

**ANALYZING INVESTOR PROTECTION IN CHINESE STATE-OWNED
ENTERPRISES: LAW AND ECONOMICS APPROACH**

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Abstract

This Article analyzes understudied aspects of related party transactions (RPTs), tunneling, and investor protection in China's state-owned enterprises (SOEs). This Article defines the government as an "institutional controlling shareholder" of SOEs. In addition, this Article examines two types of RPTs in the SOE sector: "corruption-RPTs" and "policy-RPTs." Corruption-RPTs are those associated with tunneling for the personal greed of SOE executives and party-government officials. Thus, from the standpoint of public investors, corruption-RPTs are always detrimental and generate cash-outflow wealth-transfers. Policy-RPTs are conducted by the government as a means of enacting public policy. In contrast to corruption-RPTs, policy-RPTs are associated with two opposite concepts—"institutionalized tunneling" (in favor of the controlling shareholder of SOEs, i.e., the government) and "propping" (to the detriment of the government). Although it is well known that investors in China are subject to the problem of insufficient investor protection, this Article finds that investors can sometimes benefit from policy-RPTs (e.g., investors of a propped SOE). Besides, this Article demonstrates that SOEs gain a variety of additional benefits from government policies in China that eventually favor the financial interests of SOE investors. Accordingly, this Article posits that investors in Chinese SOEs are, to some extent, economically compensated by an informal, extra-legal compensation mechanism (ELCM), although SOE investors are not adequately protected by the legal systems.

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I. Introduction

For the last four decades, the Chinese economy has shown historic development.¹ The quality of corporate governance in the country, however, remains low.² Investors are particularly concerned about the prevailing practice of corporations engaging in transactions with related parties (e.g., controlling shareholders, directors, and executives) that can exercise influence over corporations' decision-

¹ See Cai Fang et al., *40 Years of China's Reform and Development: How Reform Captured China's Demographic Dividend*, in CHINA'S 40 YEARS OF REFORM AND DEVELOPMENT: 1978–2018 6 (Ross Garnaut et al. eds., 2018) (documenting the changes in the Chinese economy and regulation).

² Daphne W. Yiu et al., *Alternative Governance and Corporate Financial Fraud in Transition Economies: Evidence from China*, 45 J. MGMT. 2685, 2689 (2019) (“Although China identified internal corporate governance as the core of the modern enterprise system and mandated listed firms to adopt modern governance practices, many state-owned enterprises (SOEs) avoided the corporate governance requirements imposed by the law.”).

making processes.³ These transactions are known as “related party transactions” (RPTs).⁴ In principle, the concept of RPTs possesses neutral connotations.⁵ As long as the terms and conditions of RPTs are fair, these RPTs can be positive and beneficial to a corporation and its investors.⁶ If, however, the terms and conditions unfairly favor a related party, then these RPTs lead to “tunneling”⁷—that is, unfair transfers of wealth where a related party siphons off corporate value to the detriment of investors. Although RPTs are not necessarily associated with tunneling, this Article explains RPTs’ issues that are related to tunneling.

Despite China’s transition to a market-based economy, the role of the government in managing the economy remains critical, and state-owned enterprises (SOEs)⁸ are the predominant entities in the

³ Guoping Li, *The Pervasiveness and Severity of Tunneling by Controlling Shareholders in China*, 21 CHINA ECON. REV. 310, 310 (2010) (“Consequently, Chinese people are concerned that entrepreneurs who took their companies public and remained controlling shareholders of their companies tend to treat the companies as their personal assets.”).

⁴ For an explanation of RPTs in China, see, e.g., Adrian C.H. Lei & Frank M. Song, *Connected Transactions and Firm Value: Evidence from China-affiliated Companies*, 19 PACIFIC-BASIN FIN. J. 470, 470–71 (2011) (“Therefore, RPTs may provide a channel to facilitate tunneling activities legally. Even though these transactions are legitimate from a legal perspective, investors may still recognize the conflict of interest and potential expropriation.”).

⁵ See generally Sang Yop Kang, *Rethinking Self-Dealing and the Fairness Test: A Law and Economics Framework for Internal Transactions in Corporate Groups*, 11 VIRGINIA L. & BUS. REV. 95 (2016) [hereinafter Kang, *Rethinking Self-Dealing and the Fairness Test*].

⁶ See *id.* at 109 (“In sum, at least in some cases, internal transactions are more efficient than external transactions in terms of transaction cost.”). As to the positive effects that RPTs generate, see *id.* at 108–09 (outlining how internal transactions can benefit companies and their affiliated shareholders).

⁷ For a further explanation of tunneling, see generally Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV. 22 (2000); see also Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430, 430 (2008) (“Specifically, those who control a corporation, whether they are managers, controlling shareholders, or both, can use their power to divert corporate wealth to themselves rather than sharing it with the other investors.”). For an explanation of controlling shareholders’ tunneling in China, see generally Li, *supra* note 3, at 310.

⁸ For simplicity in analyzing Chinese SOEs, in this Article’s hypothetical examples, the term “SOE” is a business entity in which the government holds more than 50% of the shares. See *infra* Figure 1. Note, however, that there is

Chinese economy.⁹ In 2015, for instance, the Fortune Global 500 listed ninety-eight Chinese companies, most of which were SOEs with only twenty-two being private.¹⁰ In 2019, 129 Chinese companies were listed in the Fortune Global 500.¹¹ SOEs accounted for over 80% of these Chinese corporations.¹² In 2011, 310 of the largest 500 enterprises in China, including all thirty of the country's largest enterprises, were SOEs.¹³

As the term indicates, in an SOE, the government in China—either the central government or a local government—is the controlling shareholder.¹⁴ At the central government level, the State-owned Assets

no universally accepted definition of “SOE.” See Lin, *infra* note 9, at 112. When defining “SOE,” the potential standards that are used include, but are not limited to, the state's whole ownership, majority ownership, or control (regardless of a majority ownership). Lin & Milhaupt, *infra* note 13, at 699–700 (describing the factors relevant to analyzing SOEs). Due to different sources' use of different definitions without sufficient explanations, statistical problems may arise when analyzing, for example, the number of SOEs, the size of the SOE sector, its size in terms of percentage, and the number of employees in the sector.

⁹ For a further discussion of the Chinese SOE sector and its reforms, see generally Li-Wen Lin, *Reforming China's State-Owned Enterprises: From Structure to People*, 229 CHINA Q. 107 (2017).

¹⁰ Scott Cendrowski, *China's Global 500 Companies Are Bigger Than Ever—And Mostly State-owned*, FORTUNE (June 22, 2015), <http://fortune.com/2015/07/22/china-global-500-government-owned/> (illustrating that SOEs remain the dominant type of entity in China). In 2015, there were 122 U.S. corporations in the list. *Id.* (comparing the relative economic strength of U.S. corporations versus Chinese SOEs.).

¹¹ Geoff Colvin, *It's China's World*, FORTUNE (July 22, 2019), <https://fortune.com/longform/fortune-global-500-china-companies/> (“American companies account for 121 of the world's largest corporations by revenue. Chinese companies account for 129 (including 10 Taiwanese companies).”).

¹² Tridivesh Singh Maini, *State Capitalism: Fortune 500 and Chinese Companies*, MODERN DIPLOMACY (Aug. 8, 2019), <https://modern diplomacy.eu/2019/08/08/state-capitalism-fortune-500-and-chinese-companies/> [<https://perma.cc/7K2R-2C9R>] (highlighting the significant percentage of SOEs that are part of the Fortune 500 list.)

¹³ Li-Wen Lin & Curtis J. Milhaupt, *We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China*, 65 STAN. L. REV. 697, 702, 702 n.15 (2013) (citation omitted) (illustrating the significant strength of SOEs within the Chinese economy).

¹⁴ *Id.* at 699–700 (“Excluding major banks and insurance companies, controlling stakes in the largest and most important of the firms are owned, ostensibly on behalf of the Chinese people, by a central holding company

Supervision and Administration Commission of the State Council (SASAC)¹⁵ is in charge of supervising and providing administrative guidance for approximately 100 state-owned corporate groups.¹⁶ Out-

known as the State-Owned Assets Supervision and Administration Commission of the State Council (SASAC), which has been described as ‘the world’s largest controlling shareholder.’”); Fan Gang & Nicholas C. Hope, *The Role of State-Owned Enterprises in the Chinese Economy, in US-China Economic Relations in the Next Ten Years: Towards Deeper Engagement and Mutual Benefit* 1, 5 (China-United States Exchange Foundation, 2013), <https://www.chinausfocus.com/2022/wp-content/uploads/Part+02-Chapter+16.pdf> [<https://perma.cc/Y2HP-33CX>] (“SOEs are owned by central, provincial or municipal governments.”). It is not precise to label corporations that are under the control or the influence of the government as SOEs, because complete “ownership” is not required for the government to exercise control or influence over corporations. Suppose that the government holds 50% (plus one) shares of a corporation (Corp. S) and the corporation holds 50% (plus one) shares of another corporation (Corp. G). In this case, even if the government does not have any single share of Corp. G, the government can effectively control Corp. G through corporate structure based on voting rights. Corp. S is owned by the government (50% ownership), but Corp. G is not. Both Corp. S and Corp. G are controlled by the government, and thus, they can be labeled as “state-controlled enterprises” (SCEs) rather than SOEs. Regarding SOEs, in numerous occasions and classes, the Author has long emphasized the concept of the state’s control or influence over a corporation rather the state’s “ownership” of a corporation. After the Author introduced the concept of the state’s control or influence over a corporation to the Author’s colleague, Mark Feldman, this Author and Professor Feldman coined the term SCE. Similarly, this Author and Professor Feldman coined the term of “state-influenced enterprises” (SIEs), i.e., corporations that are influenced by the government. In sum, the term of SOEs often includes SCEs and even SIEs, as well as “narrowly defined SOEs,” i.e., corporations where the government holds the entire or a significant amount of ownership (e.g., 30%). In order to avoid confusion, however, in this Article the Author uses the term of SOE as the term that is generally used in our daily life.

¹⁵ See, e.g., SASAC, WHAT WE DO, http://en.sasac.gov.cn/2018/07/17/c_7.htm [<https://perma.cc/HA5B-ATXZ>]. For a further explanation of SASAC and Chinese SOEs, see generally Lin & Milhaupt, *supra* note 13 (“China now has the second-largest number of Fortune Global 500 companies in the world. Most of the Chinese companies on the list are state-owned enterprises (SOEs) organized into massive corporate groups with a central government agency, known as SASAC, as their ultimate controlling shareholder.”).

¹⁶ As of March 2021, there were 97 SOE corporate groups at the central-government SASAC level. See Guowuyuan Guoyou Zichan Jiandu Guanli Weiyuanhui Yangqi Minglu (国务院国有资产监督管理委员会

side the central government level, local governments supervise and manage SOEs in various provinces and cities.¹⁷ The Communist Party of China (CPC or Party) has a critical role in controlling and supervising SOEs through its unique ability in the Chinese SOE sector to appoint, remove, and discipline the executives of SOEs.¹⁸ In virtually every material aspect of the Chinese economy and politics, it is impractical to distinguish the government from the Party, since these two organizations are deeply intertwined.¹⁹

In this light, the analyses of this Article are based on the notion that the government's activities and policies are the outcomes of the collaboration with the CPC. Also, this Article presents the government as a standalone and fictitious person, who is the controlling shareholder of SOEs.²⁰ This Article analyzes the RPT issues of SOEs primarily in the industrial (i.e., nonfinancial) sector; issues relating to SOEs in the financial sector (e.g., SOE-banks) are covered to a lesser

央企名录) [SASAC, LIST OF CENTRAL-LEVEL SOES], (Mar. 13, 2021), <http://www.sasac.gov.cn/n2588035/n2641579/n2641645/index.html> [<https://perma.cc/TD2K-B6HM>] (official SASAC website in Chinese listing the 97 central-level SOEs, including the China National Nuclear Corporation, the China Aerospace Science and Technology Corporation, the China Aerospace Science and Industry Corporation, etc.).

¹⁷ See Fan & Hope, *supra* note 14, at 5.

¹⁸ See *id.* at 6 n.6 (“In 2008, a trial program was launched to allow boards of directors to recruit and nominate top executives. Nevertheless, SASAC and the Central Organization Department (COD) of the Chinese Communist Party still appoint the majority of senior managers in central level SOEs.”).

¹⁹ For the explanation of the CPC from the Western perspective, see generally Eleanor Albert et al., *The Chinese Communist Party*, COUNCIL ON FOREIGN RELATIONS (June 9, 2020), <https://www.cfr.org/background/chinese-communist-party> [<https://perma.cc/7Q8B-X2G6>] (illustrating the CPC's power in China and the challenges that it faces).

