

Legal Risks of Chinese Enterprises' Overseas Investment and Mergers & Acquisitions

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Abstract: Chinese enterprises' overseas investment and mergers & acquisitions have high risks: on the one hand, overseas investment and M&A process easy to make losses; on the other hand, some enterprises after completing overseas investment and M&A, have not achieved their expectations. And investing risks faced by enterprises in addition to political risk, also include economic risks, such as market risk, financial risk and operational risk, and many other legal risks, such as intellectual property risk, financial regulation risk, risk of environmental protection, anti monopoly review and competition policy, and anti acquisition risk. Summing up the legal risks, and proposing feasible solutions have constructive significance for overseas investment environment research and promoting Chinese enterprises overseas investment and acquisitions. And it can strengthen scientific assessment of investment projects, and provide service for implementing the "going out" strategy, protecting Chinese enterprises' overseas interests.

Keywords: Overseas investment; Legal risks; Prevention and controlling; Advice

1. Introduction

Overseas investment and M&A is the only way for the globalization of Chinese enterprises, as well as an important management measure of enterprise under the background of globalization. In recent years, Chinese enterprises' overseas investment and M&A business has made some achievements. For example, on December 8, 2004, Lenovo announced the acquisition of IBM's global PC business; China's third largest oil and gas group -- China National Offshore Oil Corporation (CNOOC) issued more than \$130 billion takeover offer to its American competitor-Unocal oil company at the end of 2004; SMIC made acquisition of Motorola chip business; SAIC negotiated the acquisition of the 70% stake of British Rover; In 2005 Haier's acquisition of Mattel. Chinese enterprises' overseas investment mainly concentrates in aspect of energy, minerals, and infrastructure. Meanwhile, it has been expand to high-tech, high-end manufacturing, agriculture, bio pharmaceutical, real estate and other fields. The main reasons for overseas investment and M&A are: using foreign exchange reserves; layout strategic assets; having access to advanced intellectual property rights and management experience; spreading assets risk; value depression brought by international economic crisis; improving internationalization of Chinese enterprises. Overseas investment and M&A are mainly active in Canada, Australia, Africa, Southeast Asia, Europe, United States, Latin America, Central Asia, Russia and other places.

Although cross-border M&A is a necessary strategy for Chinese enterprises to carry out overseas expansion, Chinese enterprises generally lack the ability to resist legal risks and political risks. These risks and their countermeasures should be carefully studied with great attention.

2. Risks of Chinese Enterprises' Overseas Investment and M&A

Chinese enterprises' overseas investment and M&A is a transnational business activity, involving the adjustment of transnational laws which include domestic laws and foreign laws. Domestic legal barriers mainly involve project approval and foreign exchange sources, etc. Foreign legal barriers mainly involve political reasons, restriction of anti monopoly law and anti unfair competition law as well as policies which restrict foreign investment. The legal system of transnational M&A in western developed countries depends on anti monopoly law, transnational M&A censorship law; securities exchange act, company law, social security law, bankruptcy law and other laws and regulations. Here, legal investigation plays important role in the success of overseas investment and M&A.

2.1. Charter Review of the Host Government

Political attacks on transnational M&A are demonstrated in legal form, especially in charter review. Legal obstacles of government charter review are embodied particularly evidently in the acquisition of energy enterprise, which can be seen from the case of acquisition of Unocal

by CNOOC. Chinese enterprises' overseas investment and M&A are facing different legal and policy risks. A lot of Chinese companies that make overseas investment and M&A are state-owned enterprises. Even if some are not state-owned enterprises, they are related to government closely. This government background will bring some unexpected troubles for Chinese enterprises in overseas investment and M&A. Some overseas people with ulterior motives tend to use it to attack Chinese enterprises, and some even have set up obstacles to prevent Chinese enterprises' overseas investment and M&A. Even if investment and M&A is successful, the policies of Chinese government and government of M&A companies will make unpredictable influence on M&A companies.

In the case of CNOOC acquisition of Unocal, America's second review delays time. Therefore, even the high purchase price still fails to change the failure of acquisition. 52 members of United States Congress use the excuses of "energy threat", "national security", and "master the deep-sea core technology" to ask Committee on foreign investment in the United States (CFIUS) to make critical review of the role of Chinese government playing in this acquisition case, attempting to make political censorship of CNOOC acquisition of Unocal. In fact, the United States government believed that CNOOC acquisition of Unocal would threaten energy security of the United States. And these reasons are untenable. Because local production of Unocal in the United States accounts for less than 1% of the total consumption of the United States, and its international output are not available in the United States market, how can it affect its energy security? The hidden real reason is that American government does not want China to control Unocal's Asian resources. CNOOC is hold by the Chinese government and the threat of energy security is only an excuse for its anti takeover.

