

# Global Mergers and National Security

by Stuart S. Malawer

The world of global mergers today is like a Virginia steeplechase, frantic and exciting, with a field of powerful participants. The competitors are hyperactive; adrenalin is flowing, leaving spectators anxious and amazed. In an instant a horse may stumble; if so, it will almost certainly face a horrible end.

Global mergers are in a turbo-charged environment, where activity is at a historical high. Corporations look for deals worldwide. But in the postmortems of all tragedies, one can usually spot early warning signs, almost always overlooked until it is too late. Were there unforeseen obstacles? Were the participants new and inexperienced? Did they understand the rules? Did the participants react irrationally?

Since September 11, 2001, the global merger field has become more dangerous. New, inexperienced players have entered the world of cross-border acquisitions and mergers. Each player has its agenda. Now the home countries of the experienced firms and others are beginning to change the rules—creating new challenges for all.

## The Global Landscape— Investment Data and Recent Deals

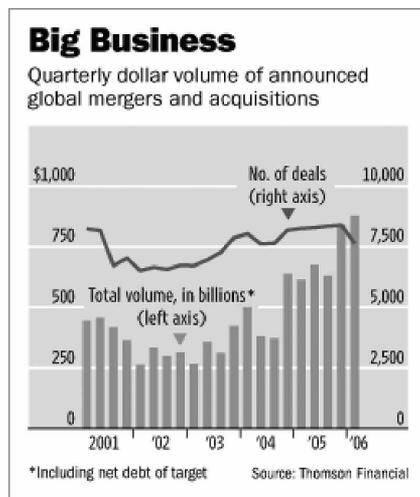
International transactions are at the heart of economic globalization,<sup>1</sup> and foreign direct investment is a critical aspect of these transactions. Cross-border acquisitions and global mergers are at the transactions' core. Transnational corporate undertakings have raised national security anxieties worldwide.<sup>2</sup> Resource nationalism and renewed reaction to globalization further stir global anxieties. Combine these concerns with the growing number of global takeovers by private and state-owned firms from China, Russia and India, and a dramatically new and unsettling global landscape emerges.<sup>3</sup>

This latest global environment has evolved in the post-9/11 world, in part from reactions to the threat of global terrorism, but also in large measure from economic change in developing and transitional economies. The change has been accentuated by high energy and commodity prices and an international economy awash in private capital, as well as corporate and government surpluses.

### Global Data

The merger boom of the late 1990s is back.<sup>4</sup> Worldwide deals reached a total volume of \$2.8 trillion in 2005, up from \$1.9 trillion in 2004.<sup>5</sup> In the first quarter of 2006, \$857 billion in global mergers and acquisitions were announced—the highest level since 2001.<sup>6</sup> See chart 1.

Chart 1



WALL STREET JOURNAL (April 4, 2006).

The year 2006 may set new records.<sup>7</sup> As of May 2006, global mergers and acquisitions topped \$1.3 trillion, a 40 percent increase over the same period the prior year. The announced U.S. merger activity for the current year as of May 2006 was \$476 billion, the highest since 2001.<sup>8</sup>

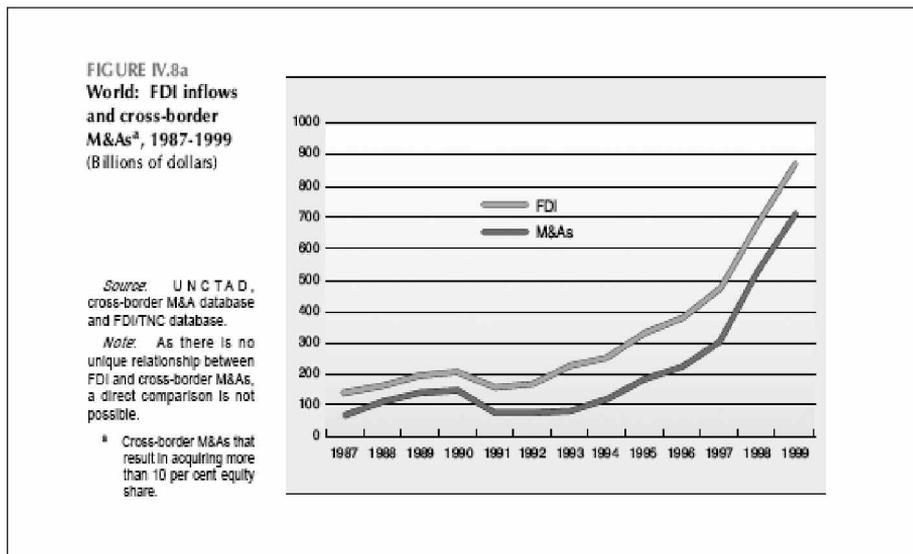
A recently released annual study on foreign direct investment by the United Nations Conference on Trade and Development (UNCTAD) determined that global foreign direct investment (FDI) inflows rose by 29 percent to \$916 billion in 2005, compared to a 27 percent increase in 2004.<sup>9</sup> “As in the late 1990s, that growth was spurred by cross-border mergers and acquisitions,” the study concluded.<sup>10</sup> The study found that the value and number of mergers and acquisitions in 2005 were comparable to the averages in 1999–2001.<sup>11</sup> The study also noted that many parts of the world undertook intense discussions on economic protectionism.<sup>12</sup> It did not discuss the issue of national security,<sup>13</sup> and it ominously concluded that “the number of changes (to a host country’s regulatory environment) making a host country less welcoming to FDI was the highest ever recorded by UNCTAD.”