²⁰ Within the Chinese government, different government agencies may have different—and sometimes opposing—goals and motivations. For instance, regarding SOE policies, the interests and policy goals of SASAC, the Ministry of Finance, and other government agencies are not necessarily aligned. Also, the central government and local governments may have different goals and motivations. However, this Article focuses on corporate governance issues among SOEs, the government (as the controlling shareholder), and public shareholders of SOEs. Issues relating to government agencies' (or local governments') own interests, allocation of resources and power, checks and balances, and tensions are beyond the scope of this Article, and the Author is currently conducting independent research on these issues.

extent and only when pertinent to the issues interrelated with the SOEs' industrial sector.²¹

Concerning SOE-RPTs in China, the current discussions in scholarship and media have usually focused on corruption, and this Article will explore these issues as well.²² However, as opposed to the usual approach that focuses on sociopolitical implications regarding corruption-RPTs, this Article relies on a law and economics framework and examines the interplay of information asymmetry, investor protection, and an anti-corruption campaign in the corporate governance context.²³

Additionally, this Article delves into a variety of understudied aspects of RPTs in Chinese SOEs based on a law and economics approach. To this end, this Article introduces two different concepts of RPTs in the SOE sector: (1) “corruption-RPTs,” which will be analyzed mainly in Section II, and (2) “policy-RPTs,” which will be discussed primarily in Section III. Corruption-RPTs occur when natural persons such as SOE executives (e.g., directors, auditors, or high-ranking managers) and party-government officials engaging in SOEs gain illicit profits from RPTs.²⁴ Corruption-RPTs are associated with “tunneling for personal greed” in SOEs.²⁵ In contrast to corruption-RPTs, policy-RPTs in the SOE sector occur when the government—which is not a natural-person but an “institutional controlling shareholder”²⁶—initiates RPTs to implement public policies. As a

²¹ See *infra* Section III.A.5 (explaining some issues relating to Chinese SOEs in the financial sector).

²² For the explanation of corruption in China, see, e.g., Raymond Fisman & Yongxiang Wang, *Corruption in Chinese Privatizations*, 31 J.L. ECON. & ORG. 1 (discussing a range of corruptive transactions in “Chinese state asset sales.”).

²³ See *infra* Section II (applying a law and economics approach to a consideration of “corruption-RPTs”).

²⁴ *Id.* (“In 2013, the president of the board of HBIS was investigated for his RPTs. For five years, he allowed Sili Mining, a company controlled by his brother, to use land, water, utility supplies, and a high-quality iron mine of HBIS, without proper payments to HBIS.”).

²⁵ *Id.* (“In SOEs, ‘tunneling for personal greed’ often arises in the form of RPTs.”).

²⁶ In this Article, the Author calls the Chinese government “institutional controlling shareholder” since it is a non-natural-person controlling shareholder that is institutionalized as the largest controller in the domestic economy. Indeed, the Chinese government is referred to as the largest controlling

result of policy-RPTs, the transfer of wealth may arise from the non-controlling shareholders of certain SOEs to the controlling shareholder, namely the government.²⁷

Unlike corruption-RPTs, policy-RPTs are not directly related to personal financial greed. Rather, in policy-RPTs, transfers of wealth, if any, take place as an institutional means of achieving the goals of public policies. In this respect, the Author views the wealth-transfer of policy-RPTs that favor the government as “institutionalized tunneling.”²⁸ Functionally speaking, institutionalized tunneling is akin to government taxation on SOEs that engage in policy-RPTs with the government.²⁹

shareholder in the world, not to mention in China. For the more explanation of institutional controlling shareholder, *see infra* Section III.A.1.

²⁷ In this respect, from the perspective of non-controlling shareholders who are financially damaged by policy-RPTs, such RPTs are functionally similar to tax that the government takes from them. Unlike individual natural-person controlling shareholders, the government may then utilize this surplus for the welfare of society, although party-government officials (who are conceptually separate from the government itself) may engage in corruption.

²⁸ The Author calls unfair wealth-transfer from non-controlling shareholders of SOEs to the government “institutionalized tunneling” since this type of wealth-transfer is conducted by the government based on an institutionalized means and purpose.

²⁹ For a similar analysis of the concept of institutionalized tunneling, *see* Curtis J. Milhaupt & Mariana Pargendler, *RPTs in SOEs: Tunneling, Propping, and Policy Channeling*, in *THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS* 245, 245–52 (Luca Enriques & Tobias H. Tröger eds., 2019). Regarding the analysis of the state’s tunneling, Professors Milhaupt and Pargendler focus on the political incentive of politicians and public officials and the concept of “non-pecuniary benefits of control.” *See id.* at 250 (“By using SOEs to promote public policy objectives, the state (or, more specifically, the politicians and public officials that manage affairs of state) may extract private benefits that are both non-pecuniary (in that they do not financially enrich state agents) and harmful to minority shareholders.”). As to the concept of non-pecuniary benefits of control, *see generally* Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 *HARV. L. REV.* 1641 (2006). For the analysis of the situation that non-pecuniary benefits of control may protect the interest of non-controlling shareholders, *see generally* Sang Yop Kang “*Generous Thieves*”: *The Puzzle of Controlling Shareholder Arrangements in Bad-Law Jurisdictions*, 21 *STAN. J.L. BUS. & FIN.* 57 (2015). In this Article, note that institutionalized tunneling is the state’s tunneling, but it is related to neither

Since RPTs are not necessarily unfair and generate transfers of wealth, policy-RPTs do not always lead to institutionalized tunneling. Moreover, for policy purposes, the government sometimes relies on policy-RPTs to award economic benefits to an SOE, namely “propping.”³⁰ “Propping” leads to cash-outflows from the government, in favor of a propped SOE.³¹ Hence, “propping” in policy-RPTs is functionally similar to the government subsidy (or expenditure) for a propped SOE, which is a mirror image of “institutionalized tunneling.”³² In sum, from the standpoint of the government—the controlling shareholder of SOEs—policy-RPTs may occur in the two opposite directions of wealth-transfers: “cash-inflows” (or “value-transfer” if transferred value is not exactly cash but “value” in general) to the government in the case of “institutionalized tunneling” and “cash-outflows” (or “value-transfer”) from the government in the case of “propping.” In this respect, policy-RPTs are markedly distinct from corruption RPTs that always result in “cash-inflows” in favor of SOE executives (or party-government officials) to the detriment of non-controlling shareholders.

Due to the prevailing practice of tunneling, non-controlling shareholders in Chinese corporations—both SOEs and privately-owned enterprises (POEs)—are often financially injured.³³ As will be explored in Section III, SOEs can access a variety of benefits as compared to POEs; for instance, SOEs usually gain better protection from competition, more stable cash flows, less risky business prospects, more steady customer bases, better opportunities for financing, and more enhanced safety systems from business failure and bankruptcy.³⁴ These privileges of SOEs will be eventually beneficial to

the political incentive of politicians and public officials nor non-pecuniary benefits of control.

³⁰ For an explanation of propping in the SOE sector, *see generally* Milhaupt & Pargendler, *supra* note 29, at 246–49.

³¹ *See id.*

³² *See id.* at 4 (“Propping by the controlling shareholder is particularly common in the state sector. However, it is also more suspect as a form of subsidy.”).

³³ Li, *supra* note 3, at 311 (“Regardless of the specific form, tunneling diverts economic resources out of public companies to controlling shareholders, which is detrimental to the interests of minority shareholders.”).

³⁴ For the discussion of the advantages of SOEs over POEs, *see, e.g.*, Long Wang & Yang Yang, *Political Connections and Credit Allocations: Evidence from China’s State-owned Enterprises in Land Market 1* (School of Entrepreneurship and Management, ShanghaiTech University, Working Paper,

their shareholders in the form of financial interests, such as appreciation of share prices, which scholarship often overlooks.³⁵ In other words, although SOE-shareholders in China are not well protected by the legal system, they can rely on an “extra-legal compensation mechanism” (ELCM) based on SOEs’ privileges.³⁶ The ELCM can *financially* compensate, at least partially, the SOE-shareholders who suffer from the lack of formal investor protection under corporate law and capital market regulations.³⁷ Despite its positive aspects favoring investors of SOEs, it is noteworthy that the ELCM is an outcome of a distortive infrastructure in China, where SOEs, in the market competition, take advantage over POEs and foreign companies.³⁸

Aug. 31, 2018) (“Compared to POEs, SOEs possess overwhelming advantages of money wealth, also referred to as soft budget constraints, and political connections in different economic activities.”).

³⁵ See discussion *infra* Section III.B. (explaining “additional benefits from being SOE investors”).

³⁶ For instance, Chinese SOEs take advantage of low financing costs, benefitting investors of the SOEs. See, e.g., Tianlei Huang, *Rising SOE Defaults Alarm Investors but Could Benefit the Chinese Economy*, PIIE (Jan. 29, 2021), <https://www.piie.com/blogs/china-economic-watch/rising-soe-defaults-alarm-investors-could-benefit-chinese-economy> [<https://perma.cc/C3J2-HABW>] (“In the past, local governments in China would do whatever they could to bail out troubled state firms in order to avoid the pain of layoffs Because of such implicit state guarantees for state firm liabilities, financing costs of many state firms in China’s onshore bond market were kept excessively low, despite their weak fundamentals.”).

³⁷ For the U.S. view on the deficiency of the Chinese legal system, see BUREAU OF ECON. & BUS. AFFAIRS, 2020 INVESTMENT CLIMATE STATEMENTS: CHINA (detailing U.S. concern with the unreliable legal system for corporate issues and market intervention).

³⁸ As to a critical view on the Chinese SOEs, see, e.g., Amir Guluzade, *The Role of China’s State-Owned Companies Explained*, WORLD ECON. F. (May 7, 2019), <https://www.weforum.org/agenda/2019/05/why-chinas-state-owned-companies-still-have-a-key-role-to-play/> [<https://perma.cc/S44N-KRCN>] (“SOEs are often criticised for abusing their preferential access to loans, and for lobbying for regulations which drive out competitive private companies. It is widely argued that the SOEs would not survive in an innovation-driven market environment without the perks they currently enjoy.”).

II. *Corruption-RPTs*

Regarding Chinese SOEs, Section II explores issues on corruption-RPTs conducted by natural-person related parties.³⁹ This analysis covers anti-corruption campaigns and their associated issues from a law and economics approach that the extant literature seldom addresses.

A. **Tunneling for Personal Greed**

In SOEs, “tunneling for personal greed” often arises in the form of RPTs.⁴⁰ The case of Hebei Iron and Steel (HBIS) is illustrative. In 2013, the president of the board of HBIS was investigated for his RPTs.⁴¹ For five years, he allowed Sili Mining, a company controlled by his brother, to use land, water, utility supplies, and a high-quality iron mine of HBIS, without proper payment to HBIS.⁴²

Concerning this type of corporate scandal, the current leadership in China initiated an unprecedentedly strict anti-corruption campaign.⁴³ Many high-ranking party-government leaders and SOE execu-

³⁹ In contrast, Section III explores issues on policy-RPTs conducted by the government, the institutional controlling shareholder of SOEs, which is a standalone, fictitious person. *See* discussion *infra* Section III.

⁴⁰ *See* Fuxiu Jiang & Kenneth A. Kim, *Corporate Governance in China: A Survey*, 24 REV. FIN. 733, 737 (2020) (“Controlling shareholders can use RPTs as a tunneling tool through favorable transaction terms.”). RPTs are not necessarily harmful to corporations and investors. RPTs may work as a means to minimize transaction costs within a large business organization. This merit is more apparent in jurisdictions where market institutions are not fully developed. For a further discussion of positive functions of RPTs, *see* Kang, *Rethinking Self-Dealing and the Fairness Test*, *supra* note 5, at 108–09.

⁴¹ *Hebei Gangtie Dongshizhang She Mou Sili, Baodi Wuchang Shiyong Guoyou Kuangchan* (河北钢铁董事长涉牟私利, 胞弟无偿使用国有矿产) [*The Chairman of Hebei Iron and Steel Is Involved in Private Profit and His Brother Uses State-Owned*], PEOPLE (June 3, 2013, 2:43 PM), <http://finance.people.com.cn/n/2013/0603/c364729-21717089.html> [<https://perma.cc/564C-QG5V>] (summarizing the investigation into HBIS).

