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RPTs in SOEs: Tunneling, Propping, and Policy Channeling

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Abstract

This essay, prepared for a volume on related-party transactions (RPTs), explores the economic, legal and policy challenges associated with RPTs in state-owned enterprises (SOEs). We show that RPTs in SOEs differ from RPTs in privately owned enterprises (POEs) in at least two ways. First, RPTs in SOEs may decrease social welfare not only when they cause harm to a given SOE by extracting wealth from minority (non-state) investors (the usual “tunneling” problem) but also when the state provides the SOE with benefits not available to POEs (“propping”). Second and more importantly, unlike the typical case with a POE, the state as controlling shareholder does not need to cause an SOE to engage in a “transaction” for it to extract private benefits from the firm to the detriment of minority investors. The state can also extract political private benefits by engaging in what we call “policy channeling” – using partial ownership of an SOE to achieve social or industrial policy objectives. As a means of carrying out these objectives, policy channeling may be preferred over regulation and taxation for a number of reasons: it may be a lower cost substitute for regulation in weak institutional environments, minority investors implicitly bear at least some of the cost of the policy’s implementation, and the SOE shields the policy from public participation and accountability. After mapping the nature of these problems in SOEs, we examine the potential of different legal strategies to address them, including those proposed by the OECD, World Bank, and stock exchange initiatives.

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RPTs in SOEs:

Tunneling, Propping, and Policy Channeling

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A chapter for Luca Enriques and Tobias Tröger, eds., The Law and Finance of Related Party Transactions (Cambridge University Press, forthcoming)

Abstract

This essay, prepared for a volume on related-party transactions (RPTs), explores the economic, legal and policy challenges associated with RPTs in state-owned enterprises (SOEs). We show that RPTs in SOEs differ from RPTs in privately owned enterprises (POEs) in at least two ways. First, RPTs in SOEs may decrease social welfare not only when they cause harm to a given SOE by extracting wealth from minority (non-state) investors (the usual "tunneling" problem) but also when the state provides the SOE with benefits not available to POEs ("propping"). Second and more importantly, unlike the typical case with a POE, the state as controlling shareholder does not need to cause an SOE to engage in a "transaction" for it to extract private benefits from the firm to the detriment of minority investors. The state can also extract political private benefits by engaging in what we call "policy channeling" – using partial ownership of an SOE to achieve social or industrial policy objectives. As a means of carrying out these objectives, policy channeling may be preferred over regulation and taxation for a number of reasons: it may be a lower cost substitute for regulation in weak institutional environments, minority investors implicitly bear at least some of the cost of the policy's implementation, and the SOE shields the policy from public participation and accountability. After mapping the nature of these problems in SOEs, we examine the potential of different legal strategies to address them, including those proposed by the OECD, World Bank, and stock exchange initiatives.

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Introduction

This essay explores the economic, legal and policy challenges associated with related-party transactions (RPTs) in state-owned enterprises (SOEs). State-owned enterprises take many forms, but they are frequently structured as business corporations. Moreover, state ownership of corporate enterprise seldom appears in isolation, with state shareholdings typically covering a number of companies in one or more sectors of the economy. This pattern of ownership gives rise to corporate groups within the state, raising the specter of problematic RPTs found in the private firm context.

Yet by their very nature, SOEs are distinctive, because the state is a political actor. SOEs therefore have a different type of controlling shareholder than private firms. Not only is the state able to shape corporate law to serve the needs of firms under its control, but the state has some motives for its ownership of enterprise that differ significantly from those of a typical private controller. Most importantly, states may use ownership of a firm to pursue public policy objectives in addition to profits. We will call this phenomenon "policy channeling." Although this use of the corporate form by the (state) controlling shareholder is not "corrupt," it may be as harmful to minority (non-state) investors' financial interests as a garden variety RPT. Any exploration of RPTs in SOEs must thus also account for the ways in which these transactions differ from RPTs in privately owned enterprises (POEs).

In this essay, we examine the extent to which RPT problems in SOEs are coterminous with, and differ from, RPTs in POEs. We show that RPTs in SOEs differ from RPTs in POEs in at least two important ways. First, RPTs in SOEs may decrease social welfare not only when they cause harm to a given SOE but also when they provide it with an undue benefit. Second, unlike the typical case with a POE, the state does not need to cause an SOE to engage in a "transaction" for it to extract private benefits from the firm to the detriment of minority investors. After mapping the nature of these problems in SOEs, we examine legal strategies available to address them.

