This article gives the views of several leading China practitioners on the opportunities created by state-owned enterprises (SOEs), and also the practical and cultural challenges they pose to those working with them.

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Since the founding of the People's Republic of China (PRC) in 1949, state-owned enterprises (SOEs) have been at the heart of the country’s economic development and they remain the most prominent category of enterprises in China’s modern economic landscape.

SOEs present unique challenges and opportunities for all those who work with them. Practical Law spoke to several leading China practitioners on their views in relation to several areas, including regulation, structure, business decisions, drafting and the future of SOEs.

CORPORATE STATUS

According to the Law of the People's Republic of China on State-Owned Assets of Enterprises 2008 (2008 State-owned Assets Law) entities in which the Chinese government has invested may exist in the following forms:

- **Wholly state-owned enterprises (WSOEs)** (国有企业).
- **Wholly state-owned companies (国有独资公司).**
- **State-controlled companies (国有资本控股公司).**
- **State-invested companies (国有资本参股公司).**

WSOEs are not companies in the technical sense as there is no conventional board and shareholder decision making structure. Rather, WSOEs are run by individuals approved by the Chinese state and pursuant to the state’s objectives.

Except for WSOEs, the other three types of state-invested entities are all companies that are subject to the regulation of the Company Law of the People’s Republic of China 1993 (1993 Company Law).

“The latter two types of state-invested entities differ in terms of whether or not the State holds controlling stakes in those SOEs,” explains Xiao Yong, head of the China practice at Vinson & Elkins. Xiao’s practice is focused on foreign direct investment (FDI) and international M&A, energy and infrastructure projects. Xiao has advised several of China’s largest state-owned companies on their overseas investments in the energy, mining and natural resources sectors around the world.

The state can hold a controlling stake either in terms of overall share of equity or under provisions in the shareholders’ agreement.

“Wholly state-owned companies, subject to the regulation of the [1993] Company Law typically follow the company structure of a board, Chairman, and so on. WSOEs, on the other hand, are not companies in the technical sense, in that they do not have a board as the decision-making body. A general manager, together with other personnel, is delegated with the fiduciary duty from the Chinese state to manage such enterprises. Recently, trends have shown WSOEs being converted to the company format,” says Xiao.

In terms of company reporting, according to the 2008 State-owned Assets Law, SOEs must maximise the value of their assets “as indicated in the annual reports and corporate documents for their enterprises. These documents also suggest that they are seeking to become internationally competitive companies in their industries,” explains Xiao. Where the SOE is subject to the 1993 Company Law, they are required to meet standards in corporate reporting “similar to that in other jurisdictions”, including, for example, in relation to reporting to the shareholders.

However, while the provisions of the 1993 Company Law may prescribe that shareholder and board resolutions are key elements of the decision making process, the reality of where the power ultimately lies within an SOE may be somewhat different. Understanding the power and decision making structure of an SOE is essential for effective client relationship management, negotiations and transaction management (see Negotiation and Client relationship management).
GATEKEEPERS

SOEs have evolved out of a range of institutions and government ministries, so how the Chinese state is represented in the structure of modern SOEs varies. In relation to WSOEs and wholly state-owned companies, Xiao explains that, in general, the State Council (中华人民共和国国务院), through the State Asset Supervision and Administration Commission (SASAC) (国有资产监督管理委员会), “invests in the central-level SOEs”. According to SASAC’s website, there are currently 116 central-level SOEs throughout many industries, including armed forces, energy, power and construction, among others (see www.sasac.gov.cn). “Local governments, through SASAC’s branch division at the local government levels, invest in local SOEs.” Xiao adds, “SASAC’s power in the relevant SOEs is analogous to the power of shareholders in a company.”

According to the 2008 State-owned Assets Law, SASAC can:

• Appoint members to the supervision committee of the SOEs.
• Nominate candidates for management positions.
• Approve significant corporate matters, including mergers, corporate restructuring, increase or reduction of registered capital, issuance of bonds, profit distribution, dissolution and petition for bankruptcy.

“Except for those,” continues Xiao, “SASAC may not intervene in the legitimate and independent business operations of the SOEs.”

While SASAC’s influence may seem somewhat restrictive, in reality their involvement varies. However, again, it points to what can be a difference between the rhetoric and the reality of where decision making power lies in contemporary SOEs.