⁴² *Id.*

⁴³ John M. Griffin et al., *Is the Chinese Anti-Corruption Campaign Authentic? Evidence from Corporate Investigations 1* (June 2020) (unpublished manuscript) (“As the largest anti-corruption campaign in modern history, China seeks to reduce political, military, and business corruption and has prosecuted

tives and low-ranking officials and SOE employees (aptly nicknamed “tigers” and “flies” respectively) have been investigated, caught, disciplined, and jailed. The case of Zhou Yongkang—the former petroleum czar and a member of the Politburo Standing Committee, the highest group in the CPC—provides an example of a tiger’s corruption.⁴⁴ However, due to the insufficient amount of public information, it is difficult to disentangle his tunneling in SOEs from other types of misconduct, such as bribery and the abuse of power.⁴⁵

Among anti-corruption authorities that have investigated corporate scandals involving party-government leaders and SOE executives,⁴⁶ the CPC’s central inspection system has played a critical role.⁴⁷ For instance, the Central Inspection Group found that relatives of executives of China Unicom, a large telecommunication SOE, earned abnormal benefits from RPTs.⁴⁸ Also, in China Shipbuilding and Dongfeng Motor Corporations, the Central Inspection Group dis-

or disciplined more than 2.9 million people. The campaign has a tremendous potential to bring fundamental changes to China’s corporate world ...”).

⁴⁴ *China Corruption: Life Term for Ex-security Chief Zhou*, BBC (June 11, 2015), <https://www.bbc.com/news/world-asia-china-33095453> [<https://perma.cc/5298-LHTM>] (describing China’s former security chief’s corruption scandal).

⁴⁵ *Id.* (“In the end, the decision to keep Zhou Yongkang’s trial secret matches the case surrounding him, and Zhou’s own public persona: inaccessible and secretive.”).

⁴⁶ See Jamil Anderlini, *China Corruption Purge Snares 115 SOE ‘Tigers’*, FIN. TIMES (May 18, 2015), <https://www.ft.com/content/ad997d5c-fd3c-11e4-9e96-00144feabdc0>.

⁴⁷ See Wang Qishan, *Strengthen Inspection to Fight Corruption*, CHINA DAILY (Aug. 25, 2015), http://www.chinadaily.com.cn/opinion/2015-08/25/content_21694439.htm [<https://perma.cc/GVQ4-FDWA>] (“After the 18th Party Congress in November 2012, during which the top Party leadership launched an anti-corruption campaign, more attention has been paid to the [central inspection] system.”).

⁴⁸ See Zhongyang Xunshi Zu: *Zhongguo Liantong You de Lingdao Cunzai Quan Qian Quan Se Jiaoyi* (中央巡视组: 中国联通有的领导存在权钱权色交易) [*Central Inspection Group: Some Leaders of China Unicom Were Bribed with Money, Power and Sex*], Renmin Wang-Caijing Pindao (人民网-财经频道) [People’s Daily Online-Finance Channel] (Feb. 6, 2015), <http://finance.people.com.cn/n/2015/0206/c1004-26518658.html> [<https://perma.cc/5Z64-SBAA>].

covered that executives and relatives engaged in RPTs and earned unfair benefits.⁴⁹

B. Lack of Investor Protection in Chinese Corporations (Including SOEs)

According to Article 21 of the Company Law in China, corporate insiders—such as a controlling shareholder, an actual controller, directors, supervisors, and senior managers—may not injure the company’s interests by taking advantage of their relationship with the corporation.⁵⁰ Article 21 is a general foundation of RPT regulations. Despite statutory declarations of investor protection from RPTs, the formal legal system in China leaves investors insufficiently protected.⁵¹ As a commentator evaluated, “[t]he legal consequences of tunneling are often very lenient in China.”⁵²

Also, China lacks an efficient derivative suit system that provides a remedy for financially injured investors. While Article 151 of the Company Law in China stipulates a derivative suit system,⁵³ it is

⁴⁹ *See id.* (“[T]he Central Inspection Group has announced reports on 6 units including China Unicom, Shenhua Group, Huadian Group, China Shipbuilding, Dongfeng Motor, and China Radio International.”).

⁵⁰ *Zhonghua Renmin Gongheguo Gongsì Fa* (中华人民共和国公司法) [Company Law of the People’s Republic of China] (promulgated by the Standing Comm. Nat’l People’s Cong., Oct. 26, 2018, effective Oct. 26, 2018), art. 21 (“Neither the controlling shareholder, nor the actual controller, nor any of the directors, supervisors or senior management of the company may injure the interests of the company by taking advantage of its connection relationship. Anyone who causes any loss to the company due to violating the preceding paragraph shall be liable for the compensation.”).

⁵¹ *See* Franklin Allen et al., *Law, Finance, and Economic Growth in China*, 77 J. FIN. ECON. 57, 59 (2005) (“Using measures from the existing literature, we first find that China’s law and institutions, including investor protection systems, corporate governance, accounting standards, and quality of government, are significantly less developed than most of the countries in the LLSV (1997a, 1998) and Levine (2002) samples.”).

⁵² Li, *supra* note 3, at 317 (recording the punishments for embezzlement by controlling shareholders and company executives were “nothing more than public reprimands”).

⁵³ *Zhonghua Renmin Gongheguo Gongsì Fa* (中华人民共和国公司法) [Company Law of the People’s Republic of China] (promulgated by the Standing Comm. Nat’l People’s Cong., Oct. 26, 2018, effective Oct. 26, 2018), art. 151 (describing requirements for bringing a derivative suit,

challenging for shareholders to bring a derivative suit due to its exacting requirements—such as a requirement that they must hold at least 1% of shares for 180 consecutive days.⁵⁴ This requirement practically discourages shareholder action, particularly for investors in large, listed companies where maintaining 1% shareholding for 180 days is difficult to satisfy.⁵⁵

In addition, shareholders are subject to a severe collective action problem in the derivative suit system.⁵⁶ In general, the core feature of this collective action problem is that costs are concentrated on a person who acts, whereas benefits are shared by everyone, including free-riders.⁵⁷ Suppose shareholders holding 1% of shares of a corporation bring a derivative suit. They assume the costs—including indirect costs such as time consumption and research efforts—relating to the suit. On the other hand, the other shareholders holding the rest of 99% of shares do not engage in the suit, and thus, they do not assume the costs relating to the suit. Nonetheless, when the plaintiff-shareholders (holding 1% of shares) win the case, the benefits from winning

including the requirements that shareholders hold at least 1% of shares for 180 days). For a further analysis of the derivative action in China, *see generally* Hui Huang, *The Statutory Derivative Action in China: Critical Analysis and Recommendations for Reform*, 4 BERKELEY BUS. L.J. 227 (2007) (introducing critical analysis of statutory derivative actions in China and describes the legal framework for the bringing of derivative actions).

⁵⁴ *See* Zhonghua Renmin Gongheguo Gongsifa (中华人民共和国公司法) [Company Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 26, 2018, effective Oct. 26, 2018), art. 151.

⁵⁵ For the discussion of the derivative suit system in China, *see, e.g.*, Huang, *supra* note 53, at 242 (“This rule appears to be both under-inclusive and over-inclusive, and thus it may restrict some meritorious actions while at the same time fail to discourage vexatious ones. For one thing, the right to bring the derivative action is given only to current shareholders to the exclusion of former members. This appears to be overly restrictive in comparison with some overseas jurisdictions, such as Australia and Canada.”).

⁵⁶ For the brief explanation of the collective action problem that investors face in corporations, *see* WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION, 367 (3d ed. 2009) (“Where all investors hold small stakes in the enterprise, no single investor has a strong incentive to invest time and money in monitoring management. Nor will derivative or class suits prove to be practical if the shareholders have no individual economic incentive to expend the time and money necessary to prosecute them.”).

⁵⁷ *Id.*

the lawsuit accrue to all shareholders, not only the plaintiff-shareholders but also the other shareholders, even those who did not directly engage in the lawsuit. Accordingly, even if shareholders are disgruntled by the potential fiduciary duty problems in a corporation, their incentive to rely on a derivative action in the first place is weak.⁵⁸

Moreover, an ineffective disclosure system also weakens the market infrastructure and worsens the information asymmetry problem⁵⁹ faced by investors.⁶⁰ In terms of the extent of tunneling for personal greed, it is difficult for investors in China to distinguish “cleaner” corporations involving less severe tunneling from “less clean” corporations involving more severe tunneling.⁶¹ Given this situation of asymmetric information, share prices do not precisely reflect the quality of corporate governance.⁶² Just as sellers in Akerlof’s

⁵⁸ Of course, a similar collective action problem exists in the U.S. In the U.S., however, the problem can be partially resolved by contingency fees that provide an attractive financial incentive to plaintiff-lawyers. For the further explanation of the lawyers’ fee arrangement in derivative litigation, see Curtis J. Milhaupt, *Nonprofit Organizations as Investor Protection: Economic Theory and Evidence from East Asia*, 29 YALE J. INT’L L. 169, 184 (2004) (“This U.S. ‘private attorney general’ model rests on procedural rules that establish fee arrangements for plaintiffs’ attorneys.”). By contrast, in general, Chinese lawyers do not expect such handsome profits from contingency fees. Currently, the Author is conducting a separate research project on the derivative suit system in China, in regard to the collective action problem, contingency fee issues, and the comparison with the U.S. derivative suit system.

⁵⁹ For a further explanation of information asymmetry, see George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 489–90 (1970) (illustrating the information asymmetry problem through the example of the used car market).

⁶⁰ Sang Yop Kang, *Re-envisioning the Controlling Shareholder Regime: Why Controlling Shareholders and Minority Shareholders Often Embrace*, 16 U. PA. J. BUS. L. 843, 857 (2014) [hereinafter Kang, *Re-envisioning the Controlling Shareholder Regime*] (“[S]ince the jurisdiction has an underdeveloped disclosure system, the information asymmetry problem becomes exacerbated.”).

⁶¹ See, e.g., *id.* at 854–55 (“In a corporation where a controlling shareholder may be actively involved in transactions tainted with conflicts of interest, the controlling shareholder knows that the fundamental value of the company has been damaged due to tunneling. Conversely, prospective investors in the securities market do not know whether the firm is involved in such misconduct and, if so, to what degree.”).

⁶² See *id.* at 855 (explaining that where there is asymmetric information and “investors only know the average quality of companies, they uniformly

“lemon” market⁶³ have little incentive to sell better quality goods, corporations—which are sellers of shares in the capital market—have insufficient incentive to make themselves “cleaner” in terms of the quality of corporate governance and extent of tunneling.⁶⁴

Indeed, many countries are subject to the potential lemon market problem in their capital markets, although the extent of the problem may vary from country to country. In this respect, China is not the only country that suffers from information asymmetry.⁶⁵ China, however, poses a special case because its economy is the second largest in the world, both by GDP and capital-market size standards,⁶⁶ yet it is still plagued by tunneling and information asymmetry.⁶⁷

discount the issuance of securities more deeply,” causing “[r]elatively well-governed companies [to] feel pressure to leave the market because the price determined by the application of the deeper discount to all issuers is too cheap for them and well below the fair value of their securities”) (emphasis omitted).

⁶³ For a further exploration of the “lemon” market problem, *see generally* Akerlof, *supra* note 59.

⁶⁴ For a similar explanation in a different context, *see* Kang, *Re-envisioning the Controlling Shareholder Regime*, *supra* note 60, at 855 (“Knowing that corporations are not distinguished in the market based on the quality of their corporate governance, issuers with good quality (i.e., companies not associated with tunneling) have no incentive to issue, and only issuers with bad quality (i.e., companies associated with an enormous amount of tunneling) participate in the securities market.”).

⁶⁵ *See id.* at 854 (explaining that “a securities market ... becomes highly vulnerable to the ‘lemon’ market problem due to the asymmetry of information” in countries where “investors suffer from insufficient disclosure systems and lack of transparency, not to mention inefficient legal infrastructure.”).

⁶⁶ *See, e.g.,* Xun Yugen & Zheng Yingliang (荀玉根 & 郑英亮), *Haitong: Zhongguo Dalei Zichan Shichang Pouxi Guimo Jiegou Ji Niu Xiing Zhouqi* (海通: 中国大类资产市场剖析 规模结构及牛熊周期) [*Haitong: Analysis of Asset Classes in China—Market Scale, Structure, and Bull/Bear Market Cycle*], TENCENT SEC. (Mar. 8, 2017, 7:42 AM), <http://stock.qq.com/a/20170308/005872.htm> [<https://perma.cc/KTP5-U8UT>] (explaining the size of the Chinese stock market); *Gross Domestic Product 2019*, WORLD BANK, (Feb. 12, 2021), <https://databank.worldbank.org/data/download/GDP.pdf> [<https://perma.cc/H6UB-KXL2>] (indicating that China has the second largest GDP in the world).

