State Capitalism and the Chinese Firm: Legal and Policy Issues

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*Milhaupt, in Cambridge Univ. Press* (forthcoming 2016)
World’s Largest Controlling Shareholder

SASAC

Total Assets of SOEs in China: $6 trillion (133% of GDP), 2008
Total Assets of SOEs in France: $686 billion (28% of GDP), 2008
China Datang
392 on Global Fortune 500; $30b revenues
Central SOE Structure

- Party (exercising parallel political control rights)
- State Council
- SASAC
- 100%
- Holding Company (Core Company in the Group)
- >50% to Major Subsidiaries (Publicly Traded)
- >50% to Subsidiaries
- >50% to Finance Company
- >50% to Other Subsidiaries
- >50% to Research institutes
- Non-Economic Institutions: Universities etc.
- Other National or Provincial Corporate Groups

Group Boundary
China’s Networked State Capitalism

- SASAC
- Party Congress
- National People’s Congress
- National SOE Group
- Local SOE Group
“SOEs” v. “Private Firms”

• Ownership does not tell us much about large Chinese firms:
  – Boundary between “SOE” and “POE” is often blurred in China.
  – The state exercises less control over SOEs than commonly assumed
  – The state exercises more control over POEs than commonly assumed.

• Chinese state capitalism is better explained by capture of the state than by ownership of enterprise
Mixed Ownership

Figure 1. Ownership Structure of ZTE Corporation

- Mr. Hou Weigui (18%)
- Zhongxingweixiangong (private) (49%)
- Xi’an Micro Electronics (state) (34%)
- Aerospace Guangyu (state) (17%)
- ZTE Holdings (30.76%)
- ZTE Corporation
Attenuated State Control Over SOEs

- Agency theory: state ownership ≠ state control (potential versus actual control)
- Low dividends paid by SOEs to government
- Large amounts of unregulated executive compensation at SOEs
- Government seldom acts in its capacity as controlling shareholder to modify SOE behavior
Extensive State Control Over/Relationship with POEs

- Politically connected entrepreneurs have extensive linkages to government-party organs just like SOE executives
- Extensive government support for (favored) private firms
- Extra-legal control over private firms
## Politically Connected Entrepreneurs

<table>
<thead>
<tr>
<th>Firm Rank</th>
<th>Firm</th>
<th>Founder or De Facto Controller</th>
<th>Party-State Affiliations, as of 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Suning Electronics Group</td>
<td>ZHANG Jindong</td>
<td>CPPCC</td>
</tr>
<tr>
<td>2</td>
<td>Lenovo Holdings Ltd. Co.</td>
<td>LIU Chuanzhi</td>
<td>CPC; NPC; CNAIC Vice Chairman</td>
</tr>
<tr>
<td>3</td>
<td>Huawei Investment Holdings Ltd. Co.</td>
<td>REN Zhengfei</td>
<td>None*</td>
</tr>
<tr>
<td>4</td>
<td>Jiangsu Sha Steel Group Ltd Co.</td>
<td>SHEN Wenrong</td>
<td>NPC; CPC</td>
</tr>
<tr>
<td>5</td>
<td>Shandong Weiqiao Group Ltd. Co.</td>
<td>ZHANG Shiping</td>
<td>NPC; Shandong People’s Congress</td>
</tr>
<tr>
<td>6</td>
<td>Zhejiang Geely Holdings Group Ltd. Co.</td>
<td>LI Shufu</td>
<td>CPPCC; Taizhou City People’s Congress</td>
</tr>
<tr>
<td>7</td>
<td>Dalian Wanda Group Ltd. Co.</td>
<td>WANG Jianlin</td>
<td>CPC; CPPCC Standing Committee; CNAIC Vice Chairman</td>
</tr>
<tr>
<td>8</td>
<td>Yurun Holdings Group Ltd. Co.</td>
<td>ZHU Yicai</td>
<td>NPC; CNAIC Standing Committee</td>
</tr>
<tr>
<td>9</td>
<td>Wanke Enterprises Ltd. Co.</td>
<td>WANG Shi</td>
<td>China Real Estate Association; Shenzhen Chamber of Commerce</td>
</tr>
<tr>
<td>10</td>
<td>Meidi Group Ltd. Co.</td>
<td>HE Xiangjian</td>
<td>Shunde District People’s Congress; Foshan City PPCC</td>
</tr>
</tbody>
</table>
State Subsidies to POEs