This current pattern of FDI growth and importance of global mergers is similar to the go-go years of the late 1990s. An earlier study by UNCTAD in 2000 determined that global mergers amounted to \$710 billion as part of the total worldwide foreign direct investment of \$880 billion in the 1990s.<sup>14</sup> See chart 2, above right.

The study determined that eighty percent of foreign direct investment into the United States during the late 1990s resulted from cross-border mergers and acquisitions.<sup>15</sup> According to the U.S. Bureau of Economic Analysis, foreign direct investment into the United States last year reached its highest level since 2001.<sup>16</sup>

Recent data confirm that the global merger boom is roaring back. Such mergers are the major source of FDI into the United States, and, despite the war on terrorism, foreign direct investment into the United States and its accompanying cross-border

Chart 2



WORLD INVESTMENT REPORT 2000 (UNCTAD).

mergers and acquisitions of U.S. firms are at their highest levels since 9/11.<sup>17</sup>

**Global Deals**

American anxiety over global mergers and their implications for national security reached record heights with the aborted management takeover of several U.S. port facilities by the United Arab Emirates-based Dubai Ports World in early 2006. This political fiasco for the Bush administration came a few short months after the China-based CNOOC Ltd. dropped its bid for U.S.-based Unocal and its global oil reserves. This aborted acquisition occurred shortly after the takeover of IBM's PC business by China-based Lenovo and Singapore Technologies Telemedia's purchase of Global Crossing and acquisition of its global fiber optics network. The recent transatlantic purchase of Lucent Technologies by France's Alcatel raised concerns of national security regarding sensitive telecommunications research.

National security concerns are not limited only to the United States government. China Mobile Communication's Corp, the world's largest wireless operator based on subscribers and market capitalization, was forced to drop its \$5.3 billion bid for European-based Millicom International Cellular.<sup>18</sup> This decision came in the midst

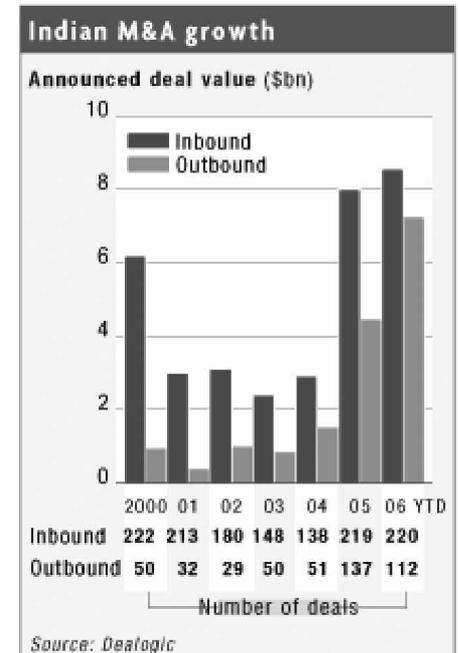
of mounting concern in Europe of Chinese ownership in the telecom sector. Only after a severely bruising battle did India-based Mittal take over European-based Arcelor to form one of the largest steel companies in the world—and only after the Russian firm Severstal was dropped, perhaps for being viewed as more of a national security risk.<sup>19</sup>

The offer by Tata Steel to buy British steelmaker Corus Group would make it the biggest foreign acquisition by an Indian company. However, the more recent offer by the Brazilian steel giant Companhia Siderurgica Nacional (CSN) for Corus strikingly highlights the tip of a very large iceberg of a rapidly changing structure of global trade. Global mergers are significantly driven by companies from developing countries. These companies are well on their way to becoming the great industrial enterprises of the Twenty-First Century.<sup>20</sup>

India's outbound merger and acquisition growth is greater than ever.<sup>21</sup> Its outbound investment is almost as great as its inbound deal value.<sup>22</sup> See chart 3 above.