⁶⁷ For the explanation of a unique tunneling problem of China, *see* Dan He & Nana Wang, *Tunneling, Information Asymmetry, and Private Placement Discounts*, 6 FRONTIERS BUS. RES. CHINA 325, 326 (2012) (“A typical case in China’s capital market [was when a company] deliberately extended suspension of its stock trade to suppress stock prices, significantly lowering

In China, the problems of an ineffective derivatives suit system and disclosure system, in principle, apply to all corporations, whether they are SOEs or POEs.⁶⁸ However, these problems are critical to the SOE sector and its investors because SOEs account for a significant portion of China's corporations. For instance, according to one report on the Shanghai Stock Exchange, as of 2016, out of 1,264 listed corporations, 648 were SOEs.⁶⁹ According to another report, in the same year, approximately 60% of the corporations listed on the main board of the Shenzhen Stock Exchange were SOEs.⁷⁰ In terms of market capitalization, SOEs accounted for more than 60% of the Shanghai Stock Exchange.⁷¹

In terms of the derivative action in China, from the standpoint of an investor, it is more difficult to bring suit against an SOE than a POE because of the burden associated with engaging in disputes with an SOE, a government entity. Even if investors bring a derivative action against an SOE, it is far more challenging to collect evidence from the SOE than a POE. In general, while investors are in dispute with a company, they may use a media campaign as an effective way

the private placement price of the controlling shareholder Additionally, the incident greatly reduced the offering funds received by listed companies, and resulted in huge opportunity losses for the holders of tradable shares in the rallied market, jeopardizing the interests of minority shareholders. This expropriation phenomenon is widely cited as tunneling”)

⁶⁸ *See id.* at 330 (“In China ... the law and regulatory system are relatively undeveloped, such that numerous controlling shareholder behaviors encroach upon minority shareholders’ interests.”).

⁶⁹ *Hu Shi Shangshi Gongsi 2016 Nianbao Shizheng Fenxi Baogao* (沪市上市公司 2016 年报实证分析报告) [2016 Annual Report: Integrated Empirical Analysis of Listed Companies in Shanghai Stock Exchange], XINHUA NEWS (May 4, 2017, 8:52 AM), http://www.xinhuanet.com/finance/2017-05/04/c_129588534.htm [<https://perma.cc/5CBB-BK7Y>] (stating that as of the 2016 annual report of the Shanghai Stock Exchange, there were 1,264 listed companies, including 648 SOEs).

⁷⁰ *Shen Jiao Suo Shangshi Gongsi 2016 Nianbao Shizheng Fenxi Baogao* (深交所上市公司 2016 年报实证分析报告) [2016 Annual Report: Empirical Analysis of Listed Companies in Shenzhen Stock Exchange], XINHUA NEWS (May 2, 2017), http://www.xinhuanet.com/fortune/2017-05/02/c_129584080.htm [<https://perma.cc/XS95-THKP>].

⁷¹ *Shen Gang Tong Qidong: Wanshi Jubei Zhi Qian Dongfeng* (深港通启动：万事俱备 只欠东风) [Launch of Shenzhen-Hong Kong Stock Connect: The Time Is Ripe], TENCENT SECURITIES (Feb. 19, 2016), <http://stock.qq.com/a/20160219/036395.htm> [<https://perma.cc/F4NH-9X8M>].

to pressure the company at issue and sway public opinion. Chinese investors, however, find this media-based strategy hard to use for disputes with SOEs.

Regarding the deficiency of disclosure and violation of securities regulations, SOE investors in China cope with the similar problems that they face in the matters of the derivative action.⁷² Unless the China Securities Regulatory Commission (CSRC), in its capacity as the regulator in the capital market, directly intervenes and punishes SOEs in violation of disclosure, it is similarly difficult for SOE investors to take legal action against SOEs. Occasionally, due to the political powerplay between government entities—for example, the CSRC and an SOE—even the CSRC can sometimes be subject to limitations in monitoring and imposing sanctions on the SOEs that violate securities regulations, including rules relating to disclosure.⁷³

C. Anti-Corruption Campaign and Corporate Governance

Recently, the Chinese party-government carried out a strong anti-corruption campaign in the public sector. Because SOEs fall within the public sector, the anti-corruption campaign has significantly influenced these SOEs.⁷⁴ Regarding the anti-corruption campaign, so far, commentators have discussed issues mostly in the context of politics and social purification. Section II.C of this Article, however, examines the issues surrounding the campaign and the CPC's anti-corruption disciplinary agencies (such as the Central Inspection

⁷² Xu Xuelei & Xu Xin, *Information Disclosure of State-Owned Enterprises in China*, 4 TSINGHUA CHINA L. REV. 1, 20 (2011) (“Most of the relevant regulations of information disclosure of SOEs are limited for internal use and thus, not available to the public.”).

⁷³ See, e.g., Donghua Chen et al., *Selective Enforcement of Regulation*, 4 CHINA J. OF ACCT. RES. 9, 9 (2011) (“The results show that the China Securities Regulatory Commission (CSRC) takes into account whether companies violating the rules have a state-owned background and the strength of that background when investigating and punishing non-compliance.”).

⁷⁴ Nick Marro, *The Unintended Consequences of China's Anti-corruption Drive*, THE US-CHINA BUS. COUNCIL, <https://www.uschina.org/unintended-consequences-china%E2%80%99s-anti-corruption-drive> [https://perma.cc/3KLV-WEMC] (“The anti-corruption campaign, which began as a crusade against graft and extravagant government spending, has affected leaders of China's state-owned enterprises (SOEs) in fields including oil, power, telecommunications, transportation, and steel.”).

Group) in the context of corporate governance through a law and economics framework.

Recall that the derivative suit system is subject to hurdles, namely shareholding requirements and the collective action problem.⁷⁵ The party-government in an anti-corruption campaign does not face the same hurdles as shareholders pursuing a derivative action. During this campaign, when the party-government recognizes corporate scandals, the party-government may impose a harsh criminal penalty based on criminal law on SOE executives or party-government officials, rather than a civil monetary penalty.⁷⁶ The SOE executives' concern of a severe criminal penalty results in a massive deterrent to tunneling for personal greed. In a derivative action, SOE executives face off against a mere shareholder or a group of shareholders. By contrast, in an investigation in an anti-corruption campaign, SOE executives contend with the CPC, the government, and law enforcement agencies such as police and prosecutors, wielding much more power than the ordinary shareholder. With respect to tunneling for personal greed, an anti-corruption campaign and the involvement of the government's law enforcement and the Party's inspection system work as an intensified deterrence mechanism to SOE executives.

In addition, regarding the presence and extent of tunneling, it is possible that disciplinary agencies such as the CPC's Central Inspection Group could play a role in providing investors with more information on tunneling for personal greed in specific SOEs. Investors would be better equipped to discern the quality of an SOE's corporate governance, and thus, the pricing accuracy of SOE stocks would be improved, if not perfected.⁷⁷ Despite an anti-corruption campaign's

⁷⁵ See ALLEN ET AL., *supra* note 56 and accompanying text (explaining that the costs of derivative suits are concentrated on plaintiff-shareholders yet the benefits are distributed to all shareholders, free-riders).

⁷⁶ Aside from criminal penalties imposed by the party-government in an anti-corruption campaign, civil litigation against corporations in China is rare. See Li, *supra* note 3, at 311 (“The findings have useful implications to the literature on state-owned enterprises (SOEs) reform and the development of capital markets in China. First, in developed countries such as the United States, both criminal (e.g. actions taken by the Securities Exchange Commission) and civil (e.g. shareholder class action lawsuits) legal actions can be taken against public companies, and the threat of civil litigation is a major factor influencing corporate behavior. In contrast, civil litigation against public companies in China is practically unavailable as a remedy.”).

⁷⁷ If a capital market is efficient, information on tunneling can be instantly reflected in a stock price. See Burton G. Malkiel, *The Efficient Market Hypo-*

positive effects on corporate governance, additional points of campaigns in general—not specifically the recent campaign—can be further examined in regard to SOE-RPTs.

First, if disciplinary agencies provide an insufficient amount of information for investors, ungrounded rumors may generate and spread in the capital market, thereby misleading public shareholders of SOEs.⁷⁸ In China, detailed information on investigations by disciplinary agencies is often unavailable.⁷⁹ Of course, the mere awareness of an investigation without more detailed information, as opposed to no notice of the investigation, may prove useful to investors. Nonetheless, it would be better for investors to have material information⁸⁰ on a specific investigation unless the information requires confidentiality in exceptional cases, such as national security issues. Second, there is also some concern that an anti-corruption campaign can function as a party-government tool to purge the opposing camp. If a sufficient number of investors begin to suspect that an anti-corruption campaign is carried out for mainly political reasons, that suspicion will weaken the campaign's role in providing investors with information on the quality of corporate governance in individual SOEs. Third, it is worth noting that SOE-RPTs are not always value-decreasing to the detriment of an SOE and its shareholders.⁸¹ An anti-corruption campaign

thesis and Its Critics, 17 J. ECON. PERSP. 59, 59 (2003) (“[W]hen information arises, the news spreads very quickly and is incorporated into the prices of securities.”).

⁷⁸ Jos Van Bommel, *Rumors*, 58 J. FIN. 1499, 1499 (2003) (“It is difficult to dispute that rumors have an important impact on stock prices.”).

⁷⁹ When it comes to disciplinary agencies, Section II.C mainly discusses disciplinary activities by the CPC's anti-corruption agencies such as the Central Inspection Group. Regarding the reasons for investigation in corporations, however, it is also worth noting the CSRC, the government's regulatory agency in the capital market. See Gongmen Chen, et al., *Is China's Securities Regulatory Agency a Toothless Tiger? Evidence from Enforcement Actions*, 24 J. ACCT. PUB. POL'Y 451, 464 (2005) (“The reasons why the CSRC initiated an investigation and what prompted the investigation (e.g. a complaint by an investor) are typically not disclosed.”).

⁸⁰ Regarding material information, see, e.g., *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449(1976) (“An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.”).

⁸¹ Regarding the neutral connotation of RPTs, see Kang, *Rethinking Self-Dealing and the Fairness Test*, *supra* note 5, at 105 and accompanying text

can prevent SOE executives from engaging in corruption-RPTs. During the campaign, however, a gigantic chilling effect might arise so that SOE executives do not actively carry forward business activities if they are concerned that such activities look suspicious. Under a tight anti-corruption campaign, accordingly, even RPTs with fair terms that create value for an SOE might not occur due to SOE executives' self-censorship and self-protectionism. In this situation, the shareholders of the SOE would lose out on the opportunity of higher corporate value and appreciation of the share price.

Fourth, due to the immature disclosure system and the less sophisticated capital market infrastructure in China, investors suffer from a severe asymmetric information problem.⁸² Hence, SOE investors would likely suspect that the revealed cases of tunneling are merely the tip of a massive iceberg. Suppose the party-government's disciplinary investigation earnestly found ten tunneling cases. Even if these ten cases are *all* tunneling cases existing in the Chinese economy, investors who chronically have been subject to severe asymmetric information might reasonably—even if mistakenly—conclude that there are as many as 100 or more unrevealed tunneling cases during that time. Before a sufficient amount of time passes and reliable information is available to indicate the relative cleanliness of certain SOEs, investors are not entirely convinced about the lack of tunneling in these SOEs, even if these SOEs are not plagued by tunneling.⁸³ In other words, due to the deficiency of the available information in the capital market, investors are unable to distinguish SOEs which partake in tunneling. Hence, it is highly plausible that investors, based on this incorrect but rational suspicion, will excessively discount the stock prices of relatively cleaner SOEs, whose quality of corporate governance is “better” among SOEs, or even absolutely clean SOEs, whose quality of corporate governance is the “best” among SOEs.

(explaining that not all related party transactions are unfair dealings or detriment to non-controlling shareholders).

⁸² See Sang Yop Kang, *Games of Thrones: Corporate Governance Issues of Children's Competition in Family Corporations*, 15 BERKELEY BUS. L.J. 185, 217 (2018) (“[Many countries] lack market infrastructures and professionals such as institutional investors, securities analysts, and credit rating agencies.”).

⁸³ For the analysis of the impact of the lack of a reliable information disclosure system in the context of the succession competition among controlling shareholders' children, see *id.* at 213 (explaining that without information transparency “investors are unable to discern the extent of children's inefficient risk-taking across various family corporations.”).

Fifth, for sustainable development in the capital market, it is essential for China to be equipped with an effective disclosure system and recourse through the enforceable mechanisms of corporate and securities law in addition to an anti-corruption campaign.⁸⁴ In some situations, an anti-corruption campaign that imposes criminal penalties may lead to over-deterrence, which will distort the incentive mechanisms of market participants such as SOE executives. In this respect, fine-tuned non-criminal penalties from corporate law are also necessary.