<table>
<thead>
<tr>
<th>Rank</th>
<th>Company Name</th>
<th>Subsidy, US$ m</th>
<th>Subsidy to Net profit, %</th>
<th>Rank in 2010</th>
<th>Rank in 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Geely Automobile</td>
<td>141.0</td>
<td>51.3</td>
<td>1</td>
<td>3</td>
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<tr>
<td>2</td>
<td>China Yurun Food</td>
<td>84.0</td>
<td>36.1</td>
<td>2</td>
<td>2</td>
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<tr>
<td>3</td>
<td>Uni-President</td>
<td>9.1</td>
<td>18.2</td>
<td>na</td>
<td>na</td>
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<tr>
<td>4</td>
<td>Sihuan Pharmaceutical</td>
<td>18.6</td>
<td>14.5</td>
<td>4</td>
<td>na</td>
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<tr>
<td>5</td>
<td>WuXi PharmaTech</td>
<td>9.9</td>
<td>12.2</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>6</td>
<td>Want Want China</td>
<td>47.4</td>
<td>11.3</td>
<td>6</td>
<td>6</td>
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<tr>
<td>7</td>
<td>Hengan International</td>
<td>35.5</td>
<td>10.3</td>
<td>na</td>
<td>na</td>
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<tr>
<td>8</td>
<td>Gome</td>
<td>26.7</td>
<td>9.2</td>
<td>9</td>
<td>na</td>
</tr>
<tr>
<td>9</td>
<td>China Shanshui Cement</td>
<td>28.2</td>
<td>7.6</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>10</td>
<td>China Gas Holdings</td>
<td>7.3</td>
<td>7.2</td>
<td>na</td>
<td>1</td>
</tr>
</tbody>
</table>

*Source: company statements, Fathom China research*
Legal and Policy Implications

• For Chinese State Sector Reform
• For U.S. Law
  • Personal Jurisdiction and Liability
  • Antitrust
  • National Security Screening for FDI
China’s “Mixed-Ownership Reforms”

- Inject more private capital into SOEs to enhance competitiveness and improve management
- But retain (and strengthen) party-state control over “strategic” and “pillar” industries
- Our analysis suggests ownership-based reforms miss the mark
- Reforming institutional environment for corporate behavior is key
Litigation in US Courts

- SASAC
  - 100%
  - CNBM Group
    - 45%
    - CNBM Co. (HK Listed)
      - 45%
      - BBNM PLC (Shenzhen Listed)
        - 45%
        - Taishan Gypsum (US)
          - 65%
            - Home Owners

China

US

Businesses, Assets
Antitrust

- Sovereign Compulsion Defense
  - Vitamin C: Alleged price fixing
  - Bauxite: Alleged conspiracy to limit supply
- Merger Analysis (cf European Commission)
National Security Screening

• Committee on Foreign Investment in the United States (CFIUS)
  • Members include heads of Treasury, Homeland Security, State, Commerce, Defense, etc.
  • Inter-agency review (30 days)
  • Can trigger 45-day investigation
  • Automatic 45-day investigation for “foreign government controlled transactions”
  • Can initiate negotiations on mitigation agreement
  • If CFIUS still has national security concerns after investigation, it can recommend that president exercise authority to block transaction
Covered Transactions by Home Country

- Home country for largest number of covered transactions in years 2012-14: China (UK or Japan second)
- China was home country of 20% of all covered transactions in years 2012-14 (compare UK: 12.5%)
CFIUS in Action

• 2008-2014: 627 notices filed with CFIUS
• 39% resulted in an investigation
• 3% withdrawn during review stage
• 8% withdrawn during investigation stage
• President made 1 decision to block a transaction (Ralls Corporation (owned by Chinese nationals who are officers of Chinese POE) acquisition of wind farms near air space restricted by U.S. Navy)
• Ralls (D.C. Cir. 2014): Fifth Amendment due process violation
Illustration of “Suspicion Tax” on Chinese Firms

• Chongqing Casin Enterprise Group to acquire Chicago Stock Exchange (Feb. 2016)
  – CCEG was formed out of formerly state-owned assets
  – Active in areas Chinese government considers sensitive
  – Chairman is member of industry group led by Mayor of Chongqing

• “The American market has little information about CCEG, and it shares many of the traditional opaque qualities of a Chinese company… Should you determine CCEG maintains a close relationship with the Chinese government – and therefore the Chinese military – we would urge CFIUS to deny this transaction.”
  
  Letter from 45 Republican Senators to Treasury Department
Conclusion

• State capitalism is dead; long live state capitalism!
• Large, globally active Chinese firms (SOE and POE) present novel legal and policy issues for a range legal regimes
• Where will change occur: Chinese firms or legal regimes?