage which would not have been available to the recipient enterprises from market sources.⁵⁷ To put it differently for the sake of clarity, the financial support should be extended in circumstances which would not be acceptable from a commercial perspective. The receiving enterprise must benefit from the financial support, by comparison with commercial alternatives.

It is therefore clear that various forms of financial support, including those which are more or less expressly bestowed to carry out an acquisition of an enterprise abroad, can be caught by WTO subsidy rules, if a non-market benefit is established.

The next, crucial question is whether such subsidy would be prohibited or objectionable under the current ASCM rules.

The ASCM distinguishes two different kinds of subsidies and regulates them according to their alleged seriousness. On the one hand, the maintenance of export subsidies (which are deemed to be specific and are “contingent upon export performance”), is considered a *per se* violation of WTO law. Such subsidies, together with the similarly harmful “local-content” subsidies (i.e., subsidies contingent on the use of domestic goods), are automatically prohibited without any need to prove any sort of injury to the competing domestic industry. If granted, they should be withdrawn.⁵⁸ Other subsidies, which in the trade jargon are termed “domestic,” since they are not clearly linked to boost export trade, are objectionable only if they cause various types of “adverse effects” to the interests of the industries of other countries.⁵⁹

Considering these rules, it seems that subsidies granted to facilitate the recipient in its bidding for a foreign company could in theory constitute export subsidies. However, a closer

⁵⁴ Appellate Body, *Japan – DRAMS*, WT/DS336/AB/R, paragraphs 250 to 252.

⁵⁵ Article 1.1(a)(1)(ii) SCM; *US – FSC*, WT/DS108. On the *FSC* case see Hudec (2003).

⁵⁶ Panel, *Canada – Aircraft*, WT/DS70/R, para. 9.115; Appellate Body, *Canada – Aircraft*, WT/DS70/AB, para. 160; Panel, *US – Export Restraints*, DS194/R, footnote 167 to paragraph 8.73.

⁵⁷ Panel, *Canada – Aircraft*, paragraph 9.112; Appellate Body, *Canada – Aircraft*, paragraph 157.

⁵⁸ See Articles 3 and 4 SCM.

⁵⁹ See Articles 5 to 7 SCM.

examination of the strict legal test to establish that a subsidy is an export subsidy seems to lead to the conclusion that, in most cases, M&A financial support would not qualify as an export subsidy under WTO rules, and that the measure would thus not be prohibited. This conclusion reflects two considerations.

First, the ASCM requires that, in order to establish the existence of an export subsidy, it is necessary to prove that it is “contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance.” While contingency in law is usually easy to prove, since it comes straight from statutory or regulatory language, contingency in fact is more difficult to establish because the case law requires a demonstration that the subsidy is *conditional* on actual or anticipated exportation or export earnings. In other words, the mere fact that the enterprise benefiting from the subsidy *is* operating in export markets does not suffice.⁶⁰

The standard thus established in the case-law is quite high and difficult to satisfy. An example of an M&A subsidy that could qualify as prohibited export subsidy under WTO law is an aspect of Spanish tax law that was recently scrutinized by the European Commission under both EC State aid rules relating to mergers in the *Iberdrola* cases (see below for additional discussion). The Spanish tax incentive scheme provided for companies that were, among other things, purchasing substantial shareholdings (at least 25% of total voting rights) in foreign companies a yearly tax credit corresponding to part of the amount invested provided that the purchase led to greater export activities. Positive proof that the transaction had led to an increase in exports was apparently required. This case is instructive because the tax relief might have been characterized as a prohibited export subsidy if WTO subsidy rules had applied. It is equally clear, however, that the Spanish government might have circumvented the strict standard of WTO export subsidy law by devising the tax concession in a more flexible way, with a more nuanced incentive that would likely have equally reached the intended objective of supporting exports.