An anti-corruption disciplinary investigation generates a deterrent effect, with the intention of reducing the level of tunneling for SOE executives' personal greed.⁸⁵ Such a deterrent effect, however, creates a side-effect. Since a disciplinary investigation indicates that tunneling exists in an SOE, it is likely that the firm value of an investigated SOE will be adversely affected in the meantime. Hence, if a disciplinary investigation is not combined with civil remedies, any resulting criminal or administrative penalties *alone* would be economically useless or even harmful to the SOE's "contemporary shareholders" who invested at the time of tunneling. If the investigation of the anti-corruption campaign fixes the tunneling problem of the SOE, after the passage of time, all else being equal, the firm value of the SOE will be higher than the firm value at the time of tunneling (and before the tunneling problem is repaired). In this respect, without civil remedies that compensate the aggrieved investors—in this analysis, contemporary shareholders—who held shares at the time of tunneling, the deterrent effect from an anti-corruption campaign will provide economic benefits to only future shareholders, who invest their wealth in the investigated SOE *after* the anti-corruption campaign addresses tunneling.⁸⁶

⁸⁴ See also Li, *supra* note 3, at 321 ("We believe that, to improve protection of investors, especially minority investors, civil liabilities and litigation should be incorporated into China's legal system.").

⁸⁵ As to law enforcement in China, the concept of 'yanda' is also noteworthy. See Tao Huang & Weiping He, *Investor Protection in China's Securities Markets: Marginalization of the Judiciary and Utilization of Political Resources*, 12 FRONTIERS L. CHINA 473, 493 (2017) ("The enforcement mode of 'yanda' conveys the meaning of 'cracking down on crime.' It is where a series of measures is implemented for a period of time by various political bodies to restrict undesirable or illegal behavior.").

⁸⁶ Benefits of the disciplinary investigation, if any, may accrue to future shareholders in two ways: (1) they purchase shares of the investigated SOE at a depressed price when the investigation adversely affects the share price of

In sum, under the criminal penalty-based deterrent effect, it is future shareholders of the investigated SOE, who generally gain a financial windfall. It is a crucial goal to improve the quality of corporate governance of the SOE by restricting tunneling for personal greed and protecting future shareholders. It is noteworthy, however, that the contemporary shareholders of the SOE who invested their capital at the time of tunneling, rather than the future investors, are the victims who are financially injured by tunneling. A policy in relation to addressing tunneling should consider the protection of and compensation for the injured investors as a primary policy aim. To award legal recourse and financial remedies to the injured investors, a more sophisticated system of shareholder litigation—which provides civil compensation to the injured investors—should be implemented in tandem with a disciplinary system that focuses on criminal or administrative penalties.⁸⁷

III. Policy-RPTs In SOEs

In corporate governance scholarship, RPTs in Chinese SOEs are still a black-box. While a limited number of studies may exist, most of the discussion and research on RPTs in Chinese SOEs concerns the misconduct of natural-person related parties, namely tunneling for personal greed. In contrast to this current situation of scholarship, this section analyzes RPTs conducted by an institutional controlling shareholder, a non-natural-person controlling shareholder (i.e., the government), as it implements public policies.⁸⁸ Also, this section

the SOE; and (2) other things being equal, they benefit from the enhanced quality of corporate governance of the SOE after the investigation which deters tunneling in the future. Some “contemporary shareholders” can be “future shareholders” if they stay in the SOE as shareholders at the time when the tunneling problem is resolved.

⁸⁷ For a brief explanation of the deficiency of the derivative suit system in China, see *supra* Section II.B.

⁸⁸ Sometimes, the Chinese government holds ownership in POEs (e.g., 10% ownership). See Curtis J. Milhaupt & Wentong Zheng, *Beyond Ownership: State Capitalism and the Chinese Firm*, 103 GEO. L.J. 665, 672 (2015) (“With the adoption of the Chinese Company Law in 1994, private entrepreneurs gained the ability to register their firms as POEs, but the state also increasingly participated in the ownership of corporate shares.”). Even without ownership, based on a variety of networks in society, the Chinese government is often influential in the private sector. See *id.* at 685–88 (describing that “the state exercises significant extralegal control rights over private firms”). In

explores institutionalized tunneling and propping and subsequently examines additional benefits that investors in Chinese SOEs can financially attain, even though the investors face the unsatisfactory level of investor protection under the legal systems.

A. Policy-RPTs: Institutionalized Tunneling and Propping

1. Institutionalized Tunneling

Let us first consider a hypothetical RPT between two SOEs. As seen in Figure 1, suppose the government has a higher percentage of ownership in SOE A (e.g., 80%) than in SOE B (e.g., 50.1%).⁸⁹ As the controlling shareholder of both SOEs, the government can exercise influence in determining the terms and conditions of the RPT.⁹⁰ Suppose SOE A sells an asset to SOE B at a higher price than a fair market price (i.e., tunneling based on an overpricing asset RPT).⁹¹

Based on the asset RPT, the government, acting as the controlling shareholder of SOE B, bears 50.1% of the losses of SOE B

either case, under certain circumstances, the government can exercise influence in a POE as a related party or a de facto related party. Section III focuses on analyzing RPTs within the governmental sector (SOE-SOE transactions). The Author is currently conducting research on the POE-SOE transactional relationship, which potentially relates to topics discussed in this Article.

⁸⁹ See *infra* Figure 1. To control a corporation, however, it is not necessary to hold a majority of shares. See Kang, *Rethinking Self-Dealing and the Fairness Test*, *supra* note 5, at 121–23 (describing controlling minority structures). For instance, if a pyramiding structure is available, the government can control a corporation with a small fraction of ownership. See *id.* at 122 (stating that “a shareholder with only a small fraction of ownership can exercise control over a corporation by relying on voting leverage schemes, including three conventional schemes such as stock pyramiding, dual-class equity structures, and cross-ownership”).

⁹⁰ For the explanation of a controlling shareholder’s influence on an RPT, see *id.* at 104 (stating that “a controlling shareholder in a corporate group exercises significant influence over the decision-making processes in both affiliates engaged in the transaction” in an RPT).

⁹¹ For the further explanation of tunneling based on an asset RPT, see Sang Yop Kang, *Diversified Enterprises with Controlling Shareholders: A Theoretical Analysis of Risk-Sharing, Control/Voting Leverage, and Tunneling*, in RESEARCH HANDBOOK ON COMPARATIVE CORPORATE GOVERNANCE (Afra Afsharipour & Martin Gelter eds., forthcoming 2021) [hereinafter Kang, *Diversified Enterprises with Controlling Shareholders*].

from the overpricing; however, as the controlling shareholder of SOE A, the government also gains 80% of SOE A's benefits from the overpricing.⁹² As a result, in ordinary cases, the government can utilize positive net benefits.⁹³ Eventually, corporate wealth shifts from the public shareholders holding 49.9% of SOE B to the government and the public shareholders holding 20% of SOE A. If the government were treated as a standalone economic person, this phenomenon would be akin to the typical tunneling by a natural-person controlling shareholder in a POE.

A similar analysis can be made when SOE A and SOE B engage in internal transactions where they both sell and purchase intermediate goods and services, particularly in a vertically integrated supply chain. For instance, suppose SOE A sells a large amount of product components to SOE B at a higher price than a fair market price (i.e., tunneling based on an overpricing product RPT).⁹⁴ Product RPTs may arise on a daily basis, unlike asset RPTs, which occur infrequently.⁹⁵ For instance, a sale of a building as an RPT can occur once in several years, whereas sales of tires in a vertically integrated supply chain in an automobile corporate group may occur thousands of times per day.⁹⁶ In product RPTs, as discussed in the case of asset RPTs, corporate wealth shifts from public shareholders holding 49.9% of

⁹² See *infra* Figure 1 (illustrating the payoff of the government through an example of institutionalized tunneling).

⁹³ See Kang, *Rethinking Self-Dealing and the Fairness Test*, *supra* note 5, at 119–20 (describing how a controlling shareholder's "ownership gap" of the two corporations that she controls can lead to her personal benefit from self-dealing transactions, where corporate wealth is transferred to the corporation where the greater economic interest is held); see also Djankov et al., *supra* note 7, at 432 ("Mr. James owns 90% of Seller and 60% of Buyer [A] \$100 wealth transfer from Buyer to Seller would reduce the value of James' equity in Buyer by \$60 but increase the value of his equity in seller by \$90."); but see Sang Yop Kang, *Internal Transactions and Tunneling: A Counter-Intuitive Analysis* (Sept. 2020) (unpublished presentation material) (on file with author) (describing, conversely, that a transaction in favor of a corporation where a controller holds a smaller economic interest may also lead to gains for the controller).

⁹⁴ See Kang, *Rethinking Self-Dealing and the Fairness Test*, *supra* note 5, at 98–100 (further explaining tunneling based on product RPTs).

⁹⁵ See Kang, *Diversified Enterprises with Controlling Shareholders*, *supra* note 91.

⁹⁶ See *id.*

SOE B to the government and the other public shareholders holding 20% of SOE A.⁹⁷

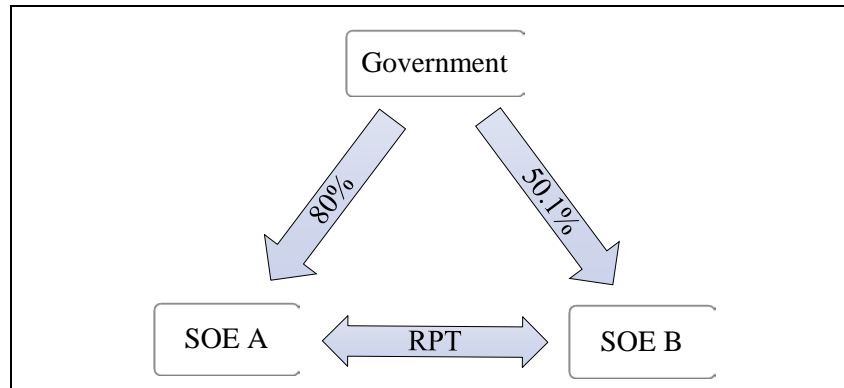


Figure 1: RPTs Between SOEs⁹⁸

In a POE, tunneling by a natural-person controlling shareholder⁹⁹ relates to stealing to satisfy selfish greed. In contrast, in an SOE, there are two different aspects regarding the nature of the controlling shareholder and its tunneling. First, although the government is the controlling shareholder of an SOE, it is a non-natural person and an entity which, at least in theory, stands on behalf of the entire citizenry.¹⁰⁰ In this respect, the government is an “institutional controlling shareholder,” which differs from a natural-person controller in a POE. Second, even in the case where the government tunnels corporate

⁹⁷ For the similar explanation, see Kang, *Rethinking Self-Dealing and the Fairness Test*, *supra* note 5, at 119–21; see also Djankov et al., *supra* note 7, at 432.

⁹⁸ For a similar analysis of RPTs between two corporations (not limited to SOEs), see Kang, *Rethinking Self-Dealing and the Fairness Test*, *supra* note 5, at 116–21. Although Figure 1 explains an RPT between two SOEs under the control of the government, an RPT can arise directly between the government and an SOE.

⁹⁹ In theory, a legal person (rather than a natural person) can be a controller of a POE. This Article explains mainly the situation where a controlling shareholder of a POE is a natural person, e.g., a controlling family shareholder.

¹⁰⁰ See, e.g., Jan Stuesson et al., STATE-OWNED ENTERPRISES CATALYSTS FOR PUBLIC VALUE CREATION? 6 (PricewaterhouseCoopers 2015) (“In particular, SOEs have a different purpose, mission and objectives which relate to some aspect of public service and/or social outcomes.”).

value, the government, unlike a POE's controlling shareholder, does not have its own personal, selfish ends. This is a primary reason why the analysis of a controlling shareholder's tunneling should be distinct in the case of SOEs. Wealth-transfer in RPTs, in which the government acts as the controlling shareholder, occurs as an institutional means to carry out the government's public policies. In this respect, as explained, the Author refers to these wealth-transfers in the SOE sector, unrelated to the controlling shareholder's personal greed, as institutionalized tunneling.¹⁰¹

In the case of the government's institutionalized tunneling, natural-person SOE insiders, such as SOE executives and party-government officials do not necessarily gain illegitimate pecuniary benefits.¹⁰² Put differently, tunneling for personal greed, discussed in Section II, is not necessarily correlated with institutionalized tunneling. It is possible that both institutionalized tunneling and SOE insiders' tunneling for personal greed can occur at the same time. With institutionalized tunneling, however, even if SOE insiders eventually obtain private benefits in an illicit manner, such wrongful conduct occurs independent of the government's tunneling. Table 1 summarizes the discussion.

| TYPE OF TUNNELING | TUNNELING IN POES | TUNNELING IN SOES | |
|---------------------|---------------------------------|------------------------------|---|
| | TUNNELING FOR PERSONAL GREED | TUNNELING FOR PERSONAL GREED | INSTITUTIONALIZED TUNNELING |
| Nature of Tunneling | Expropriation (Stealing) | Expropriation (Stealing) | Means of Policies |
| Who Tunnel(s)? | Natural Persons | Natural Persons | Non-natural Person |
| | Mainly Controlling Shareholders | SOE Executives | Government (as the Controlling Shareholder) |

Table 1: Taxonomy of Tunneling

¹⁰¹ See *supra* Section I (defining "institutionalized tunneling").