However, India is also concerned about national security—particularly the effect of foreign investment into its infrastruc-

Chart 3



FINANCIAL TIMES (October 4, 2006).

ture. China has complained that several Chinese companies, including telecommunications firm Huawei Technologies Co., have been blocked from bidding on projects because security clearances have been withheld.<sup>23</sup> India is considering new legislation similar to the legal regimes in the European Union and the United States that review foreign investment in context of security concerns. China is also raising fears that it will restrict foreign takeovers of state-owned companies.

Russia-based Gazprom's proposed takeover of Centrica in the United Kingdom and its interest in investing in European pipelines has raised concerns in the United Kingdom and Europe, relating primarily to the aggressiveness of Russian firms in the global energy sector.<sup>24</sup> This aggressiveness has particularly aggravated the situations in France<sup>25</sup> and Germany.<sup>26</sup> Russia's cutoff of natural gas supplies to the Ukraine earlier this year, and its interest in increasing its stake in EADS, an aerospace group, has further inflamed political sentiment.<sup>27</sup>

The Russian Federation's most recent threat to curb foreign investment into the massive Sahalin-2 project and the

Shtokman natural gas field,<sup>28</sup> along with its growing restrictions on investment in the energy sector generally, highlight a new dimension of global mergers and national security—one of “resource nationalism,” in which the protection of natural resources, principally oil and energy reserves, is viewed as a matter of national security. This trend is also visible in Bolivia’s recent restrictions on foreign firms participating in its oil industry<sup>29</sup> and the attempt by Ecuador to terminate its long-term production agreement.<sup>30</sup> These actions by Bolivia and Ecuador further extend resource nationalism in Latin America that is evidenced by Venezuela’s long-standing restrictions on its oil industry, which are clearly directed against the United States.

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The intriguing aspect of these new global realities is that many of the global mergers are now emanating from companies in the Middle East, China, India and Russia. For example, the recent merger of two Russian firms (Rusal and Sual) and a Swiss firm (Glendore) created the world’s largest aluminum company, overtaking Alcoa of the United States.<sup>31</sup> If concluded the proposed acquisition of Oregon Steel by the Russian firm Evraz will be the largest Russian takeover of a U.S. firm. Many of the transactions are energy and commodities related. But now some of these countries are concerned about growing foreign investment into their strategic industries. Countries are beginning to restrict foreign

takeovers based on their own national security calculations—in many ways mirroring those made in the United States and Europe.

This increasing concern for national security in economic and business transactions is new to today’s global economy. The recent 2006 report of the Organization for Economic Co-operation and Development (OECD) on foreign direct investment states, “Issues of security and other strategic concerns have moved to the forefront of domestic and international investment policy making.”<sup>32</sup> The secretary-general of the OECD noted it recently. He said, “The global economy is also facing a resurging risk of international investment protectionism. Foreign corporate takeovers have been made subject to tighter political scrutiny in major countries, both members and non-members of the OECD.”<sup>33</sup> Indeed, the OECD considers recent action restricting takeovers to be going “beyond just national defense to include energy security.”<sup>34</sup> The report notes that “concerns about security and other essential national interests are on the rise” and can be seen in Europe, the United States, China and India.<sup>35</sup>

### Major Developments

Four newer realities in global trade in the post-9/11 world are clearly discernible:

- Takeovers and foreign investment are emanating from firms based in developing countries such as India and the United Arab Emirates (UAE), as well as from countries transitioning from central planning such as China and Russia.
- National security fears are arising among many governments, not only those in the United States and Europe, but also governments in Russia, India and China.
- More resource nationalism is evident in countries with significant oil and gas reserves and production facilities.
- This rise occurs in tandem with latent protectionism in many countries and with an increasing reaction against global integration, now referred to by some as “economic patriotism.”

Most important is understanding why takeovers and foreign investment are emanating more today from developing countries and those transitioning from central planning to free markets. There are five major reasons and five supporting causes.

