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Antitrust Review or Regulation of Foreign Investment?: Understanding the PRC's Anti-Monopoly Regime and the Coca-Cola/Huiyuan Decision

On March 18, 2009, the Ministry of Commerce of the People's Republic of China ("**MOFCOM**") issued a decision (the "**Coca-Cola/Huiyuan Decision**") prohibiting Coca-Cola Co. from acquiring China Huiyuan Juice Group Limited for approximately US$2.4 billion (the "**Acquisition**"), on the basis that the Acquisition would have adverse anti-competitive effects on the juice market in China.

Ever since September 2008, when Coca-Cola announced its agreement to acquire Huiyuan, barely a month after China's new Anti-Monopoly Law (the "**AML**") had come into effect, the international business community had awaited the Coca-Cola/Huiyuan Decision with great interest, viewing it in part as a means to obtain greater clarity regarding some of the AML's key concepts and guidance on the future implementation of the AML.

Following a six-month review, MOFCOM's much anticipated Coca-Cola/Huiyuan Decision was met with what may be characterized as widespread disappointment in the international business community. Some commentators criticized MOFCOM's position as being overly protectionist. Others predicted that the Coca-Cola/Huiyuan Decision was a harbinger of increased government scrutiny with respect to foreign investment in China. There was also speculation that the Coca-Cola/Huiyuan Decision could trigger protectionist decisions by governmental authorities in other countries, who may seek to retaliate by, for example, blocking proposed cross-border investments by Chinese companies.

The Coca-Cola/Huiyuan Decision presented a case in which market competition considerations were commingled with foreign investment considerations. In addition, the nationalist sentiment surrounding the acquisition of a well-known domestic brand by a prominent foreign brand generated significant public interest and pressure, which might ultimately have influenced MOFCOM. Indeed, MOFCOM listed the prominence of the Huiyuan brand as an important factor in its consideration. MOFCOM concluded that by acquiring the Huiyuan brand, Coca-Cola could significantly increase its control of the domestic juice market and raise the barriers to entry. It is arguable whether MOFCOM would have applied the same rationale had Huiyuan been a foreign brand (if, for example, Coca-Cola was proposing to acquire Pepsi's China operations).

The significant downturn in the global economy may also have played a role in the unraveling of the Acquisition and in Coca-Cola's inability to reach an agreement with MOFCOM regarding the imposition of conditions that would mitigate MOFCOM's antitrust concerns. Reaching a modified agreement may well have been difficult in the current market environment, especially on the basis of pricing terms as originally proposed.

The following sections describe the Coca-Cola/Huiyuan Decision itself and discuss noteworthy points raised by the Coca-Cola/Huiyuan Decision with respect to the interplay between China's anti-monopoly regime and its regulation of foreign investment. In addition, Appendix I provides background information on the AML (the legal basis upon which MOFCOM rendered the Coca-Cola/Huiyuan Decision).

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I. The Coca-Cola/Huiyuan Decision

Following a review of the materials submitted by Coca-Cola and Huiyuan, an examination of the Chinese juice market and consultations with trade associations, juice producers and legal, economic and agricultural experts, MOFCOM found that the Acquisition would have the following adverse effects on competition in China's juice industry:

- » Following the consummation of the Acquisition, Coca-Cola would be in a position to leverage its dominant position in the carbonated beverage market to restrict competition in the juice market.
- » Branding is a key element to competing successfully in the juice market. Through an acquisition of Huiyuan, one of the most prominent juice brands in China, Coca-Cola could significantly enhance its control over China's juice market, which would effectively raise the barriers to entry for other potential competitors.
- » Coca-Cola's market share in China's juice industry post-Acquisition would impede the growth of small domestic juice producers and suppress the continued development of the Chinese juice market.

In an attempt to mitigate these effects, Coca-Cola engaged in two rounds of negotiations with MOFCOM. Ultimately, however, the concessions that Coca-Cola was willing to offer proved insufficient to address MOFCOM's concerns.

MOFCOM did not provide a detailed discussion of its deliberation in rendering the Coca-Cola/Huiyuan Decision.