2.2. Insurance of Overseas Investment

Overseas investment and M&A have more uncertainty than domestic M&A, so it is facing more risks. But China is still unable to provide comprehensive risk protection for Chinese enterprises overseas investment and M&A activities. In the process of overseas investment and M&A, Chinese enterprises may encounter various political risks and commercial risks. Generally, it is believed that commercial risks should be undertaken by the merchants themselves. And political risks are the biggest risks faced by overseas investment behaviors which include overseas investment and M&A transaction. ¹

¹ Political risks refer to the risks related to the host country's politics, society, and law and out of the control of investors. These risks include: (1) Expropriation risk refers to the host country, based on the needs of the national and social public interests, makes expropriation, confiscation or nationalization

The political risks faced by overseas investment are the biggest risk to investors, which greatly hinders the development of overseas investment. And overseas investment guarantee system is a universal and effective legal system which the investment country uses to encourage overseas investment and ensure the security and interests of overseas investment. ² China should refer to the United States, Japan and other countries for some effective experience in overseas investment guarantee system establish an overseas investment guarantee system with Chinese characteristics based on China's reality. And make domestic guarantee system in accordance with bilateral investment agreement signed by China with foreign counties and international investment protection convention which China has joined in.

2.3. Anti Monopoly Review and Competition Policy

The analysis of international M&A effect shows that the biggest negative effect is that it may lead to monopoly, which is easy to suppress the host country's immature industry, control the host country market, and destroy the original competition order of the host country. Therefore, the core law to overcome the negative effect of international M&A is the anti-monopoly law.

Western developed countries have two different approaches in the development of review law of international M&A. In the United States, Britain, Germany and France, both in domestic and international M&A transactions, the country's anti Monopoly Authority or an authorized government department should conduct the anti monopoly management duties and reviewing processes within the anti monopoly law; and Australia and Canada have developed two sets of different laws and different

of foreign capital enterprises; (2) Transfer risk refers to the host country because of its international payment difficulties, implements foreign exchange controls, prohibits or restricts foreign investors to transfer the original, profit and other legitimate income out of the host country; (3) War and civil strife risk refers to political instability, ethnic or sectarian conflict, revolution, war and civil strife in host country make foreign invested enterprises or property suffer heavy losses, so that they cannot continue to operate; (4) Default risk is the situation that host country government defaults, and investors can not or can not ask judicial or arbitral institutions for help in time, or although there is arbitrary result, it can not be applied for execution, etc.

² Overseas investment guarantee system, also known as the overseas investment insurance system, is insurance responsibility which capital exporting countries or the government of investing country takes for domestic investors' political risks in overseas investment. Based on the insurance contract, the capital exporting countries or the government of investing country is responsible for compensating investors for their losses in host country's political risk. It is a domestic legal system to obtain right of subrogation.

review departments for domestic and international M&A. Domestic mergers and acquisitions reviews are conducted by domestic anti monopoly authorities mainly with the application of domestic competition law; and the reviews of transnational mergers and acquisitions are conducted by foreign capital management departments mainly applying foreign capital management law. The anti trust laws of all countries are not the same in the identifying standard and examining process of the monopoly. Especially in British and American law systems which advocate the case, there is some flexibility to judge illegality of monopoly. Legal monopoly is the inevitable result of competition. And Chinese enterprises in overseas competition may produce legal monopoly. However, because some countries' anti monopoly system is too strict, legal monopoly of Chinese enterprises may become the target of anti monopoly.

2.4. Anti Acquisition Risks

Chinese enterprises implement mergers and acquisitions of foreign company means that representatives of Chinese enterprises have participated in the management of target companies and obtained the controlling right. The management team of the original company for their own interests and the resistance for foreign corporate culture will make a variety of anti acquisition efforts. For example, they will persuade the anti monopoly department to prevent the merger and acquisition, collect evidence that show the procedures which may violate the company law, securities law, anti monopoly law and other relevant laws and regulations, improve the potential acquisition costs, make an acquisition offer with high price or take other economic means to increase the difficulty of acquisition.