The five major reasons are:

- The World Trade Organization (WTO) has spurred the growth of world trade and investment over the last ten years. India and China have greatly benefited from membership in the WTO, and the Gulf states have prospered from both trade liberalization and higher oil prices.
- Foreign companies that have foreign government equity are in a strong position to mount foreign takeovers. They do not have to worry about the reaction of public markets. This is true of firms in many countries, including China and Russia.
- Growth in foreign corporate profits and surpluses (retained earnings) provide a ready war chest to be utilized by foreign corporations in their cross-border takeovers.<sup>36</sup>
- Foreign countries have amassed huge surpluses that can help finance private takeovers and investments.
- The increase in oil revenues and those due to higher commodity prices have allowed foreign governments to finance overseas activities. Russia and the UAE are examples of this development.<sup>37</sup>

Because abundant liquidity exists throughout the world, it is easy to convert corporate reserves into corporate bids. Historically low interest rates for corporate borrowers facilitate ever more cross-border transactions. An explosion in foreign capital markets of initial public offerings (IPOs) allow for even greater financing.<sup>38</sup> For example, the IPO of the Industrial & Commercial Bank of China, Ltd. (ICBC), in October 2006, was the world’s largest IPO. This has pushed China’s stock exchanges into the world’s biggest source of new listings, ahead of those in New York and London. Growth in private equity, respon-

sible for more than 20 percent of recent merger activity in the U.S. and the EU, introduces a new and potentially significant and worrisome player into global mergers, and strong economic growth in a range of countries provides firms a strong basis for global undertakings.

There are new major players in global trade that have so much capital available and growing market prowess that they are able to more strenuously compete for global mergers—which they have done with increasing success.

### U.S. Response to the New Landscape

The U.S. response to this new landscape has been to bog itself down with a debate over foreign investment focused on revamping the Exon-Florio legislation and the related congressional review process. Public demand for increased congressional oversight of foreign takeovers persists, but to a weakened degree. “A key issue for Congress is whether and in what way it should respond to essentially private economic investment activities and how to assess the impact of such investments on the nation’s security.”<sup>39</sup> After a year of consideration, Congress has not enacted any changes.

The principal legislative and regulatory process to review foreign takeovers of U.S. firms is the Committee for Investment in the United States (CFIUS) as strengthened by the Exon-Florio amendment. This review process gives the U.S. president significant powers to block particular types of foreign investment.

In 1975 an executive order established CFIUS as an interagency panel, primarily to monitor foreign direct investment into the United States.<sup>40</sup> In 1988 the Exon-Florio amendment strengthened and better focused the review of acquisitions and mergers.<sup>41</sup> This amendment was enacted amid congressional concerns over foreign acquisitions of U.S. firms, particularly by firms from Japan. This change was included as a provision of the Defense Production Act. The new legislation authorized the president to investigate the

Chart 4

CFIUS 1997–2004 Data					
	Notifications	Acquisitions	Investigations	Notices w/d	Pres. Determinations
1997	62	60	0	0	0
1998	65	62	2	2	0
1999	79	76	0	0	0
2000	72	71	1	0	1
2001	55	51	1	1	0
2002	43	42	0	0	0
2003	41	39	2	1	1
2004	53	50	2	2	0
Total	470	451	8	6	2

GAO Testimony, “Implementation of Exon-Florio.” p. 13 (GAO-06-135T—October 6, 2006).

impact of foreign acquisitions of U.S. companies on national security. It also authorized the president to suspend or prohibit acquisitions that might threaten national security. CFIUS was delegated responsibility for investigating foreign acquisitions, when necessary.

The legislation established a ninety-day review process involving a voluntary submission by the acquiring party, an initial review period of thirty days to determine whether the acquisition could pose a threat to national security, and an additional forty-five-day investigation that results in a report to the President. The president then has fifteen days to allow, suspend or prohibit the transaction. It is important to note that national security is not defined; only factors to consider are enumerated. Withdrawing and refining notices restart the review clock.

In 1992 amendments were adopted that require greater reporting to Congress. A report to Congress was required if the president made any decision. An investigation was required if the acquiring company is controlled or acting on behalf of a foreign government (Byrd Amendment). When credible evidence was found, a report was also required every four years.

The current regulatory process is minimally transparent and discretionary only. The committee’s mandate is not well defined; there is no definition of national

security to provide guidance to the committee or parties to a transaction. The statute provides for factors to be considered in determining a threat to national security. They include the transaction’s impact on domestic production for national defense; the effect on the capacity of industries to meet defense requirements; the foreign control of commercial activity; the transaction’s implications for national security, the military, technology transfer as to terrorism; and the potential effects on U.S. technological leadership.

In a seminal study last year, the Government Accountability Office empirically examined the cases considered by the CFIUS between 1997 and 2004. The CFIUS had 470 notifications<sup>42</sup> and only 45 investigations, resulting in just two presidential determinations—both concerning telecommunications. *See chart 4 above.*

Clearly, this process has not resulted in many or even significant decisions blocking foreign takeovers for national security reasons. It seems that the CFIUS process draws more heat than the outcome would otherwise suggest.