II. Antitrust Review vs. Regulation of Foreign Investment

In view of the growing significance of the Chinese economy and the increasing sophistication of the Chinese legal system, the general trend has been for the Chinese government to enhance its regulation of foreign investment. The Coca-Cola/Huiyuan Decision, among other things, illustrates this trend in the context of China's anti-monopoly regime. The following points further discuss this intersection between antitrust review and the regulation of foreign investment.

A. The AML Applies to Onshore and Offshore Investments

The Acquisition was not subject to MOFCOM's review as a matter of foreign investment in a Chinese company and, if not for the antitrust review mandated under the AML, would not have come under any MOFCOM review.[1] Compared to its powers to conduct antitrust reviews under the AML, MOFCOM has much broader powers with respect to regulating foreign investment in China (and may under the relevant laws take into direct account broader national policy considerations, such as whether the target is in an industry in which the government encourages foreign investment or whether an acquisition involves the transfer of ownership of prominent Chinese brands, without having to find that a proposed transaction would have adverse effects on other policy goals such as, in the case of its antitrust review for example, the encouragement of competition). For instance, in the Carlyle Group's attempt to acquire a controlling interest in the Xugong Group, a Chinese heavy equipment machinery manufacturer, MOFCOM used its broad powers regarding the regulation of foreign investment in Chinese companies to induce the Carlyle Group to renegotiate the major terms of the acquisition. The Carlyle Group did not eventually complete that acquisition. In the Coca-Cola/Huiyuan transaction, however, Coca-Cola contemplated the acquisition of Huiyuan's parent company, which was incorporated in the Cayman

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[1] Some commentators seem to have missed this point and were under the impression that the Coca-Cola/Huiyuan Decision was rendered pursuant to Article 12 of the *Regulations Governing Acquisitions of Domestic Enterprises By Foreign Investors* (the "**M&A Rules**"). Article 12 governs foreign acquisitions of Chinese companies which may impact China's economic security or which involve the transfer of prominent Chinese brands. Such commentary prompted MOFCOM to publicly state that Huiyuan is a foreign company and that the acquisition of Huiyuan is not subject to the M&A Rules.

Islands. Because the Acquisition involved the acquisition of an offshore entity, MOFCOM could not review the Acquisition under its powers to regulate foreign investment in China.

Prior to the adoption of the AML, offshore investments, such as the Acquisition, would not ordinarily be subject to review by the Chinese government and could typically be completed more quickly and with a greater degree of certainty than foreign investments onshore. Upon the promulgation of the AML, however, MOFCOM was provided with a legal basis for reviewing offshore transactions such as the Acquisition (although, as mentioned above, its powers of antitrust review granted under the AML are much narrower in scope than the powers conferred in connection with the regulation of foreign investment in a Chinese company). The AML disregards the corporate forms used and looks to the activities of the transaction parties within China. The AML also covers transactions that are not directed at the Chinese market, so long as the parties to the transactions have a sufficiently high level of sales activity within China.

B. AML Review is Conducted by Central rather than Local Agencies

The responsibility for reviewing and approving foreign investments is allocated among the central, provincial and city-level governments based on deal size and the industry involved. Typically, provincial and city-level approval is easier to obtain because of the lower profile of the deals involved and the close relationships between Chinese targets and the provincial and/or city-level government. Under the AML, all antitrust reviews are conducted by the Anti-Monopoly Bureau (the "**Bureau**"), a division of MOFCOM, which itself is an agency of the central government. This dual-level review process can create logistical and timing hurdles for deals that are subject to review by both the local government under foreign direct investment laws and by the Bureau under the AML. The likelihood of such interaction in future transactions appears to have increased as the Chinese government recently adopted new rules relating to the deal size of transactions subject to central government review. Apparently intended to encourage foreign direct investment in the face of recent declines in capital inflows into China, the new rules, among other things, increase the deal size thresholds for transactions that would require central government review and approval.

C. Authority to Impose Conditions May Be Used to Restrict Future Operations

The AML authorizes MOFCOM to impose conditions on its clearance of potential deals. While this allows for some degree of flexibility, the imposition of conditions may substantially restrict post-transaction business operations. For example, MOFCOM allowed the InBev acquisition of Anheuser-Busch in late 2008 to proceed subject to certain conditions, including the requirement that the surviving entity seek MOFCOM's approval before increasing its stake in its Chinese subsidiaries or investing in any additional domestic Chinese breweries. It is arguable how meaningful such conditions would be since it is likely that any future acquisitions or investments by the merged entity of or in domestic Chinese breweries would require MOFCOM's review and approval under China's foreign direct investment laws or the AML. However, the imposition of the conditions makes it mandatory to obtain such central government review and approval and ensures that such review and approval could not in the future be circumvented by, for example, the use of an existing WFOE and truncated investments falling below the deal size thresholds.