The second difficulty of applying WTO export subsidy rules comes from the special scenario of an M&A subsidy. In this case, the foreign company receives a subsidy and, as a consequence, is in a better position (as compared to a US competitor) to put in a successful bid and purchase a US enterprise. However, bearing in mind the strict standard of contingency-conditionality outlined above, the impact of the M&A subsidy on “exportation or export earnings” does not seem sufficiently direct and immediate. On the contrary, the export impact looks only indirect and potential, and perhaps only hypothetical. To put all this in a simple, easy sentence, the WTO rules on subsidies are *directly* focused on merchandise trade flows, either for the export market or the domestic market. It is only when an impact on trade flows can be established that the subsidy which facilitates an acquisition in a foreign company may be prohibited or be otherwise objectionable.⁶¹

In conclusion, it seems that existing WTO subsidy rules could not easily apply to subsidies granted by a government to facilitate an acquisition abroad. In order to bring the WTO into the M&A subsidy picture, the ASCM would need to be extended to cover such cases. Again

⁶⁰ Appellate Body, *Canada – Aircraft*, WT/DS70/AB, paragraphs 162 to 174. A similar interpretation should also apply in the context of the AoA where Article 1 reads: “(e) ‘export subsidies’ refers to subsidies contingent upon export performance [...]”.

⁶¹ This conclusion seems to hold true also with respect to the definition of the various forms of “export financing support” (export credits, export credit guarantees, or insurance programs) in the field of agriculture that are currently under negotiations.

a distinction might be drawn between prohibited and objectionable M&A subsidies, depending on whether the subsidy is narrowly targeted on a particular M&A transaction, or instead provides broad support to the enterprise. Alternatively, with a different focus in mind, the WTO could adopt an approach that we could dub a “distortion of competition” standard, such as the approach currently used under EC State aid rules (see below). This would tackle the negative effects that subsidized acquisitions might have on welfare and competition in the relevant markets. However, extending the WTO rules to M&A activity in this manner would entail a major multilateral negotiation. Given the perilous state of the Doha Round, adding a major new subject to the WTO negotiating table is not realistic for the next several years, but it might be considered in a future round of WTO negotiations.

EC Rules

Since M&A subsidy situations have occurred with a certain regularity in the European Union, we now consider the European experience in controlling takeover bids, particularly if a subsidy issue is raised. Three possible legal avenues will be considered: EC State aid control, EC merger control, and EC internal market rules.

The European system of State aid control, which dates back to 1951 for the coal and steel sectors and to 1957 for the other industries, is remarkable in its uniqueness being the most developed “international” system of control of “national” State subsidies.⁶² In a nutshell, EU Member States are under an obligation to notify to the European Commission their plans to grant State aid that might distort intra-Community competition and trade, so that the Commission can in turn exercise preventive control if necessary. In the exercise of its wide powers, the European Commission can conclude that the measure is not a State aid or, often following negotiations with and commitments from the relevant Member State, conclude that there is a State aid but this is “compatible with the common market” because it remedies a market failure or pursues an otherwise legitimate objective (as provided in the EC Treaty and developed in subsequent practice, case law, and legislation). If a State aid is granted before the Commission has given its authorization, full repayment can be ordered. In this regard, aggrieved competitors can go to any competent national court of the 27 Member States and request an order of recovery of the illegal aid against the granting Member State.

In order to address the M&A subsidy issue in the context of EC State aid law, it is necessary to quote the definition of EC State aid. Under Article 87, paragraph 1, of the EC Treaty of 1957, unless declared compatible with the common market, what is prohibited is “any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods ... in so far as it affects trade between Member States.” Two aspects are relevant for our purposes.

First, the language is very broad, so broad that over the years various forms of financial support for companies (e.g., capital injections; loans; State guarantees; favorable rescheduling of

⁶² For a recent overview of EC State aid control law see the latest version of the *Vademecum – Community rules on State Aid*, 15th February 2007. Regular updates on EC State aid law (Commission’s practice, legislation and case-law can be found in the website of the Commission’s Directorate General on Competition: http://ec.europa.eu/comm/competition/index_en.html. For a more detailed analysis of EC State aid law see Hancher, Ottervanger, Slot (2006) and Rubini (2008).

debts; and tax incentives) have been repeatedly and consistently held by the Commission to be State aids. The criteria are highly similar to those found in WTO subsidy rules, in particular financial support is prohibited if it is not in line with normal market conditions. Various tests are used in this regard, such as the “Market Economy Investor Test,” the “Market Economy Creditor Test,” etc. With respect to tax incentives, the crux of a complex test is whether the tax measure at issue derogates from the applicable normal tax treatment.