Additionally, although the financial contributor to most SOEs is SASAC, many other government ministries and commissions may also contribute funds to SOEs. “For example the contributors for SOEs in the banking, post and civil aviation industries are government financial departments. Provisions stipulated by SASAC on SOEs … do not directly apply to these enterprises, where SASAC is not an investor … legal application may vary according to the different investors,” says Jihong Wang, Partner at Grandway Law Offices in Beijing.

GROUP STRUCTURES

Large scale SOEs often have many subsidiaries, however their investment funds will be planned and allocated by their parent or controlling company. For large investments, the subsidiaries “may have to seek approval from the parent/controlling company,” says Wang.

In relation to publicly listed SOEs, Robert Woll, Partner at Deacons in Hong Kong, who has over 20 years’ experience in PRC-focused and international M&A and private equity, with substantial experience in relation to SOEs, explains that, “typically, the listed entity is a subsidiary carved out of the parent SOE. The parent remains 100 percent state-owned. The listed entity could be incorporated in China (listing A shares or H shares) or in Hong Kong under the Companies Ordinance. The latter are known in the market as mainland-affiliated enterprises or ‘red chips’, and this red-chip structure was in vogue from the late 1990s, with China Mobile as the best-known example, through to around 2004. Recently, this red-chip structure has given way to A share listings, H share listings, or dual A-H share listings by mainland-incorporated companies, governed by the [1993] Company Law. The listed companies are also governed by the securities laws of the jurisdiction where they are listed (China, Hong Kong, the US, and so on) and the rules of the relevant stock exchange.” Several larger SOEs are also listed on US and UK stock exchanges.

For fund managers wishing to invest in natural resources or telecoms in China, these publicly listed companies offer virtually the only means to invest and are an important channel for capital into China. The state-owned parent company remains the majority shareholder, although their listing prospectus will make it clear that the majority shareholder (that state-owned parent) may not always act in the interests of the minority shareholders. Beyond that, there are not many prescribed rules governing the relationship between the parent and subsidiary company. Clearly, this raises the question of how that power relationship will ultimately operate in practice. While many will argue that it is exactly the same as any majority shareholder situation, other observers may expect that having a parent company owned by the Chinese state gives rise to some significant risks.

Now that corruption is openly acknowledged as the biggest issue facing China’s bureaucratic system, SOEs operating in that wider context inevitably face significant challenges in maintaining and developing standards in transparency, accountability and compliance (this issue is not only limited to listed companies). It remains to be seen whether greater internationalisation of China’s SOEs will be a catalyst for change or trigger the unravelling of the business establishment.

“GO OUT” POLICY

SOEs have been at the forefront of the Chinese government’s “go out” policy and are making investments across the world in various sectors, from natural resources and finance through to technology, R&D, innovation, real estate and fashion. This increased visibility and autonomy is raising questions around transparency and accountability, both in a global context and within China.
SASAC has also set out some parameters for overseas investments by SOEs. For example, Article 5 of the *Interim Measures for the Supervision and Management of Overseas Investment of Central Enterprises 2012* (2012 Overseas Investment Interim Measures) outlines certain principles that these investments should follow, including:

- Meeting the needs of the national economy.
- Complying with the state industrial policy on overseas investment. In principle, this requires that a central-level SOE may not invest outside of its main business without prior approval of SASAC. The SASAC’s approval is required even where an investment is within the SOE’s main business. However, it is possible to submit an annual investment plan to SASAC that compiles all planned investments, which can be more efficient than proceeding on a case-by-case basis.

In addition to SASAC approval for overseas investments, SOEs may also be required to obtain several regulatory approvals from different bodies of the Chinese government. For those new to doing deals with Chinese partners, this can be a little unnerving although so far there have not been any reports of major outbound investments being blocked. The regulatory bodies that need to sign off on overseas investments commonly include the *National Development and Reform Commission of China* (NDRC) (中华人民共和国国家发展和改革委员会国家发改委), the *Ministry of Commerce* (MOFCOM) (中华人民共和国商务部) and the *State Administration of Foreign Exchange* (SAFE) (国家外汇管理局).

As Xiao points out: “The bodies required to approve a specific transaction depend upon the size and type of the investment, and [these approvals] often require 60 days or more to obtain, potentially resulting in a slight delay to a transaction”.