The essay proceeds as follows. Part I examines the dual nature of RPT problems in SOEs: transactions that are harmful to the SOE and its private (non-state) shareholders, and those that are beneficial to the SOE and its private shareholders. Part II explores the ways in which the state can extract private benefits from an SOE at the expense of outside investors without the need for a *transaction*, a function of policy channeling. Part III examines legal strategies to control RPTs in SOEs. Part IV concludes.

I. The Dual Nature of RPTs in SOEs: Tunneling and Propping

The potential problems posed by RPTs in private firms are well known.[1] Economists have coined the term "tunneling" to describe the various ways in which corporate insiders may extract wealth from the firm to the detriment of minority

[1] For an overview, *see* Luca Enriques, Gerard Hertig, Hideki Kanda & Mariana Pargendler, *Related-Party Transactions, in* ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH (3rd. ed., 2017).

shareholders.[2] Short of outright theft, most instances of tunneling take place through different types of RPTs. Tunneling may occur slowly and methodically, for example, through an ongoing series of transactions that systematically favor a firm wholly owned by the controller at the expense of another firm in the group with shares owned by outside shareholders. Or it may take the form of a one-time grab, as where a controlling shareholder cashes out minority shareholders at a price below fair market value.[3]

As the previous passage implies, corporate group structures multiply the opportunities for RPTs, and consequently, of abuse of minority shareholders. It is widely known that corporate group structures are common in family owned firms and in emerging market economies. The South Korean *chaebol* presents a prototypical example. But corporate group structures are also common in the state sector. For example, Chinese economic strategists were influenced by the apparent success of the *chaebol* and *keiretsu* in the Korean and Japanese economies, respectively, when they consciously constructed corporate groups in the state sector in the 1990s.[4] Because state ownership of business firms rarely appears in isolation, state-owned enterprises formed into groups are quite common around the world. So long as SOEs are structured as separate legal entities from the state and have minority investors, the state may stand to profit by engaging in tunneling through RPTs.

Thus, tunneling may occur in SOEs in precisely the same forms as in corporate groups under private control. The state (either directly or through a wholly-owned subsidiary) may enter into a commercial contract with a listed SOE under terms that are detrimental to the latter. To take some examples from Brazil, investors suspect that Petrobras has overpaid in the acquisition of oil exploration rights from the Brazilian government, its controlling shareholder.[5] The government has also renegotiated existing concession contracts with its controlled firm Eletrobras on terms that were rejected by private power companies.[6] Alternatively, state officials may engage in insider trading or appropriate to themselves valuable corporate opportunities. Here we focus on the first type of tunneling, which entails an effective transfer of assets from outside investors to the state itself.

Quite apart from their use as a means of extracting wealth from minority shareholders, however, RPTs can also be used to *assist* firms, conduct known as

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[2] Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Tunneling*, 90 AM. ECON. REV. 22, 22 (2000) (explaining that the term was "coined originally to characterize the expropriation of minority shareholders in the Czech Republic) as in removing assets through an underground tunnel), to describe the transfer of assets and profits out of the firm for the benefits of those who control them").
[3] For an interesting analysis of the determinants of systematic versus one-time tunneling in corporate groups, *see* Sang Yop Kang *"Generous Thieves": The Puzzle of Controlling Shareholder Arrangements in Bad-Law Jurisdictions*, 21 STANFORD J LAW, BUS. & FIN. 57 (2015).
[4] See Li-Wen Lin & Curtis J. Milhaupt, *We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China*, 65 STAN. L. REV. 697 (2013).
[5] For a discussion, *see* Mariana Pargendler, *State Ownership and Corporate Governance*, 80 FORDHAM L. REV. 2917, 2941-2 (2012).
[6] For a discussion of the ensuing legal controversy, *see* note *infra* 35 and accompanying text.

"propping."[7] Such assistance can come from other sister firms within the corporate group, in which case it is simply the flip side of tunneling: resources are transferred from one company within the group (the victim of tunneling) to another (the beneficiary of propping). Things are different, however, if the controlling shareholder itself supports a controlled firm. Unlike tunneling, propping by a controlling shareholder benefits both minority investors and creditors, and ordinarily does not decrease social welfare in the private sector. Propping has therefore attracted far less attention from corporate law scholars than tunneling.

Propping by the controlling shareholder is particularly common in the state sector. However, it is also more suspect as a form of subsidy. Although propping (whether by means of a transaction or a direct payment)[8] benefits the outside investors in the SOE, it can reduce overall social welfare by distorting competition in the economy and misallocating public resources. For this reason, the OECD promotes "level playing field" policies for SOEs.