The second important aspect is the increasing application of the rules as “competition” rules – meaning that the Commission investigates the likely economic impact of the subsidy on the various markets that might be affected. This seems to be a major difference between EC rules and WTO rules. EC rules focus more on the impact of a subsidy on the workings of (intra-Community) *competition* rather than on *trade* flows (the latter being inherent in the former). This competition and economic orientation of EC State aid law is one of the crucial objectives of the so-called “State Aid Action Plan” launched in June 2005 by the newly appointed Commissioner on Competition, Ms Neelie Kroes.⁶³

In light of these two circumstances, it appears that the broad language of EC State aid law – which prohibits “any aid in any form whatsoever” which “distorts or may distort competition” – may be used to tackle subsidies that enable a beneficiary to successfully bid on the takeover of a firm based in a Member State. Indeed, following a proper and detailed economic analysis, the European Commission may reach the result that a subsidy which facilitates an acquisition abroad by an EC firm could cause a distortion of competition in a relevant EU market. For example, it may be concluded that a subsidized bid distorted competition because, *but for the subsidy*, the bid of a more efficient EC enterprise would have prevailed. In addition, it might happen that, due to the success of a subsidized acquisition, the resulting competitive situation in the market is impaired.⁶⁴ These concerns were certainly in the background when the European Commission took its 16th December 2003 Decision on the State Aid granted by France to EDF and the electricity and gas industries (see the discussion of “EDF’s expansion abroad” in the main text).

A good example of this application is the scrutiny of State aid in the *Iberdrola* case cited above (see below for the connected merger investigation).⁶⁵ In this case, a Spanish tax scheme enabled Spanish companies that were among other things purchasing relevant shareholdings in foreign companies to offset part of the price paid against their tax liability, the amount of the offset being linked to the extent that the acquisition led to increased exports from Spain. The law also provided a tax deduction for part of the expenses incurred to acquire control of an active business outside the EU, provided the acquisition entailed a new business venture unrelated to activities already exercised in Spain. These tax measures were held to be State aids “incompatible with the common market.”

Finally, another important element of EC State aid control should be underlined. Since the beginning of the 1980s, the European Commission has introduced rules to guarantee the transparency of the financial relations between governments and public undertakings, namely

⁶³ “State Aid Action Plan: Less and Better Targeted State Aid: A Roadmap for State Aid Reform 2005-2009”, 7th June 2005, COM(2005)107 Final.

⁶⁴ Official Journal L49/9.

⁶⁵ “Proposal of appropriate measures under Article 88(1) EC on the aid scheme implemented by Spain in the form of direct tax incentives in favor of export related investments” – Aid E 22/2004 ex NN 13/2004; Commission Press Release IP/06/355.

enterprises under the control of the government.⁶⁶ Over the years, these duties, which include separate accounting for the various businesses carried out by the public undertaking as well as notification obligations, have been broadened to encompass even measures that are not, strictly speaking, classed as State aid in the first place – namely measures that merely offset the costs of a public service obligation imposed on the controlled enterprise, and thus do not confer a competitive advantage. The notification requirements are designed to ensure transparency in the muddy waters of government-public sector financial relations, and suggest a good model to follow.

The importance of ensuring transparency in relation to government subsidies to state-owned companies was reflected in the proposal submitted in June 2007 by the US government in the Rules Negotiating Committee in the context of the current Doha Round Negotiations.⁶⁷

The second legal avenue for tackling M&A subsidy cases in the European Union is through merger laws.⁶⁸ The European Commission is entrusted with the preventive control and authorization of planned mergers and acquisitions. All mergers of a “Community dimension” – those that satisfy certain minimum turnover thresholds – must be notified in advance. In deciding the merits of a merger between previously independent firms or the acquisition of control over one or more firms, the Commission considers the consequences that the grant of State aid to the affected companies has on the maintenance of effective competition in all relevant markets. The substantive analysis focuses on whether the proposed merger will “significantly impede effective competition” in the common market or a substantial part of it “in particular as a result of the creation or strengthening of a dominant position.” If this is the likely case, even after modifications are considered, the merger cannot go ahead (although this has been extremely rare in practice).