### General timeline for the Chinese governmental approval process

1. **Submit preliminary report to NDRC**
2. **Receive preliminary consent from NDRC**
3. **Submit formal approval application to NDRC**
4. **NDRC approves the transaction**
5. **Submit application to MOFCOM**
6. **MOFCOM approves the transaction**
7. **Submit approval application to SAFE**
8. **Receive approval from SAFE**
9. **Approval obtained**

**Key**
- NDRC: National Development and Reform Commission of China
- SAFE: State Administration of Foreign Exchange
- MOFCOM: Ministry of Commerce
- SPA: Share purchase agreement

**Pre-approvals and communications**
- SPA signing
- 2-3 weeks
- 11-14 weeks

### IMPORTS AND OPERATIONS

In addition to these gatekeepers, “compared to private enterprises, Chinese foreign policy impacts more on investment direction and scope of SOEs”, says Wang. On the importation side, the regulation of SOEs is no stricter than for private companies. However, Wang explains that “SOEs can be greatly affected by state regulation and control [in relation to] their operations and investment in two keys ways: direct intervention and indirect intervention.”

Wang further explains that “direct intervention, for example, [occurs] where to maintain macro-control of the real estate market, the government directly demands that the key state-owned enterprises gradually withdraw from the real-estate market and specifically lists which SOEs are allowed to continue to invest in real estate projects. Indirect intervention [can be seen], for example, where the government adopts more lenient credit policies to encourage investment in certain industries and fields, and adopts restrictive credit policies to restrict investment in certain other industries and fields. Those polices will guide the investment of SOEs.”
DEALING WITH SOES: PRACTICAL AND CULTURAL ISSUES

As the history, structure and regulation of SOEs indicate, working with SOEs involves managing several dynamics. It can feel like “SOEs have a unique culture,” says He Fang, Partner at Jun He in Beijing who specialises in M&A, inbound and outbound investments and general corporate matters.

WHO AND WHAT IS DRIVING THE BUSINESS DECISIONS?

For many, although SOEs may now generally be driven by commercial considerations, they remain alter egos of the state. It is a relationship that can influence all stages of a transaction.

Many observers feel that the line between state and private enterprise is increasingly blurred and inevitably there are tensions and ambiguities that external advisers and business partners must deal with. This transformation process is also something that the SOEs themselves need to come to terms with from an organisational and business development perspective, particularly as they seek to compete on the international stage.

The perceptions of SOEs vary considerably. To the suspicious, they are “arms of the Chinese government following a path of state sponsored economic imperialism” as opposed to an independent commercial agenda, but by others they are viewed as commercially driven organisations, amply able and willing to compete against one another in the pursuit of profit, and whose management is increasingly made up of a new generation of internationally minded Chinese business people.

The legacy of the past (see box, SOEs in China: history) still permeates the behaviour of SOEs and while on a day-to-day level the state may exhibit little control, it remains the ultimate choreographer one way or another.

NEGOTIATIONS

Policy factors

“The SOEs’ Officers may not always be responding directly to commercial factors,” says Amy Sommers, Partner, K&L Gates in Shanghai who is a specialist in M&A, inbound and outbound investments and general corporate matters.

Similarly, Robert Woll at Deacons says that SOEs do get called on by their government sponsors “to undertake special projects”. However, it is not always entirely clear how that is filtered down and communicated through the organisation.

Identify and access the main decision makers

When negotiating in China, it is important to know who you are speaking to. It sounds basic, but it may be that the person you are in direct communication with is not actually the main decision maker. “In fact, SOE personnel assigned to speak to outside lawyers often are not in a position to make decisions or even to communicate outside legal advice effectively to those more senior in the SOE hierarchy, which is very strictly observed. This can be a significant risk factor for legal practitioners, particularly foreign lawyers, who cannot be certain that their advice is being heard or conveyed to the actual decision makers. It is unusual for members of the SOE’s party committee, where the real power lies, to meet with outside ‘technical’ advisors;” says Woll.

Accessing the real decision makers or ensuring that your messages are clearly and effectively communicated to them can take time and a lot of skill.

To find out who the main decision makers are, you need to do your research. It is not always easy.

If you have a small team of lawyers, the other professional advisers involved in your deal may be better placed to investigate who within the SOE will make the final decision. In particular, the banks often have larger teams working on a transaction than the China office of an international law firm. In addition, there may be a more obvious ‘way in’ to the SOE for them because they will have a relationship with the CFO.

SASAC has been pushing for SOEs to develop stronger in-house legal teams and many of the larger SOEs are doing that to the point where they are less reliant on external counsel. However, in general, they still have a long way to go. The legal function is also still separate from the business decision making process. While that is a dynamic common to several jurisdictions, it is more exaggerated in the context of SOEs who are in the early stages of developing their in-house legal capability.