¹⁰² See, e.g., Angelo M. Solarino & Brian K. Boyd, *Are All Forms of Ownership Prone to Tunneling? A Meta-Analysis*, 28 CORP. GOVERNANCE: INT'L REV. 488, 491 (2020) (highlighting circumstances in which the Italian government benefited from "non-self-serving tunneling" involving a state-controlled energy company).

Although institutionalized tunneling occurs under the government's public policies, public investors in the injured SOE may feel that the government—acting as the controlling shareholder—expropriates corporate value to the detriment of public shareholders.¹⁰³ In other words, from the standpoint of the financially injured investors, institutionalized tunneling is neither functionally nor economically different from tunneling for personal greed, even if there is no natural person who gains illicit benefits from the institutionalized tunneling. As will be discussed below, these investors in China face the problem of the lack of solid legal recourse under the current corporate law system.¹⁰⁴

Primarily, policy rationales to improve the public interest justify policy-RPTs behind institutionalized tunneling in an SOE.¹⁰⁵ From the standpoint of Chinese SOE investors, it is impractical to sue the government as the controlling shareholder for shareholders' financial damages resulting from policy-RPTs, which are designed to enhance the level of the public interest. Even if a derivative suit were available, rational investors in China would be unlikely to challenge the authoritarian, powerful government in court. Rather, if investors wished to appeal to the government, they might discuss the issue with the government unofficially and privately, which is generally considered a weak party's preferable way of resolving a dispute. Regarding institutionalized tunneling, accordingly, legal actions brought by the investor side are limited.

Legal actions brought by the government or quasi-government agencies are limited as well. Regarding the government's tunneling, without corruption, it is also difficult to expect intervention by the CSRC, the stock exchanges, or anti-corruption authorities, to keep policy-RPTs in the SOE sector in check. In addition, the Company Law in China is subject to a limit concerning the regulation of institutionalized tunneling. Specifically, Section (4) of Article 216 stipulates that “the enterprises controlled by the state do not incur a connection

¹⁰³ See Milhaupt & Pargendler, *supra* note 29 (illustrating how the government, as the controlling shareholder, can transact with the SOE to the detriment of the minority shareholders).

¹⁰⁴ These investors, however, may rely on informal mechanisms to be compensated for their loss from institutionalized tunneling. See *infra* Section III.B.

¹⁰⁵ Milhaupt & Pargendler, *supra* note 29, at 249 (“Policy channeling is the state's use of an SOE (as opposed to regulation or taxation) to achieve a public policy or political objective.”).

relationship [which is the basis of RPTs] simply because their shares are controlled by the state.”¹⁰⁶

2. *Propping*

RPTs within the SOE sector do not always lead to institutionalized tunneling. In Figure 1, suppose the pricing of an RPT favors SOE B, where the government has a lower percentage of ownership (i.e., 50.1%), to the detriment of SOE A, where the government has a higher percentage of ownership (i.e., 80%). Note that this situation is precisely the opposite of the preceding one discussed in Section III.A.1, where the pricing of an RPT favors SOE A to the detriment of SOE B.

In terms of the policy, this sort of RPT, which favors SOE B, amounts to the government’s propping of SOE B. In this case, contrary to institutionalized tunneling, the government, namely the controlling shareholder of the two SOEs, voluntarily and purposely incurs financial deficits from the RPT.¹⁰⁷ In other words, while the government gains profits from the RPT as the controlling shareholder of SOE B, its losses from the RPT as the controlling shareholder of SOE A are greater than the profits from SOE B’s side. This is because the government has a higher percentage of ownership in SOE A (i.e., 80%) than in SOE B (i.e., 50.1%). As a result of the RPT, the non-controlling shareholders holding 49.9% of shares of SOE B, which is propped by the government, gain benefits, resulting in the functional equivalent of a government’s subsidy to SOE B. The practice of propping appears as an industrial policy by the Chinese government, and Western countries have expressed concern over a level playing field in competition with Chinese SOEs. In contrast, the non-controlling shareholders holding 20% of shares of SOE A ordinarily bear financial losses since SOE A props SOE B.

¹⁰⁶ Zhonghua Renmin Gongheguo Gongsi Fa (中华人民共和国公司法) [Company Law of the People’s Republic of China] (promulgated by the Standing Comm. Nat’l People’s Cong., Oct. 26, 2018, effective Oct. 26, 2018), art. 216 (4).

¹⁰⁷ See Milhaupt & Pargendler, *supra* note 29, at 246–49.

3. *Shareholders' Investment Diversification in SOEs*

Investors in the Chinese capital market may invest in multiple SOEs, diversifying their investments across the SOE sector. In this case, the net effect of policy-RPTs, from both institutionalized tunneling and propping, will likely be offset in a systematic manner. Suppose an investor invests in both SOE A, where the government holds 80% of shares, and SOE B, where the government holds 50.1% of shares.¹⁰⁸ Based on an SOE-RPT between the two SOEs, suppose institutionalized tunneling arises in favor of SOE A to the detriment of SOE B. As a shareholder of SOE B (a tunneled SOE), the investor is financially damaged by the government's institutionalized tunneling. However, the investor's financial damage can be mitigated since the investor is also a shareholder of SOE A, a tunneling SOE. In other words, the investor has piggybacked on the government's institutionalized tunneling. Three additional points are worth explaining further.

First, in addition to just the "mitigation" of investors' financial damage in institutionalized tunneling, these investors can, in some cases, end up with net profits from institutionalized tunneling. These cases arise when investors have a higher ownership in a tunneling SOE than in a tunneled SOE.¹⁰⁹ In these cases, it is noteworthy that these investors are not victims but beneficiaries of institutionalized tunneling.¹¹⁰ In this respect, if *only* public investors' financial damage from a tunneled SOE is taken into account within an investor protection analysis relating to institutionalized tunneling, the analysis is misleading due to the lack of a holistic analytical framework. In essence, the financial benefits that public investors gain from a tunneling SOE should also be considered.

Second, although public investors can directly invest their capital in both a tunneled and tunneling SOEs, the diversification of their investment can be achieved in a more convenient manner if the investors, particularly retail investors, use institutional investors such as mutual funds.¹¹¹ In this regard, public investors' investments in

¹⁰⁸ See *supra* Figure 1.

¹⁰⁹ For the further analysis of tunneling and the discrepancy of ownership percentages between two affiliated companies in the same corporate group, see Kang, *Rethinking Self-Dealing and the Fairness Test*, *supra* note 5, at 120.

¹¹⁰ See *id* at 145–46 (explaining the situation where non-controlling shareholders benefit from a controlling shareholder's RPTs).

¹¹¹ It is also possible that institutional investors can invest in other institutional investors which invest in SOEs.

institutional investors can function as an insurance mechanism or a safety net for these investors to smooth out their cash inflows and prevent substantial losses that may occur if public investors concentrate their investment in a tunneled SOE.

Third, however, less-developed institutional investing creates an inherent problem in China's stock market. For instance, according to a report, the investment of individual (retail) investors, in terms of ownership, accounted for almost 50%.¹¹² Based on another report, it is stated that “[i]ndividual investors make up 80 percent of the trading volume”¹¹³ The lack of access to sophisticated institutional investors in China limits individual investors' ability to diversify.¹¹⁴

Fourth, the analysis in Section III.A.3 is mainly based on the implicit assumption that both tunneled and tunneling SOEs are listed companies, and thus, no serious legal or market obstacles to investors' diversification exist. In a case where a tunneling SOE is unlisted, however, it is difficult or even impossible for public investors—either through direct retail investing or indirect investment by means of institutional investors—to invest in the tunneling SOE. To the Author's knowledge, there is no convincing, reliable data about how often and to what extent this type of case arises in the Chinese SOE sector. Empirical studies are needed to understand such a difficulty that public investors face. Nonetheless, this Article theoretically points out the possibility that public investors in China may lose their corporate value systematically from institutionalized tunneling, if the direction of wealth-transfer is set from a listed SOE to an unlisted SOE.

4. RPTs Within SOE Corporate Groups

In China, many SOEs belong to corporate groups.¹¹⁵ In an SOE corporate group, transactions frequently take place among affli-

¹¹² Xun & Zheng, *supra* note 66 (“[Retail investors accounted for 47.7% [of Chinese investors]”).

¹¹³ *In China, It's Global Money Managers vs. Mom and Pop*, BLOOMBERG BUSINESSWEEK (Sept. 28, 2017), <https://www.bloomberg.com/news/articles/2017-09-27/in-china-it-s-global-money-managers-vs-mom-and-pop>.

¹¹⁴ *See id.* (describing retail investing in China as opposed to the situation in “the U.S. and Europe where institutional investors dominate”); *see also* Kang, *Rethinking Self-Dealing and the Fairness Test*, *supra* note 5, at 146 (explaining that “the role of institutional investors is limited” in China).

¹¹⁵ For a further explanation of SASAC and its SOE corporate groups, *see supra* Section I.

ated SOEs.¹¹⁶ RPTs within SOE corporate groups are not necessarily associated with wealth-transfers since some RPTs are neutral or positive in terms of corporate governance.¹¹⁷ For instance, among affiliated companies, intermediate goods and services can be traded at fair prices.¹¹⁸ In these cases, neither institutionalized tunneling nor propping occurs. Given the relatively low level of trust in society as well as the less sophisticated market institutions and legal systems in China, a party would like to rely on transactions with another party that the former has a trustworthy relationship with. In this regard, RPTs—specifically those in a corporate group—might be a more efficient way to do business in China than we have thought since the “transaction costs” between related parties can be low, as compared to the “transaction costs” between two parties that do not have any close relationship.

Although many RPTs are neutral or positive in terms of corporate governance in relation to specifically tunneling, a large portion of RPTs in China is suspected as value-shifting RPTs, i.e., tunneling. However, even when RPTs within SOE corporate groups lead to wealth-transfers, some value-shifting RPTs—which corporate governance scholarship traditionally consider negative in terms of investor protection—may work as a means of “risk-sharing” among affiliated companies. In an SOE corporate group, for instance, one affiliated SOE benefits from RPTs with another affiliated SOE when the former is financially in need. Later, when the latter is financially in need, the latter may benefit from RPTs with the former.

This practice can be understood as an “implicit contract” concerning investor protection between the government as the controlling shareholder on the one side and an SOE corporate group’s affiliates on the other side. Alternatively, an implicit contract can exist among affiliated companies of an SOE corporate group. In any case, the Author does not overemphasize the positive aspect of these implicit contracts. When an implicit contract among affiliated SOEs is

¹¹⁶ As to RPTs in the private sector, see Kang, *Rethinking Self-Dealing and the Fairness Test*, *supra* note 5, at 99 (describing how internal transactions occur within corporate groups).

¹¹⁷ See also *supra* Section I. See generally Kang, *Rethinking Self-Dealing and the Fairness Test*, *supra* note 5 (discussing that in some instances RPTs can be neutral or good).

¹¹⁸ However, if a fair price “range” (rather than a pinpointed fair price) applies to an RPT, it is still possible that wealth-transfer can occur, since a related party can take advantage of the “range.” See *id.* at 101.

arbitrarily interpreted and abused by the government, acting as the controlling shareholder of the corporate group, public investors can face severe damage unless they diversify their investment among SOE affiliates in a balanced manner. Nonetheless, in order to accomplish a holistic analysis of institutionalized tunneling and propping, it is vital to take into consideration the presence, or at least the possibility, of these implicit contracts.

Within an SOE corporate group, the government does not always directly intervene to arrange the terms and conditions of specific RPTs, particularly—but not limited to—when RPTs occur routinely for intermediate goods and services in vertical integration. In this case, SOE executives may exercise a great deal of discretion when implementing corporate group RPTs. In other words, the controlling shareholder of an SOE corporate group may broadly allow its agents, namely SOE executives, to make business decisions on a variety of matters, including SOE-RPTs.¹¹⁹ Nonetheless, these discretionary decisions by SOE executives are made within the scope of the government’s general policy direction.