In its review of the Acquisition, MOFCOM proposed certain mitigating conditions to Coca-Cola, which were not specified in the published Coca-Cola/Huiyuan Decision. According to media reports, however, the conditions may have included the requirement that the Huiyuan brand itself be carved out from the transaction. Ultimately, no agreement was reached on any such conditions.

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The Chinese anti-monopoly regime is relatively new and still evolving. Since the AML became effective in August 2008, MOFCOM has reviewed 25 transactions involving a "concentration"[2], of which it approved 23 without imposing conditions, the only two exceptions being the InBev/Anheuser-Busch transaction (which was ultimately approved following the imposition of several conditions) and the Acquisition.

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[2] *See* Appendix I for a discussion of the transactions subject to MOFCOM's review under the AML.

In our view, there is no reason to infer from the Coca-Cola/Huiyuan Decision that future offshore transactions would face increased difficulties in obtaining Chinese government approval on antitrust matters. The published reasons for the Coca-Cola/Huiyuan Decision appear to have as much to do with the policy considerations familiar to foreign investors in the area of regulating foreign investment in China as with anti-monopoly considerations. Absent the specific circumstances of the Coca-Cola/Huiyuan transaction, the Bureau may well be better able to fashion a compromise that would permit the completion of a future transaction, whether or not through the imposition of conditions on post-transaction business operations. The specific circumstances of the Coca-Cola/Huiyuan transaction involved the transfer of a prominent domestic brand (which presented issues familiar to foreign investors in the area of regulating foreign investment, but which eluded MOFCOM's review except under the heading of antitrust review) as well as a significant decline in the market valuation of the target during MOFCOM's review period (which may have created its own disincentives for the completion of the transaction on the pricing terms originally proposed). Indeed, in performing its regulatory functions under the AML, MOFCOM appears sensitive to the sentiments of the foreign investor community, taking pains to announce that the substantial majority of 23 out of 25 transactions have been approved under the AML without imposing conditions, and to clarify publicly that the offshore Acquisition was not subject to the M&A Rules that apply to investments in domestic companies.

By most indications, Chinese government regulators appear interested in developing clearer guidelines for a more rule-based antitrust review of transactions that come before them. Towards this end, the following suggestions could help: (i) improve transparency by including more detail of the Bureau's antitrust analysis in published decisions; (ii) enhance the institutional independence of the Bureau and its antitrust review from the other policy imperatives of MOFCOM; and (iii) add a *de minimis* deal size threshold below which notification under the AML would not be required.

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If you have any questions regarding this newsletter, please contact either of the lawyers listed below or your regular Davis Polk contact.

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APPENDIX I
China's Anti-Monopoly Law

The AML is relatively new legislation, having taken effect in August 2008, and supplements existing rules on the acquisition of Chinese assets (most notably, the anti-monopoly section of the M&A Rules). Under the AML, parties to a transaction that may potentially result in a "concentration" are required to seek MOFCOM's clearance before consummating such transaction.

A "concentration" is defined as any of the following:

» merger;

» obtaining "control"[3] through acquisitions of equity interests or assets; or

» obtaining "control" or the power to exercise decision-making influence by contractual means or otherwise.

I. Filing Thresholds[4]

Under the AML, if the "turnover" of the parties to the transaction meet either of the following thresholds, the parties are required to file notification materials with MOFCOM:

» the combined worldwide "turnover" of all parties in the preceding fiscal year exceeds RMB10 billion (approximately US$1.46 billion) AND the "turnover within China" of at least two of the parties in the preceding fiscal year exceeds RMB400 million (approximately US$59 million) each; or

» the combined "turnover within China" of all parties in the preceding fiscal year exceeds RMB2 billion (approximately US$293 million) AND the "turnover within China" of at least two of the parties in the preceding fiscal year exceeds RMB400 million (approximately US$59 million) each.