Project managers on a transaction may also be more junior members of SOEs. Often internationally educated and fluent in English and other languages, they may also be faced with the tricky task of acting as a bridge back to their senior management, who may not have such an international mindset, or “may never have been out of the country,” says Dina Yin, Partner at King & Wood Mallesons in Beijing who specialises in helping large SOEs with their outbound investments.

Keep in mind that the junior people negotiating on behalf of the SOE may be subject to criticism from their bosses unless they are seen to be reducing the external party’s demand. “The Chinese party works on the assumption that ‘if you tell me you want X, what you really want is 20 or 30 per cent less than X’. So, if the junior is not succeeding in paring back [your demands] they may not gain credibility with their superiors and
may then struggle to get buy in from their superiors later on when they seek approval for the negotiated terms,” explains Sommers.

Further, large SOEs tend to have many departments, each of which has functions that are clearly delegated and defined, and each department will have strict reporting procedures. Additionally, when working with SOEs you may have individual contact points for each department, which can require time and diplomacy to co-ordinate.

**Regional differences in commercial awareness and sophistication**

Some practitioners observed that there were differences in commercial awareness and sophistication between central and local level SOEs. One felt that SOEs from South China tended to be more commercially minded than their counterparts elsewhere. Although anecdotal, this may illustrate the influence of China's early strategy to opening up the economy that had its roots in the southern provinces close to Hong Kong.

**Practical points**

All these factors can make the decision making process slower. “It’s manageable but project partners need to be aware of that,” says Ulrike Glueck, Managing Partner at CMS in Shanghai. Glueck has been working in China for more than 15 years and specialises in M&A and corporate projects. She advises foreign multinationals on investment and restructuring in China and Chinese companies on investments abroad, in particular in Europe.

It may also mean that there are frequent changes to the structure of a project and a “higher frustration threshold may be required [to deal with those frequent changes]. If you have lots of time to do the amended work it’s fine, but if there’s a tight deadline then it’s more challenging,” says Glueck.

All the lawyers we spoke to emphasised how increasingly international many SOE employees are in their outlook and that they are often fluent in other languages. Nevertheless, as Xiao explains “as a practical matter, although an increasing number of SOE employees speak English, it is greatly helpful to communicate with them in Chinese. Ideally, outside counsel would not only speak Chinese but would also have cultural fluency in order to avoid miscommunication regarding the Chinese party’s intention during negotiations and other stages of the transaction.”

**DRAFTING**

Differences in the approach to drafting documents may confuse those from outside China. Yin explains that the SOE counterpart may not share “what we [in Europe or the US] take for granted in terms of execution dates and how complete a document needs to be”. It is more about “the overall deal, the commercial terms, and how one perceives the long term relationship is with their business counterpart”.

Yin also points out that while SOEs “will ask for things like a MAC [material adverse change] clause, a lot of the time the character of the deal is driven by where the deal is being done and what the industry standard is there. So in China they are less likely to ask for those things because they are familiar with the system; but say in the UK or the US, they are more keen to know the usual business standards for contract provisions and prefer to adhere to them without much deviation.”

“In the US and UK it’s all about ‘buyer beware’ and it’s a litigation driven environment. Sometimes it takes time for SOEs to familiarise themselves with that and while they increasingly use a ‘common language’ in drafting provisions, it is still a learning process,” explains Yin. Certainly, once an SOE has become involved in litigation it “changes attitudes pretty quickly”.

It is also about experience and the passage of time as “the ones that have more exposure with outbound investment are more comfortable and are on the same page as their Western counterparts. For the rest, it will be a quick learning process, I’d imagine,” says Yin.

**VISAS AND NATIONAL HOLIDAYS**

Beyond the gatekeepers, cultural differences and organisational politics, it is also important to factor in visas and national holidays to your China transaction timeline.

Chinese citizens require visas to visit and do business in many jurisdictions where citizens from other countries may not have the same requirement. Therefore, Chinese parties often require extended notice for meetings. “If meetings cannot be conducted via conference calls or have to happen at short notice it may be that the counterparties of SOEs ‘need to travel to mainland China or Hong Kong’ to minimise the impact of visa delays on the transaction timeline,” says Xiao. Also, remember the importance of particular holidays in China when “SOE employees may be difficult to reach … among these holidays the Chinese New Year Holiday ranks highest in importance”.