It is within this context that subsidies granted to one of the bidding companies have been considered by the European Commission and the Court of First Instance in two cases, one in the coal sector (*RJB Mining*, 2001), and another in the energy sector (*Iberdrola/ScottishPower*, 2007). What was feared in both cases was that the subsidy might have strengthened the financial and commercial position of the bidding company and, as a consequence, undermined competition in the relevant markets.

In the *RJB Mining* case⁶⁹ at issue was the acquisition of the entire share capital of Saarbergwerke AG (“SBW”) from the Federal German Government and the Regional Government of Saarland, by RAG Aktiengesellschaft. Against a real value of 1 billion DM (Deutsche Mark), the price of the transaction was just 1 DM. In its decision, the Court of First Instance noted that “in adopting a decision on the compatibility of a concentration between undertakings within the common market the Commission cannot ignore the consequences which the grant of State aid to those undertakings has on the maintenance of effective competition in the relevant market.” The Court concluded that the Commission failed to examine the price paid

⁶⁶ See Commission Directive 80/723/EEC on the transparency of financial relations between Member States and public undertakings (“Transparency Directive”) 1980, Official Journal L195/35, as subsequently amended in 1985, 1993, 2000 and 2005.

⁶⁷ Proposal from the US, TN/RL/GEN/146, 5th June 2007.

⁶⁸ The current laws can be found in the Regulation 139/2004/EC of the Council of 20 January 2004 on the control of concentrations between undertakings [2004] Official Journal L24/1. For an analysis of EC merger laws see Jones and Sufirin (2007) Chapter 12.

⁶⁹ Case T-156/98 *RJB Mining v Commission of the European Communities* [2001] ECR II-337.

by RAG to acquire SBW, and failed to analyze whether, and to what extent, this bargain price had strengthened the financial and commercial position of RAG. The Commission's decision authorizing the merger was thus annulled.

Another interesting case is that of the authorized acquisition of *Scottish Power Plc* by *Iberdrola SA*.⁷⁰ Two measures were considered in the overall assessment of the acquisition. The first (a tax incentive for purchasing of shareholdings in foreign companies if this led to greater exports) has already been examined. The second was the possibility for Spanish companies purchasing shares in a foreign company to amortize the cost of financial "goodwill" (i.e. the difference between the value of tangible assets acquired and the purchase price). The Commission considered whether these two measures could have increased the financial and commercial strength of the bidding company and, crucially, whether such a strengthening could have raised concerns about the quality of competition following the merger. The Commission had already found that, leaving aside the two tax incentives, there were no concerns over a significant impediment to effective competition in any relevant market. Since there was no indication that the importance of the tax incentives could put the merged company in a position that could weaken the competitive constraint exercised by its rivals in the relevant energy markets (UK or Spain), the merger was authorized.

This overview of EU experience with the surveillance of takeover bids can be nicely concluded with a brief reference to internal market rules, namely rules about removing obstacles to the free circulation of economic factors within Europe, particularly capital.

It does not appear that internal market rules would be applicable in the M&A subsidy scenarios of recent U.S. experience. Hypothetically, a subsidy granted by EU Member State A to acquire a firm in EU Member State B could be regarded as an obstacle to the free circulation of capital for EU Member State C, if the subsidy undercut the bid put forward by one of the companies in State C. This set of circumstances does not seem to match the scenario of a foreign company bidding for a U.S. company, thereby undercutting the takeover attempt of another US company.