2.5. Approval System of Chinese Government

Legal barriers to foreign investment M&A are not only from the laws of the host country. Chinese enterprises overseas investment and acquisition is also facing such special legal obstacles as rigid approval system of national government and many restrictive policies. Although China has established the "going out" strategy early in 1999, there lacks of effective and practical actions as policy support. From the macro management of the government, there is a contradiction between the encouragement and fear of being out of control for Chinese government. China's economic policies and the legal system for overseas investment and M&A are still not perfect. And the biggest obstacle for overseas investment and M&A comes from government's control, especially foreign exchange control and investment approval. Considering from preventing capital flight, regulatory difficulties and other factors, China takes strict examination and approval system and foreign exchange control system—"approval step by step and quota management". According to the existing provisions, projects that make

overseas investment more than a certain scale must be reported to the state departments for examination and approval. And those involving overseas investment in different industries should also going through joint hearing and joint trial. This increases difficulty for Chinese enterprises to carry out overseas investment and M&A and is easy to make the enterprise loss the fleeting opportunities of overseas investment and M&A. In addition, related mergers and acquisitions regulations in China are scattering in company law and securities law, which lacks of a clear law which is similar with Law for Promoting Overseas Investment and M&A. There is a serious shortage of related policies which is obviously falling behind compared with the rising Chinese overseas investment and M&A actions.

2.6. Difference between Legal System and Legal Culture

Prior to overseas investment and M&A, potential of cultural differences and conflicts should be understood. The impact of cultural differences on overseas investment and M&A has caused widespread attention. Legal system is also a kind of culture. The differences between the legal system and legal culture often affect the transnational economic activities. On the one side, this difference reflects the lack of understanding of Chinese enterprises for the host country, which makes a higher requirement for legal services; on the other hand, it also reflects the lack of understanding or even misunderstanding of the host country for China's laws. For example, in the wave of Chinese enterprises overseas mergers and M&A, especially large state-owned enterprises and large state-owned enterprises are the main forces and many large cases of overseas investment and M&A are performed by state-owned enterprises. When Chinese state-owned enterprises conduct overseas investment and M&A, they will inevitably attract outside particular attention. Such a view widely existed in developed countries as the behavior of Chinese state-owned enterprises is equivalent to the behavior of the Chinese government. Although state-owned enterprises have close contact with the country and are national investing or holding enterprises, state-owned enterprise behavior cannot simply be equal to national political behavior. Legal status of state-owned enterprises is independent commercial subject.

2.7. Legal Risk in Operation Phase

The legal risk of overseas investment and M&A is in the phase of acquisition and operation. And some experts believe that the former accounts for 20% of the legal risk, and the latter 80%. The legal risk in operation phase involves various aspects of enterprises operation. Due to the difference of the legal system and legal culture, Chinese enterprises lack the proper attention to some legal risks. For energy companies, for example, environmental

protection should be given due attention. The environmental protection law of the western developed countries is more perfect than China, and the related punishment for environmental pollution is severer. In addition, the legal issues related to foreign investment and M&A also include intellectual property, labor law, contract management, corporate governance and other aspects, which are likely to become the legal risks in operation phase.

3. Prevention of Legal Risks for Chinese Enterprises' Overseas Investment and M&A

Investment and M&A is an important feature in the era of economic globalization, and it is the only way for China's economic globalization. Chinese enterprises are in the learning stage in overseas investment and M&A, and they lack of risk management consciousness, for which they have paid a high price. The top priority should be to build a risk control system for overseas investment and M&A from the two aspects of enterprise and government: Enterprise should face the risks in international mergers and acquisitions, and constantly improve the risk identification and risk management capabilities; the government should establish a policy support system for overseas investment and M&A to provide policy and legal support, and help enterprises solve problems in time.