**CLIENT RELATIONSHIP MANAGEMENT**

As already explained, there are various issues connected to SOEs that may impact on the timing and flow of a transaction that can be confusing and frustrating for the counter-party at times. Sommers recommends that if you have a team that is not familiar with doing transactions in China, then bringing “external counsel in at an early stage of any planned transaction with SOEs is advisable”.

On the SOE side, building an effective relationship either as a business partner or professional adviser with SOEs takes a long time. Sometimes, SOEs may be constrained by internal issues and it is their legal counsel that must help guide them through that.
WORKING WITH STATE-OWNED ENTITIES IN CHINA

From the outset there can be differences. One lawyer described how engagement letters may often contain more elaborate obligations than usual and emphasised the need to be clear about what you can deliver, particularly if you are a small team. They also pointed out that SOEs are used to getting discounts in all areas of their business operations and the same was often expected for the provision of legal services. While payment of fees was never a problem, several lawyers commented that where there was a fixed fee for a transaction, that could become challenging if there were a lot of changes to the deal structure and delays.

“Building trust is not that simple,” says Cathy Yeung, Partner and Co-Chair of the Greater China practice at Latham & Watkins and based in Hong Kong. Yeung has been working with SOEs for 20 years and explains that “it’s a challenging job. It takes a long time and requires a lot of effort”.

Yeung has worked with several large SOEs as they have expanded overseas and along the way helped them with a variety of in-house training on issues like the corporate governance regulatory requirements of different stock exchanges. Yeung says that “it’s mutually beneficial” and helps build the trust and understanding required to work together effectively on deals. But it is not just about legal and communication skills. It is “interpersonal skills” that are paramount.

As a Chinese national, Yeung also feels that she is in a strong position to better understand the business and economic rationale behind the decisions of her clients. Over the last ten years in particular, Yeung has seen the larger SOEs become increasingly sophisticated and internationally minded, “especially in relation to outbound investment, where overseas listings have brought them even closer to international markets”.

Yin also describes the “big time commitment” involved and notes that SOEs are becoming more discerning about which law firms they engage. “It’s more than just an institutional relationship. It doesn’t work in the same way as what we are used to [in the US]. It still matters very much on a personal level that they have worked well with you,” says Yin. Eventually, as the in-house teams are growing and expanding, SOEs will also become less reliant on external counsel.

In terms of recruitment in general, SOEs are looking to international markets to attract the best people with the right skill set to pursue their global ambitions.

LOOKING AHEAD

It is clear that the role of legal counsel (whether working directly or indirectly with SOEs) is a challenging one, but also integral to SOEs’ ability to adapt and evolve into sophisticated, well managed and modern organisations. If both sides get it right, it is potentially hugely rewarding.
WORKING WITH STATE-OWNED ENTITIES IN CHINA

SOES IN CHINA: HISTORY

In relation to all sectors of the economy until the 1980s and 1990s, the SOE concept could be placed (fairly neatly) into one category: WSOEs. It was a case of one structure fits all.

Historically, WSOEs have not been commercially driven and have been characterised as cumbersome, inefficient and, in general, found to be incompatible with the aspirations of the modern Chinese state.

During the 1980s and 1990s, a process of corporatisation took place in China with the aim of transforming many of these WSOEs into modern commercial entities. This was due to a combination of factors, including:

- The opening up of the economy.
- The desire to attract foreign capital (for example, through joint ventures).
- The growing burden of underperforming loans to SOEs.

The Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure was passed in 1993, following which a series of laws and regulations related to SOE reform were promulgated. China’s 1993 Company Law was also promulgated during this time and has been revised several times since, which has had a significant impact on the reform of SOEs. “The modern enterprise system has become the focal point of SOE reform in China since then,” explains Jihong Wang, partner at Grandway Law Offices in Beijing, who specialises in corporate, construction, infrastructure and energy law. “Today, newly-set-up SOEs may be established either as limited liability companies or joint stock limited companies. Limited partnerships are also now permitted” and there has been a general trend towards converting WSOEs into corporate structures.

This legislative change made a big impact. “Prior to the [1993] Company Law, there was no real need for corporate governance structures and processes,” says Amigo Xie, partner and specialist in PRC-focused M&A at K&L Gates in Shanghai. Following the legislative change, there has been, and continues to be, a significant change in management culture and systems.

A recent phase of this transformation process has involved creating greater liquidity in many enterprises through the trading of shares on the mainland, Hong Kong and international stock exchanges. Several SOEs are now also publicly listed companies.