By contrast, the free movement rules may well apply – and have been applied recently – to various "golden shares" and "special rights" introduced to control the foreign acquisition of domestic EU companies, particularly after privatization and in sensitive sectors such as energy, telecommunications, and airport management. A string of cases confirm that these measures are generally illegal since they constitute an obstacle to the free movement of capital within Europe which would hamper the creation of an internal market in the relevant sectors.⁷¹ These restrictions have been justified only rarely, notably when the defendant Member State could prove that the restriction was justified for public security reasons (such as the maintenance of minimum supplies of gas in the event of a real and serious threat).⁷²

In this regard it is interesting to note Italy's attempt to block EDF's expansion into the Italian energy market by passing legislation that would suspend voting rights attached to share

⁷⁰ Case No COMP/M.4517 – *Iberdrola / Scottish Power*.

⁷¹ See Case C-112/05 *Commission v Germany*, Judgment of 23rd October 2007, not yet reported; Joined Cases C-282/04 and 283/04 *Commission v Netherlands* [2006] ECR I-9141; Case C-98/01 *Commission v UK* [2003] ECR I-4641; Case C-463/00 *Commission v Spain* [2003] ECR I- 4581; Case C-483/99 *Commission v France* [2002] ECR I-4781; Case C-367/98 *Commission v Portugal* [2002] ECR I-4731; Case C-58/99 *Commission v Italy* [2000] ECR I-3811

⁷² Case C-503/99 *Commission v Belgium* [2002] ECR ECR I-4809.

holdings that exceeded 2% of the capital of firms in the electricity and gas sectors. The Commission rejected the Italian argument that its measures were introduced as a defense against “asymmetries” in the liberalization of national energy markets. Following previous case law, the European Court of Justice accordingly declared this defensive measure illegal.⁷³

Finally, with respect to the European surveillance of takeover bids, brief mention should be made to the so-called “Takeover Directive,” adopted in December 2003 after 14 years of negotiations.⁷⁴ Two crucial provisions (Articles 9 and 11) prohibit target firms from adopting (without shareholder approval) defensive actions to frustrate bids, and allow bidders to overcome certain restrictions of the target company in order to achieve full control. However, individual Member States can opt out of these provisions – the price of achieving a compromise.

OECD practices

The OECD’s experience with monitoring export subsidies sheds some light on practices that might be adopted in the M&A subsidy context. The most important conditions that the Export Credits Group (ECG) applies to officially supported export credits, via the provisions of successive Consensus Agreements, are the following:

- at least 15% of the contract is to be covered by a cash payment;
- the maximum repayment term is 10 years; and
- when official financing support is extended in the form of direct credits, refinancing, or interest rate subsidies, a minimum rate of interest is set.

In order to promote transparency, the ECG provides that any participant may query any other participant about whether a particular export credit transaction is in accordance with the rules. The participant receiving the query must reply within a specific period.⁷⁵ As a consequence, full disclosure has become the normal practice between competing official export credit agencies. A similar practice could become the agreed norm in cross-border M&A bids.

One other aspect of the ECG model might find application in the M&A realm. The original “Gentleman’s Agreement” of 1976 and the OECD Export Credits Group were both created by countries that were all on the same side of official export credit transactions – namely countries *granting* export credits and guarantees. Similarly, in the first instance, an M&A compact should be spearheaded by countries that are on the same side of the merger equation – namely *recipients* of M&A. Recipients concerned with subsidized M&A and SWFs, such as the United States and the European Union, might have little leverage to draft a set of rules that would be readily accepted by subsidizing countries such as China and Korea, and creators of

⁷³ Case C-174/04 *Commission v Italy* [2005] ECR I-4933.

Another interesting case has recently been passed by the European Court of Justice (6th December 2007) in Joined Cases 463/04 and 464/04 *Federconsumatori*. It concerns privatized undertakings, and in particular an Italian provision under which the articles of association of a company limited by shares may confer on the State or a public body holding shares in that company the power to appoint directly one or more directors to the board. The result, a situation of power which is disproportionate in relation to the actual shareholding, has been considered as an obstacle to free movement of capital and hence unlawful.

⁷⁴ Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, Official Journal L142/12.

⁷⁵ See Ray (1995 40-1) for a more detailed description of the ECG.

SWFs, such as China and Middle East states. However, the United States and European Union might find ready agreement with Canada, Australia, and Japan on these matters.

Notes