3.1. Making Scientific M&A Decision

Before overseas investment and M&A, a clear strategy for enterprise development should be made to ensure the correct development direction of the enterprise. The fact should be noticed that transnational M&A is not the only model and the best choice for enterprise development. Transnational M&A and international business model such as enterprise strategic alliance both have their own strengths. Overseas investment and M&A should be incorporated into the strategy planning framework of enterprise development. Under the guidance of the planning, carry out overseas investment and M&A. First, find M&A industry and the target enterprise. Then carry out analysis of strategic consistency, the ability matching, and the complementary of advantages. Based on this analysis, make a overall judgment on whether the M&A is in line with the of enterprise development strategy; second, analyze the feasibility and make clear acquisition plan, including designs of strategic assessment, business integration, transaction structure, payment method, payment rhythm and risk prevention, as well as the operation principle after M&A and integration strategy, etc; Finally, conduct full investigation on the target enterprise. Chinese enterprises can hire investment banks and other intermediaries to make a comprehensive analysis of the industrial environment, financial position and management ability of the target enterprise. Therefore, Chinese enterprises can make reasonable forecast of the target enterprises from the perspectives of the core strengths,

key technologies and marketing channels, so that the assessed value will be closer to the real value of the target enterprise.

3.2. Properly Handle the Political Risks

Transnational mergers and acquisitions tend to cause a lot of economic and social shocks, so that a flexible strategy needs to adopt. In the acquisition of the target enterprise in the host country, a gradual approach should be taken. First, Chinese enterprise can use joint venture or cooperation to establish a good corporate image, and then consider mergers and acquisitions; Also, it can make M&A by controlling all stocks or nearly all stocks instead of making a wholly owned M&A. And carry out further acquisition at the right time; besides, it can also find a joint venture in the country where the target company is as the agent of transnational M & A, in order to avoid the host government or local government intervention. Use various channels to carry out moderate communication and lobbying with the host government, the public and the media, letting them fully understand the motivation and background of Chinese enterprise's mergers and acquisitions and eliminate the misunderstanding and prejudice as much as possible. For example, Chinese enterprises can through diplomatic channels, the two countries' non-governmental friendship organizations or the influential political figures from the country where the target company is, obtain understanding and support of the government of the host country, and meet the requirements of the government of the host country in terms of employment as far as possible. At the same time, try to get the friendly cooperation of the target company. In these ways, can the local government provide a loose political environment for Chinese enterprises' transnational M&A, considering from their industrial development and social development.

3.3. Be Familiar with Laws

It is a compulsory course for Chinese enterprises' overseas investment and M&A to have a deep understanding and research on the legal system of the country where the target enterprise is located. Close attention should be paid to anti-monopoly law of the host country as well as the capital market supervision and control of foreign exchange by the government. And in the countries and regions with high unemployment rate or serious labor issues, careful examination should taken to the situation of labors, trade unions and the welfare of the host country. Employee risks which may be brought by M&A should be given enough consideration to avoid new labor disputes. In the process of mergers and acquisitions, lawyers with rich experience must be hired to effectively avoid the above problems and risks.

3.4. Resolve the Financing Traps

Chinese enterprises should understand the local financial market conditions and financial policies, and use the financial derivative instruments to solve the financing trap. In the exchange market, currency swaps, interest rate swaps, forward rate agreements, futures trading, options trading and other tools should be used to reduce the interest rate risk and exchange rate risk caused by fluctuations of interest and exchange rates. Besides, stock futures or options, stock index futures or options and other trading tools can be used in the stock market to effectively reduce the risk of stock price fluctuations. But what should also be noticed is that financial derivatives are a "double-edged sword". With proper usage, it can effectively help companies get higher returns or hedge business risks. On the other hand, without sufficient understanding of the risks of derivative products, hastily participation or excessive speculation are possible to bring great losses to traders. A lot of facts have proved that without proper control of the derivative financial instruments, it will give a bitter lesson to the traders. But this is not the fault of the transaction itself, but rather the fault of the people.

In short, overseas investment and M&A is a complex transaction which involves various factors like transnational economies, laws, politics and cultures. Chinese enterprises which want to "go out" must establish a clear strategy of M&A before carry out overseas investment and M&A. And they also make an overall investigation and estimation on themselves and the target enterprises. Besides, a modern enterprise system should be established to standardize enterprise behavior, preventing all kinds of legal risks from the sources.

4. Suggestions on Perfecting the Legal Risk Prevention System of Chinese Enterprises' Transnational M&A

This paper tries to put forward some countermeasures and suggestions from aspects of macro and micro, as well as government and enterprises and from the point of view of law.

4.1. Formulate and Improve Relevant Laws and Regulations

Although transnational M&A has become the main form of international investment, China's current law on international investment is still based on the new enterprise mode which ignores the special requirements of M&A for government regulation in capital, foreign exchange, property management and other aspects. In addition, China has gradually introduced a number of laws about foreign enterprises make mergers and acquisitions of Chinese enterprises, but there is still a legal blank for the Chinese enterprises' overseas investment and M&A.