5. *Policy-RPTs*

With a variety of channels and means to exert influence over an SOE’s decision-making process, the government, through SOE executives’ implementation, has broad leeway to link its public policies to RPTs.¹²⁰ For example, via an employment-stabilizing policy, the government, either at the central or a local level, could transfer an SOE’s surplus funds to support a troubled SOE to prevent layoffs that might

¹¹⁹ Some scholars classify Chinese SOEs into at least two categories: SOEs under the government’s strong intervention and weak intervention. For the explanation of the executive turnover in the context of the government’s intervention in the Chinese SOEs, see Feng Liu & Linlin Zhang, *Executive Turnover in China’s State-Owned Enterprises: Government-Oriented or Market-Oriented*, 11 CHINA J. ACCT. RSCH. 129, 130 (2018) (“This paper focuses on the executive turnover of China’s SOEs and the implementation of the related evaluation mechanisms under different levels of government intervention.”)

¹²⁰ Regarding RPTs in SOEs, another related concept is “policy-channeling.” See Milhaupt & Pargendler, *supra* note 29, at 245 (“[S]tates may use ownership of a firm to pursue public policy objectives in addition to profits. We will call this phenomenon ‘policy channeling.’”).

result in social unrest.¹²¹ The government does not have to directly transfer wealth from the former SOE's treasury to the latter SOE's treasury; instead, if the SOE with surplus funds purchases intermediate goods (e.g., raw materials) from the troubled SOE at a higher price than the fair price, in general, the latter SOE benefits, and the former SOE loses.¹²²

Most banks and financial institutions in China are SOEs. For instance, the largest four banks in China—Industrial and Commercial Bank of China (ICBC), China Construction Bank, Agricultural Bank of China, and Bank of China—are state-owned.¹²³ A loan from an SOE-bank to a borrower-SOE is a government RPT, since the government, the controlling shareholder in the SOE sector, often exercises influence implicitly or expressly over bank-loan transactions between an SOE in the banking sector and another SOE in the industrial sector.¹²⁴ For example, during the financial crisis in the late 2000s, it was reported that “[e]ighty-five percent of the country’s staggering 9.59 trillion yuan (\$1.4 trillion) bank loans in 2009 were granted to SOEs, leaving others more vulnerable in the economic recovery.”¹²⁵ Although reports on Chinese statistics often lack support from reliable data or clear explanations of the data,¹²⁶ one may still reliably

¹²¹ See Jia He et al., *Business Groups in China*, 22 J. CORP. FIN. 166, 169–70 (2013) (explaining issues relating to layoffs).

¹²² This wealth-transfer might occur within the same corporate group. Alternatively, it could occur beyond a corporate group.

¹²³ In 2015, in terms of total assets, these Chinese banks were on the list of the five largest banks in the world. See, e.g., Don Weinland, *Four of World’s Five Biggest Banks in China*, SOUTH CHINA MORNING POST (Aug. 9, 2015, 10:00 PM), <http://www.scmp.com/business/banking-finance/article/1847728/four-worlds-five-biggest-banks-china>.

¹²⁴ See, e.g., Ing. Jan Bejtkovský, *State Capitalism in China: The Case of the Banking Sector*, in PROCEEDINGS OF THE INTERNATIONAL ACADEMIC RESEARCH CONFERENCE ON SMALL & MEDIUM ENTERPRISE 7 (Viet. SME Conference, Paper ID VS611, 2016) (explaining how the government gives preferential access to capitals to SOEs through its influence on SOE banks).

¹²⁵ *Deputy Raps SOEs’ Imparity on Taxes and Jobs*, CHINA DAILY (Mar. 10, 2010), http://www.chinadaily.com.cn/china/2010-03/10/content_9567711.htm [<https://perma.cc/CW9K-NMJM>]. For a similar explanation, see Bejtkovský, *supra* note 124 (explaining that the Chinese government’s stimulus package in 2009 was mainly used for the SOE sector).

¹²⁶ According to a critic, the data which indicate that 85% of bank loans were channeled to SOEs are not supported. See Nicholas Borst, *SOEs Are Important, But Let’s Not Exaggerate*, PETERSON INST. FOR INT’L ECON. 1 (Nov. 21,

conclude the SOE sector is the principal beneficiary of financial resources in China. By contrast, POEs generally do not have sufficient access to financial resources such as bank loans.¹²⁷

In China, credit markets are less developed, and the demand for credit exceeds the available supply.¹²⁸ Accordingly, SOEs' access to bank loans in itself is a privilege.¹²⁹ An outcome of this privilege is that SOEs are incorporated into a gigantic "internal capital market"¹³⁰ within the hefty banking industry SOE complex.¹³¹ For instance, the China Development Bank and the Export-Import Bank of China have engaged in policy loans.¹³² Many Chinese banks, in collaboration with

2011), <https://piie.com/blogs/china-economic-watch/soes-are-important-lets-not-exaggerate>. [<https://perma.cc/W3MW-PRBQ>].

¹²⁷ See Fan & Hope, *supra* note 14, at 11–12 (indicating continued bias by the Chinese government toward SOEs compared to POEs because China's SOEs are much more capital intensive than their private counterparts"). For an explanation of the allocation of loans to POEs in China, see generally Michael Firth et al., *Inside the Black Box: Bank Credit Allocation in China's Private Sector*, 33 J. BANKING & FIN. 1144, 1144 (2009) ("We find that the banks extend loans to financially healthier and better-governed firms, which implies that the banks use commercial judgments in this segment of the market. We also find that having the state as a minority owner helps firms obtain bank loans and this suggests that political connections play a role in gaining access to bank finance.").

¹²⁸ As to the loans, in particular, to the private sector in China, see *id.* at 1144–45 (describing banks' inactive role in private financing and their limited ability to lend to the private sector in China).

¹²⁹ *Id.* at 1145 ("[B]ank statistics show that although the private sector accounts for 50% of the economy, it accounts for just 7% of bank lending.").

¹³⁰ Regarding "internal capital market," see, e.g., Jeremy C. Stein, *Internal Capital Markets and the Competition for Corporate Resources*, 52 J. FIN. 111, 111 (1997) ("[I]nternal capital markets channel limited resources to different uses inside a company.").

¹³¹ Although the term "internal capital market" here is discussed in the context of the banking industry SOE sector, the term has been usually analyzed in the context of corporate groups. See, e.g., David Buchuk et al., *The Internal Capital Markets of Business Groups: Evidence from Intra-Group Loans*, 112 J. FIN. ECON. 190, 190–92 (2014) (discussing internal capital markets and intra-group lending among Chilean firms); Sangwoo Lee et al., *Disappearing Internal Capital Markets: Evidence from Diversified Business Groups in Korea*, 33 J. BANKING & FIN. 326, 333 (2009) ("Internal capital markets play a major role in allocating capital in diversified firms.").

¹³² Kevin P. Gallagher & Amos Irwin, *China's Economic Statecraft in Latin America: Evidence from China's Policy Banks*, 88 PAC. AFF. 99, 101–02

the government, provide loans with low interest rates to SOEs for various policy reasons.¹³³ Of course, this does not mean that every bank loan is a policy loan; banks also engage in loan arrangements with SOEs for commercial purposes. As will be examined in Section III.B, SOEs are typically more reliable, stable, and profitable business entities than POEs.¹³⁴ In general, it is to the banks' advantage if they provide loan opportunities for SOEs rather than POEs.¹³⁵

In essence, government RPTs—either within or beyond an SOE group—are often, if not always, associated with policies designed to promote the public interest.¹³⁶ These policy-RPTs result in wealth-transfers in different directions, depending on the government's relative ownership between the two SOEs.¹³⁷ In a policy loan case, when the government has a higher percentage of ownership in a borrower-SOE than in a loan-providing SOE-bank, a preferential loan with a low interest rate generally gives rise to institutionalized tunneling.¹³⁸

Conversely, suppose the government has a higher percentage of ownership in an SOE-bank than in a borrower-SOE. In this case, a loan in favor of the borrower-SOE normally leads to the transfer of wealth from the government to the borrower-SOE.¹³⁹ In other words,

(2015) (describing the China Development Bank and the Export-Import Bank of China's use of policy lending).

¹³³ As to the U.S. view on the interest rates to SOEs in China, *see* Fan & Hope, *supra* note 14, at 12 (“The financial market backdrop in recent years should also be borne in mind when analyzing complaints by U.S. firms that Chinese SOEs derive an unfair advantage through the low interest-rate loans they borrow from state-owned banks.”).

¹³⁴ *See infra* Section III.B.

¹³⁵ *See, e.g.*, Fan & Hope, *supra* note 14, at 12 (explaining generally banks' preference to lend to SOEs, due to less risk).

¹³⁶ *See* Milhaupt & Pargendler, *supra* note 29, at 249–52.

¹³⁷ For an additional discussion of a controlling shareholder's ownership gap (i.e., relative ownership between two corporations directed by the controlling shareholder), *see* Kang, *Rethinking Self-Dealing and the Fairness Test*, *supra* note 5, at 120–125 (discussing how a controlling shareholder can exploit its economic stakes in two corporations for self-dealing purposes).

¹³⁸ In this case, a preferential loan with a low interest rate is an RPT of the government, as described *supra* Figure 1. For the discussion of institutionalized tunneling, *see supra* Section III.A.1 (illustrating when the government has a higher percentage ownership of one SOE than another, the government can grant preference to the higher percentage ownership corporation and reap more gains than losses).

¹³⁹ *See* Milhaupt & Pargendler, *supra* note 29, at 4 (discussing how propping “benefits the outside investors in the SOE” but “can reduce overall social

propping of the borrower-SOE arises at the expense of the government.¹⁴⁰ It does not mean, however, that the government bears entirely the losses from the loan favoring the borrower-SOE. Instead, the Chinese government can suppress deposit interest rates when depositors save their money in SOE-banks.¹⁴¹ Put differently, the costs from the loan in favor of the borrower-SOE are, partially or entirely, borne by depositors.¹⁴² Consequently, by regulating deposit rates in the banking sector in China, the government can pass on to depositors at least part of the financial burden from generous lending to SOEs.¹⁴³

In any event, it is noteworthy that the public shareholders of the borrower-SOE benefit from the preferential policy loan to the detriment of the government and/or bank depositors. Roughly speaking, bank depositors are ordinary citizens or taxpayers, and the government is or acts on behalf of ordinary citizens or taxpayers. In other words, gains and expenses of the government belong to eventually the entire group of citizens, and thus, the government's economic losses from the preferential policy loan in favor of the borrower-SOE are ultimately borne by ordinary citizens or taxpayers. In this light, the economic impact of preferential policy loans favoring the SOE sector in China causes, in general, the transfer of wealth from ordinary citizens or taxpayers to SOEs. Consequently, the public shareholders of Chinese SOEs, even if the legal system in China lacks comprehensive investor protection, have financial gains in the Chinese banking sector's mechanism where the government determines and suppresses

welfare by distorting competition in the economy and misallocating public resources.”).

¹⁴⁰ *Id.* (characterizing propping “as a form of subsidy”).

¹⁴¹ See Gui Haoming (桂浩明), *Zhongguo Hui Jinru Chaodi Lili Shidai Ma?* (中国会进入超低利率时代吗?) [*Is China Entering into an Ultralow-Deposit-Rate Era?*], *SECURITIES TIMES* (证券时报) (Aug. 29, 2015), <https://finance.qq.com/a/20150829/009897.htm> [<https://perma.cc/77EZ-WZ A7>] (discussing how China can follow suit with countries like Japan and the U.S., which have kept interest rates hovering near zero).

¹⁴² See *id.* (discussing how, with low interest rates, depositors will no longer take deposit as a financial instrument).

¹⁴³ For a brief explanation of China's low deposit rates, see *id.* (discussing how China has cut interest rates to stimulate the economy); see also Chi Lo, *Here's What Interest Rate Liberalisation Means for China*, *SOUTH CHINA MORNING POST* (Nov. 09, 2015), <http://www.scmp.com/business/banking-finance/article/1877144/heres-what-interest-rate-liberalisation-means-china> [<https://perma.cc/PB3R-S69T>] (describing Chinese banks' liberalization of setting interest rates and their limits).

deposit rates. Based on this holistic analysis, the statement that SOE investors in China are victims of the deficiency of formal investor protection in the legal system is correct but does not show the entire picture. SOE investors are legally under-protected, but the lack of protection could be overstated if benefits from investment in SOEs are not properly taken into account.¹⁴⁴

**B. Lack of Formal Investor Protection, But
Additional Benefits for SOE Investors: ELCM**

SOE shareholders in China are financially damaged by tunneling from personal greed and institutionalized tunneling.¹⁴⁵ However, they sometimes benefit from propping.¹⁴⁶ In addition to propping, as explained, SOE investors can gain benefits from wealth-transfers at the sacrifice of ordinary citizens or taxpayers.¹⁴⁷ Moreover, as discussed below, SOE shareholders have various opportunities to attain additional benefits from being SOE investors. Even if SOE investors suffer from tunneling and the lack of formal investor protection under the legal systems, these additional benefits economically alleviate SOE investors' financial damages by providing SOE investors with an ELCM.¹⁴⁸

First, compared to POEs, SOEs are better situated to circumvent cumbersome regulations and attain business licenses required in industries. These benefits accrue to SOEs and are shared by SOE investors. Second, some SOEs take advantage of an imperfect industrial organization, i.e., a (quasi) monopoly market situation, which the government implicitly or expressly maintains. These SOEs can acquire more stable profits and cash flows, which eventually benefit their shareholders.¹⁴⁹ Third, government subsidies or supports are concen-

¹⁴⁴ In Section III.A.5, the Author explains the transfer of wealth from the ordinary citizens or taxpayers to the SOE investors. In addition, in Section III.B, the Author explores additional benefits of being investors in SOEs.