To be sure, SOEs are not the sole beneficiaries of state largesse around the world: governments often support POEs that are viewed as "strategic" or "too big to fail." While state subsidies or bail-outs of POEs do not take the form of RPTs, their welfare implications are equally, if not more, problematic.[9] State propping of SOEs, however, appears to be more prevalent for several reasons: SOEs are generally key players in their countries' respective economies, they are by definition in close contact with the government, and the corporate group structure of many SOEs provides both opportunity and cover for the provision of disguised subsidies through RPTs.

For example, Chinese SOEs under the control of the central and local governments often receive benefits such as cross subsidies from other firms in an SOE group, free use of land, and cheap bank credit. A 2011 study by a respected Chinese think tank puts the total of such benefits from 2001-09 at 7.5 trillion RMB ($1.19 trillion).[10] Propping reduces the space for private enterprise and allows firms that would not survive on a level playing field to remain in business, while potentially misallocating state funds that could be better used to finance other public goods. Using China as an example once more, as one commentator concludes, "[f]or China's economy to keep growing at a rapid pace, … enterprise efficiency must be improved. Since private companies are already highly

[7] Eric Friedman et al., *Propping and Tunneling*, 31 J. COMP. ECON. 732 (2003). The principal motivation to prop a failing firm is thought to be to reduce incentives for investor expropriation when returns are temporarily low. *Id.* at 735.

[8] Beyond propping through an RPT, the state can also confer special benefits on an SOE by subjecting it to a more favorable legal regime, which is a form of regulatory subsidy. Just as the state does not need to engage in a transaction in order to prop up a firm, it does not need a transaction in order to extract benefits at the expense of minority shareholders. See *infra* part II.

[9] In the private sector, subsidies and bail-outs raise the specter of "privatized profits and socialized losses," while in SOEs the profits tend to be at least partly socialized.

[10] UNIRULE INSTITUTE OF ECONOMICS, THE NATURE, PERFORMANCE AND REFORM OF STATE-OWNED ENTERPRISES.

productive, these efficiency gains must come from both an expansion of the space in which private firms are allowed to operate and a rationalization of the state sector."[11]

II. Policy Channeling

Thus far, we have seen that RPTs can be used to engage in one type of conduct (tunneling) common to both POEs and SOEs, and another type of conduct (propping) that is arguably more prevalent in SOEs than POEs. Now we turn to a type of conduct conceptually related to, but distinct from, RPTs that is exclusively found in SOEs: what we will call *policy channeling*. Policy channeling is the state's use of an SOE (as opposed to regulation or taxation) to achieve a public policy or political objective.[12] Policy channeling is not in the financial interests of private investors in the SOE when it diverts financial and managerial resources to projects that are not designed to maximize profits in the short or long term. States may engage in policy channeling because it generates a distinctive type of non-pecuniary private benefit of control—what we will call *political* private benefits of control.

The comparative corporate governance literature has revealed that controlling shareholders may extract both pecuniary and non-pecuniary private benefits of control.[13] Non-pecuniary private benefits of control attributable to controlling shareholders of POEs are mostly psychological in nature: for example, the social and political clout associated with controlling shareholder status and the psychic benefits of running a firm in the manner the controller wishes. As such, they are usually not harmful to minority shareholders.[14] The concept of non-pecuniary private benefits of control is useful in explaining the prevalence of concentrated ownership structures in "good law" environments where pecuniary private benefits of control are low.[15] The situation is different, however, in the realm of SOEs. 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.

To be sure, private controlling shareholders may also sometimes promote non-financial objectives at the expense of shareholder wealth maximization.[16] In the famous case of *Dodge v. Ford*, Henry Ford restricted dividend payments to shareholders in order to reinvest the funds in the company, with the stated purpose of maximizing employment

[11] ARTHUR R. KROEBER, CHINA'S ECONOMY: WHAT EVERYONE NEEDS TO KNOW 110 (2016).

[12] While states may also seek to enlist private firms in the promotion of public policy objectives, this sort of cooperation is typically grounded in an informal quid pro quo producing countervailing benefits to the firms (or at least their controlling shareholders).

[13] Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641 (2006).