Legislative proposals during the 2006 congressional session have generally required greater congressional notification and greater review by the CFIUS. The Senate and House have considered two different sets of proposals. Currently, legislators are at a standoff. Strangely, the House’s delib-

erations are more balanced and less restrictive—contrary to its normal position in trade matters when compared to the Senate.

In the Senate, the Shelby-Sarbanes Bill required congressional notification when a review is initiated. It mandated a forty-five-day investigation when a foreign government-controlled entity is involved. It also required a ranking of countries based on compliance with weapons-control deals. In the House, the Blount Bill was less stringent than the Senate deliberations would have required. The House appears to have recognized to a greater extent that economic security entails encouraging foreign investment. Congressional notification would be required only upon the completion of a review. Other items also considered were the tracking of mitigation agreements that protect critical infrastructure and provide for new roles for the Department of Homeland Security and the Director of National Intelligence.<sup>43</sup>

As of the 2006 mid-term elections, the Congress has not enacted any changes to the CFIUS regime. Virginia Senator John W. Warner has been a voice of reason,<sup>44</sup> who blocked an attempt to push through the Senate a proposal that would have toughened national security reviews of foreign takeovers of U.S. assets.<sup>45</sup>

### Conclusions

The policy challenge to the United States is to continue promoting the economic benefits of global trade and mergers within this new global dynamic. The unanswered question is whether in the coming years new national security goals will outweigh other goals that promote economic development and political development. The future of the trading system depends on the answer that the United States and others provide.

We have had a change in the political dynamics within the United States and within other countries. The role of national security and reaction against globalization are growing pieces of this new post-9/11 era. In global trade relations today, the world is more multipolar, as evidenced by the rise of the BRIC countries (Brazil, Russia, India and China) the reemergence

of Japan; and the dynamic growth of Korea. New sources of wealth from global trade and petrodollars are fueling and super-charging global mergers. New players are emerging with new interests.

Warning signs show that the global trading system could suffer a disaster. Russia is reimposing controls on foreign investors in strategic industries. India is considering controls on Chinese investment into its infrastructure and energy sectors. China is wary of foreign takeovers of its state-controlled industries. Korea is worried about foreign private equity in its industry reorganization.<sup>46</sup> The Ukraine is considering restricting foreign participation in the development of its Black Sea oil and gas reserves.<sup>47</sup>

The promotion of global mergers promotes global trade, which holds the promise of aiding in transforming inefficient markets and undemocratic societies.

The current slowdown in the U.S. economy and continuous growth overseas will only enhance the activities of foreign firms and create even more fertile ground for global mergers.<sup>48</sup> This year's record U.S. investment abroad in foreign capital markets only adds greater fuel to cross-border takeovers to be undertaken by a range of foreign firms.<sup>49</sup> The declining dollar will also spur greater acquisitions of U.S. firms.

The promotion of global mergers promotes global trade, which holds the promise of aiding in transforming inefficient markets and undemocratic societies. However, a concern for national security is increasingly posing a challenge to the growth and promise of trade in the post-9/11 era. The

reemergence of latent protectionism fueled by growing reaction to global integration only adds to this situation. But if the warning signs are heeded, the global system may yet avoid a catastrophe.

There are positive global developments. While investment controls are being considered worldwide, few have been adopted. The United States has recently concluded negotiations with Russia concerning its accession to the WTO and Vietnam has won admission to the WTO.<sup>50</sup> The proposals to change U.S. legislation regulating foreign direct investment have stalled. U.S. policy remains anchored in the belief that global business transactions, global mergers, trade and investment are beneficial to bringing needed political and cultural change worldwide.

However, as a result of the historical victory of the Democratic Party in the mid-term elections, there is now a new uncertainty about U.S. trade policy. The Vietnam trade bill extending most-favored-nation treatment to Vietnam was initially defeated prior to its passage in the end-of-the year tax and trade bill. Congressional approval of legislation implementing Russian accession to the WTO as well as renewal of "Fast Track Authority" has become more questionable.<sup>51</sup>

The global economy seems strong; all of its horses are running. But warning signs are present. Almost a century ago an earlier era of globalization was ended by a single shot. Overreaction today could have the same result. ☹

Endnotes:

- 1 Foreign direct investment includes either mergers and acquisitions or the establishment of a new firm. This article focuses upon mergers and acquisitions. The establishment of a new firm is termed a "greenfield" investment. "Foreign Direct Investment in the United States: An Economic Analysis." (Congressional Research Service, Report RS21857) (March 23, 2005).
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- 25 "French Poll Shows Support for Corporate Protectionism." *Financial Times* (June 9, 2006).
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