Aiming at the legal obstacles of overseas investment and M&A, the relevant departments of China should, from

the strategic height, set up the legal system of overseas investment in accordance with international management as soon as possible. From the perspective of legislation, China should formulate and perfect legal regulations such as Overseas Investment Law, Overseas Investment Insurance Law and even Overseas Investment and Mergers and Acquisition Promotion Law. Increase the intensity of macroeconomic support, and proving clear legal provisions for the problems in overseas investment and M&A such as approval process, foreign exchange control, financing, insurance support, and tax policy. And develop a suitable operation method and procedure to realize the standardization and legalization of overseas investment and M&A. From the perspective of the organization, China should set up a specialized management institution for overseas investment and M&A, and formulate the strategic plan and policy of Chinese enterprises' overseas investment and M&A. This institution should be separated from and coordinate with the national development and Reform Commission, Ministry of Commerce, People's Bank of China, the Ministry of finance, the State Administration of foreign exchange and other relevant departments to provide policy guidance and advisory services for Chinese enterprises' overseas investment and M&A as well as timely resolve various problems in practice. From the perspective of policies, China should improve policies related to Chinese enterprises' overseas investment and M&A, appropriately loose license approval for overseas investment, reduce the government's unreasonable control, simplify examination and approval procedures, improve government work efficiency, and strengthen the government's functions of organizing and guiding as well as information services.

Besides, China should also learn from the United States, Japan and other developed countries, establishing overseas investment insurance system and expanding the coverage of the bilateral investment protection agreement. Meanwhile, strengthen the connections between overseas investing enterprise with risk investment companies and insurance companies to establish a risk sharing mechanism, helping Chinese enterprises guard against and defuse the risks in overseas investment and M&A.

4.2. Attach Importance to Legal Issues Related to M&A

From the perspective of the enterprise, all aspects of the legal issues related to overseas investment and M&A may be involved in. Overseas investment and M&A mainly involves the anti-monopoly law, transnational M&A examination law, securities exchange act, corporate law, social security law, bankruptcy law and other laws and regulations, which have caused great attention. But some other legal issues such as intellectual property rights, labor law, contract management, and corporate governance have not been paid attention to. For example,

Chinese enterprises develop under the condition of immature domestic market, while foreign market regulations, especially in developed countries, are more perfect and complete. Laws and regulations about protecting labor relations can be said to exist everywhere. And difference even exists in the legislative concept. This requires that the Chinese enterprises, especially the legal counsel of the enterprise should be familiar with the labor laws of the host country.

4.3. Attach Importance to the Markets in Developing Countries

It not only has the economic significance, but also has legal significance to attach importance to the markets in developing countries. From the current cases of Chinese enterprises' overseas investment and M&A, it can be seen that the target markets of the Chinese enterprises' investment and M&A are mainly in the developed countries, which has improved the cost of Chinese enterprises "going out". From economic perspective, the profit of internationalization generally comes from the economic gap, that is, it will be easier to earn the profits for regional enterprises with a high technical level and business level to go to a region with a low business level. In accordance with this law, Chinese enterprises, especially private enterprises in the implementation of overseas investment and M&A should pay more attention to markets in developing countries. From a legal perspective, the legal environment of in developing countries about markets may be closer to the domestic legal environment, so that the Chinese enterprises may face less legal barriers in overseas investment.

4.4. Provide High-quality Intermediary Service

Overseas investment and M&A can not be separated from the support of high-quality intermediary service. China should vigorously develop the intermediary service agencies in the field of overseas investment and M&A. At present, many of China's enterprises' overseas investment and M&A depend on the foreign intermediary service agencies with cost high, which greatly increase the cost of overseas investment and M&A. Therefore, China should vigorously develop the intermediary organizations for overseas investment and M&A, especially to form a number of international organizations with a certain reputation and high level. And foster China's large investment banks and expand lawyers and accountants which have the ability to deal with foreign affairs to provide a full range of services for Chinese enterprises' overseas investment and M&A. In short, Chinese enterprises in overseas investment and M&A should be familiar with international rules and international practice, and understand and study the legal system and culture of the

host country to overcome legal obstacles and get the best advantage of overseas investment and M&A. The Chinese government should also give due legal and political support by developing and perfecting relevant laws and regulations.

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