¹⁴⁵ For the discussion of tunneling from personal greed in SOEs, *see supra* Section II.A. For the explanation of institutionalized tunneling in SOEs, *see supra* Section III.A.1.

¹⁴⁶ *See supra* Section III.A.2.

¹⁴⁷ *See supra* Section III.A.5.

¹⁴⁸ As to "ELCM," *see supra* Section I.

¹⁴⁹ Some SOEs in monopoly markets, in collaboration with the government, may abstain from profit-maximization prices. It is also possible that due to the government's policy concerns, a monopoly SOE may charge a lower price than a fair price. In this case, the monopoly SOE loses, but other SOEs that

trated on the SOE sector, resulting in financial benefits to shareholders in SOEs. The government often saves SOEs that are in trouble since the industries where SOEs predominate are usually strategically crucial.

From the standpoint of investors, the government's measures to support SOEs act as insurance, lessening the business risks that SOEs face. In other words, these SOE investors can utilize moral hazard¹⁵⁰ in their favor. Regarding this insurance, a crucial policy variable is that the Chinese government has intensified its efforts to overhaul the SOE sector. One reform relates to “zombie SOEs” which are not competitive from a business perspective but survive due to the government's subsidies and bailouts.¹⁵¹ However, since the extent and the agenda of the reforms are still unclear, it is too early to speculate on their future effects on SOEs and their shareholders.

Fourth, as already discussed in Section III.A, SOEs in the industrial sector have a definite advantage in their easy access to bank loans and the favorable conditions of such loans,¹⁵² and accordingly, their shareholders also benefit. On the other hand, it is possible that another type of SOE (i.e., SOE-banks) and their shareholders are financially damaged. For example, some SOE-banks suffer from non-performing loans, which were created when these banks awarded favorable loans to corporations in trouble.¹⁵³ As explained, however, by suppressing deposit rates, banks can shift some economic costs to depositors.¹⁵⁴ In addition, it is highly anticipated that the government

rely on the monopoly SOE's product as an intermediate product can benefit. The government may subsidize the monopoly SOE in another form.

¹⁵⁰ For the further analysis of moral hazard, *see generally* John M. Marshall, *Moral Hazard*, 66 AM. ECON. REV. 880 (1976).

¹⁵¹ For instance, Premier Li Keqiang was quoted: “We should speed up the move to knock out backward industries and zombie firms while enhancing corporate performance and efficiency of resource allocation.” Daniel Ren, *Premier Li Keqiang Vows to Kill off China's 'Zombie Firms'*, SOUTH CHINA MORNING POST (Dec. 3, 2015, 11:30 PM), <http://www.scmp.com/news/china/economy/article/1886631/premier-li-keqiang-vows-kill-chinas-zombie-firms> [<https://perma.cc/C2BQ-AYCY>].

¹⁵² *See supra* Section III.A.5.

¹⁵³ *See generally* Dayong Zhang et al., *Non-performing Loans, Moral Hazard and Regulation of the Chinese Commercial Banking System*, 63 J. BANKING & FIN. 48 (2016).

¹⁵⁴ *See supra* text accompanying notes 141–43.

will support and protect banks if they are in need.¹⁵⁵ Therefore, structurally, investors in the SOE-banks are not put seriously at a disadvantage.

Fifth, when the stock market performs poorly, the Chinese government is likely to rescue it. The government's rescue packages may focus on the SOE sector.¹⁵⁶ Alternatively, the government's policies may prop the entire capital market so that all corporations, both SOEs and POEs, benefit. As discussed, SOEs account for a significant portion of both the Shanghai and Shenzhen exchanges.¹⁵⁷ Practically speaking, thus, even policies to support the entire stock market would end up significantly favoring SOEs. In any event, shareholders of SOEs benefit from the government's policies.

In the stock market crash of 2015,¹⁵⁸ with strict regulations on short-selling,¹⁵⁹ the Chinese government directly took a myriad of measures to boost the stock market. In addition, the government urged financial institutions to invest in the tumbling stock market.¹⁶⁰ For

¹⁵⁵ Since additional discussions relating to Chinese SOE-banks require a separate analytical framework, these issues are beyond the scope of this Article. See *supra* Section I (explaining that this Article focuses on RPT issues regarding non-financial SOEs). The Author plans to examine additional issues regarding SOE-banks in an independent project.

¹⁵⁶ See, e.g., Fan & Hope, *supra* note 14, at 4 (explaining the Chinese government's support for SOEs in response to the global financial crisis in 2008).

¹⁵⁷ See *supra* text accompanying notes 69–71 (explaining the significance of SOEs in the Chinese capital market).

¹⁵⁸ Robin Wigglesworth et al., *China Stocks Sink Lower as Rout Intensifies*, FIN. TIMES (Aug. 24, 2015), <https://www.ft.com/content/855d2014-4a30-11e5-b558-8a9722977189> (discussing the financial crash in the Chinese market in 2015).

¹⁵⁹ See Yifan Xie & Horatio Fu, *China Clamps Down on Short Selling*, WALL STREET J. (Aug. 4, 2015), <https://www.wsj.com/articles/china-clamps-down-on-short-selling-1438664957> (“The clampdown on short selling comes a day after the China Securities Regulatory Commission, the country’s securities watchdog, began to freeze several automated trading accounts.”).

¹⁶⁰ As to the Western view of China’s policy reaction to the falling stock market in 2015, see, e.g., Editorial, *Lessons from China’s Stock Market Meltdown*, WASH. POST (July 9, 2015), https://www.washingtonpost.com/opinions/beijing-should-give-its-markets-the-freedom-to-fail/2015/07/09/48827d1c-2666-11e5-b77f-eb13a215f593_story.html (“China’s response has seemed increasingly top-down: ordering a halt to initial public offerings, pumping money into securities firms so they can buy stocks and ordering major shareholders not to sell.”).

instance, “[the government] allowed [or encouraged] pension funds managed by local governments to invest in the stock market ..., potentially [channeling] hundreds of billions of yuan into the country’s struggling equity market.”¹⁶¹ It is also alleged that the government, via state-influenced funds, has maintained a stock-market stabilization policy even after the market’s drastic decline in 2015.¹⁶²

There have been many criticisms of the legitimacy and effectiveness of the government’s intervention in the stock market.¹⁶³ This Article does not evaluate these issues, which are beyond the scope of this Article’s research. Instead, this Article emphasizes the price of shares that capital-market investors hold is upheld by the Chinese government’s propping of the stock market, in spite of any distortions, inefficiencies, and harms to the general economy of China generated by the government’s propping of the stock market. In this respect, the government’s propping of the stock market can be construed as an *extra-legal* means to compensate investors who suffer from the lack of investor protection. Put differently, the Author argues that in the capital market, the Chinese government does not sufficiently provide investors with formal, legal protection but with the informal, economic compensation. Of course, government intervention during turbulent times in financial markets is not unique to China.¹⁶⁴ Compared to the

¹⁶¹ *China Gives Pension Funds Access to Stock Market*, REUTERS (Aug. 23, 2015), <https://www.reuters.com/article/china-stocks-pensions/china-gives-pension-funds-access-to-stock-market-idUSL4N10Y09620150823> [perma.cc/T938-7FVX] (explaining the Chinese government’s policy change in regard to pension funds’ investment in the stock market).

¹⁶² See Zhang Shidong, *CSRC Says State Meddling Stabilises China Stock Market*, SOUTH CHINA MORNING POST (Aug. 16, 2017), <http://www.scmp.com/business/china-business/article/2107054/csrc-says-state-meddling-stabilises-china-stock-market> (explaining the CSRC’s view that state intervention stabilizes the Chinese stock market).

¹⁶³ For instance, as to the government intervention in the Hong Kong stock market, see Katherine Lynch, *The Temptation to Intervene: Problems Created by Government Intervention in the Hong Kong Stock Market*, 29 HONG KONG L.J. 123, 133 (1999) (“Although the Financial Secretary, Sir Donald Tsang, and the Chief Executive of the HKMA, Joseph Yam, argue that the intervention was essential to maintaining the stability of Hong Kong’s financial markets, the government has been criticized for its interventionist acts.”).

¹⁶⁴ See *Lessons from China’s Stock Market Meltdown*, *supra* note 160 (contrasting different government intervention during financial crises). See also Lynn Bai & Rujing Meng, *Deterring Double-Play Manipulation in Financial Crisis: Increasing Transaction Cost as a Regulatory Tool*, 35 N.C.J. INT’L L.

other major economies, however, the government's intervention and influence in China is more consistent and significant in terms of its frequency and extent, so that the payoffs of investors in the capital market—many of them are SOE investors—are more affected by the government policies.

Despite the government's propping of the stock market, investors are not fully compensated when they lose financial interests in a falling market. These investors might be the victims of a previous bubble that earlier policies (e.g., stimulation packages) artificially created. Even in this case, investors gain benefits, in the sense that they *lose less value* if the stock market is propped by government policies that sacrifice other groups. For instance, in a falling stock market, the government guides or orders pension funds to purchase stocks.¹⁶⁵ When pension funds are used as an intermediate means to prop up the Chinese stock market, wealth would transfer from the beneficiaries of the pension funds to shareholders of the listed companies, including many SOEs.¹⁶⁶ Alternatively, the government could exercise influence over institutional investors to purchase shares of specific SOEs rather than shares of listed companies in general. Furthermore, the government could implement a variety of capital market policy measures in favor of investors, particularly in SOEs, if the policies are designed to protect, rescue, or benefit SOEs. When such policy measures are used in tandem with government expenditure, it is noteworthy that they are ultimately funded by taxpayers or the entire group of citizens. In other words, when the government uses its financial resources to support the stock market, the wealth in society results in transferring from the entire group of citizens to investors in the stock market, most of whom are investors in the SOE sector.

Of course, this sort of artificial investor protection may distort wealth allocation in society and reduce society's general welfare; therefore, in this respect, it may be socially undesirable. Nonetheless,

& COM. REG. 137, 140 (2009) (“In order to deter such a manipulative scheme, and to alleviate the pressures that it inflicted on the local currency and the equity market, some Asian governments, in particular the Hong Kong Monetary Authority, took an unprecedented approach by intervening in both the currency market and the equity market.”).

¹⁶⁵ See *supra* note 161 and accompanying text (discussing China's decision to allow pension funds managed by local governments to invest in the stock market).

¹⁶⁶ Note that most of the listed companies in the Chinese stock markets are SOEs. See *supra* Section II.B.

if only “shareholders’ wealth” rather than “social welfare” is analyzed, it can be said that public shareholders of Chinese companies, most of which are SOEs, are *economically* protected to some extent, although investors are not *legally* well protected by the formal investor protection under the legal systems.¹⁶⁷

IV. Conclusion

This Article explores certain corporate governance issues of RPTs in the Chinese SOE sector. Corruption-RPTs are associated with tunneling for personal greed, and in contrast, policy-RPTs are associated with propping¹⁶⁸ as well as institutionalized tunneling.¹⁶⁹ By economic standards, while shareholders of tunneled SOEs lose, shareholders of propped SOEs gain. In addition, mainly due to protective and favorable government policies, SOEs gain a variety of additional benefits that can improve the economic interests of SOE investors and function as an ELCM.¹⁷⁰

This Article proposes a new analytical framework for RPTs in Chinese SOEs. Obviously, one article does not cover all relevant issues associated with RPTs in the Chinese SOE sector, but the hope is that it will provide a foundation for future studies that will build new approaches to explain corporate governance issues in SOEs, not only in China but around the world.

¹⁶⁷ See *supra* Section III.B.

¹⁶⁸ See *supra* Section III.A.2.

¹⁶⁹ See *supra* Section III.A.1.

¹⁷⁰ See *supra* Section III.B.