The draft *Interim Rules on Concentration of Operators Notification* (the "**Draft Interim Rules on Concentration**"), released on January 20, 2009 for public comment, clarify that "turnover" means revenues net of taxes (other than income tax and value-added tax) and "turnover within China" means revenues generated from buyers located within mainland China. The turnover of a party includes the turnover of all "affiliates" of such party. An "affiliate" is defined as an entity controlled by, controlling or under the common control of, such party. Although "control" is not defined in the Draft Interim Rules on Concentration, it is reasonable to assume that MOFCOM will apply the same definition of "control" that is used with respect to determining what constitutes a "concentration."[5]

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[3] The AML itself does not define "control." On January 20, 2009 MOFCOM published a draft of the *Interim Rules on Notification of Concentration of Operators*. These draft rules define "control" as either (i) the acquisition of more than 50% of the voting securities or assets of the target or (ii) the possession of the power to (a) appoint one or more of the members of the target's board of directors or to (b) determine financial budget, marketing, pricing, material investment or other major management or operation policies of the target. Basic minority investor protections such as veto rights regarding amendments to the target's constitutional documents, changes to the target's share capital or the voluntary liquidation of the target are not deemed to be "control." Foreign takeovers of Chinese companies or acquisitions of majority stakes have been rare in China due to restrictions on foreign ownership in some industries and the prevalence of a founder/controlling shareholder in many Chinese companies. Most of the non-strategic investments in Chinese companies take the form of minority equity investments and usually include director designation rights and minority veto rights with respect to management and important corporate actions.

[4] The AML does not specify the thresholds, but instead delegates to China's State Council the task of promulgating clarifying rules. On August 3, 2008, the State Council promulgated the *Provisions on Thresholds for Prior Notification of Concentration of Operators.*

[5] *See* footnote 1.

Unlike the U.S. antitrust regime, the AML does not include exemptions from notification obligations based on deal size and therefore imposes a heavier filing burden on multinational businesses (who, due to their size, have much higher global turnover, and possibly higher turnover within China as well, and may thus more easily trigger the notification thresholds).

II. Notification and MOFCOM's Review Process

If a transaction meets the revenue thresholds mentioned above, all parties to the transaction are required to jointly file notification materials with the Bureau and obtain clearance from the Bureau before consummating the transaction. The Bureau has provided guidelines on the filing and review procedures. MOFCOM has also recently published for public comment draft interim rules to clarify certain procedural matters.

The AML provides for an initial review period by MOFCOM of 30 calendar days, commencing only upon MOFCOM's determination that the submitted notification is complete. In the Acquisition, Coca-Cola and Huiyuan initially filed their notification materials with MOFCOM on September 18, 2008, which was supplemented with four subsequent filings. MOFCOM's 30-day review period commenced on November 20, 2008, more than two months following the initial submission.

If MOFCOM determines within such 30-day period that it will not require further review of the proposed transaction or if MOFCOM does not issue a decision within such period, the parties are free to consummate the transaction. Under MOFCOM rules, further review, if any, is required to be completed within 90 calendar days, subject to an extension of no more than 60 calendar days. In the Acquisition, MOFCOM requested further review on December 20, 2008 and completed such review on March 18, 2009.

Under the AML, the parties to a transaction blocked by MOFCOM on grounds that such a transaction would violate the AML may request further administrative review of MOFCOM's decision and further challenge any such administrative review through administrative litigation. Coca-Cola has indicated that it will not make such appeals in connection with the Acquisition.

III. Standard of Review

MOFCOM is required under the AML to consider the following factors in rendering its decision on a transaction it reviews:

» the market share of each party and their respective control over the "relevant market";

» the degree of concentration in the "relevant market";

» the impact on market entry and technology development as a result of the transaction;

» the impact on consumers and other related operators as a result of the transaction;

» the impact on the development of the national economy as a result of the transaction; and

» other competition-limiting factors that MOFCOM deems appropriate to consider.

The Bureau recently issued draft guidelines on how to determine the "relevant market." The draft guidelines indicate that MOFCOM needs to determine both the market for the specified products or services (including close substitutes) and the relevant geographic areas involved.

The catch-all language in the last factor listed above gives MOFCOM significant latitude in its antitrust review. As mentioned in the Coca-Cola/Huiyuan Decision, one factor MOFCOM considered was the prominence of the Huiyuan brand.