[14] However, minority shareholders could be harmed by the psychological attraction of a controller to a particular line of business if it results in misallocation of resources. *See id.*

[15] *Id.*

[16] Benefit corporations – corporations with mixed profit and social objectives -- are a vehicle for precisely this course of action in the private sector.

and consumers' access to cars—a motive that the court found to be impermissible.[17] More recently, in a dispute between eBay and craigslist, the Delaware Chancery Court found it unlawful for craigslist's controlling shareholders to use a poison pill to protect a "corporate culture" that did not maximize shareholder wealth.[18] Nevertheless, such cases are rare because the pursuit of business strategies that do not seek to maximize profits are not nearly as pervasive in POEs as in the SOE context.

Policy channeling by the state in its role as controlling shareholder is common because the state is a distinctive type of owner. Like a private owner, the state may seek financial returns from its ownership interest in SOEs. But unlike a private owner, the state is a political actor that has incentives to use an SOE (and minority shareholders' capital) to pursue public policy goals, in part because doing so helps shield government action from public law constraints such as mechanisms of accountability and participation. Indeed, state ownership represents an alternative to the government's pursuit of public policy objectives through taxation and regulation of private firms.[19] Thus, the state is a Janus-faced controller: it behaves in some ways like a private controlling shareholder and in other ways like Leviathan.

One implication of policy channeling is that RPTs are not as central a tool for the extraction of private benefits of control in SOEs as compared to POEs. As noted, private benefits of control harmful to minority shareholders in the POE context tend to be pecuniary in nature. Short of outright theft of corporate assets, RPTs provide the principal tool for the extraction of pecuniary private benefits of control to the detriment of minority shareholders. That is to say, a *transaction* is the mechanism of extraction.

In SOEs, however, putting aside corruption and cronyism, the state uses SOEs to pursue non-pecuniary and non-psychological—political—private benefits of control. As Leviathan, the state can pursue these benefits by fiat through its power as a controlling shareholder. A recent example is provided by Petrobras, the state-controlled oil company in Brazil. In an effort to fight inflation, the government kept fuel prices charged by Petrobras at prices below those prevailing in international markets. This policy helped Brazilian consumers but hurt the private investors in Petrobras, including foreign ADR holders. In essence, this form of policy channeling resulted in the outside investors of Petrobras being "tunneled" for the benefit of Brazilian consumers—and of course, for the benefit of the politicians who pursued a macroeconomic policy objective while concentrating its costs on a subset of the population (many of whom are not Brazilian citizens). India's SOE Coal India has also sold coal below market prices, becoming the

[17] To be sure, Ford's decision to withhold payment of dividends was not solely motivated by altruistic concerns. He also sought to deprive the Dodge brothers of funds with which to establish a competing car company.
[18] eBay Domestic Holdings, Inc. v. Newmark 16 A.3d 1 (Del. Ch. 2010).
[19] For an analysis of Chinese SOEs as an efficient response to high regulatory costs in a weak institutional environment, see Si Zeng, *State Ownership as a Substitute for Costly Regulation, The Law and Economics of State-Owned Enterprises in China*, Working Paper, (2017).

object of an activist campaign by a UK hedge fund.[20] Another common example of policy channeling throughout the world is a government's use of SOEs as a means of maintaining employment. For example, research indicates that labor redundancy is a major cost incurred in RPTs motivated by the public interest in China.[21]

Not all states with extensive ownership of business enterprise pursue policy channeling, however. Singapore's ruling People's Action Party (PAP), for example, has pursued the distinct strategy of using "government-linked companies" (GLCs) to grow the economy while using the government's share of the profits from these companies to pursue public policy objectives.[22] Temasek, the state holding company that holds shares in these GLCs, seeks to run the GLCs in a completely commercial, profit-maximizing fashion. The GLCs have not been completely privatized because of the PAP's strategy of using state ownership to reap political private benefits of control in the form of regime legitimacy and stability—a strategy that has been highly successful. At the same time, the long-term financial performance of Temasek's portfolio has been very favorable, and private investors in the GLCs have shared pro rata with the state in this success. Thus, although state *ownership* of business enterprises is used as a means of pursuing policy objectives, *management* of the enterprises is not.

III. Legal strategies

After examining the various forms RPTs take in the SOE context, we now consider possible strategies to address them. Because RPTs necessarily involve different legal persons, interventions could in theory take place in at least three levels. First, and most fundamentally, intervention could occur at the level of the state, which is the ultimate controlling shareholder of SOEs. There is little question that the quality of government—or "Governance with a Capital G"—matters greatly for the state's behavior as a shareholder.[23] A well-functioning government is less likely to employ RPTs in welfare-decreasing ways, or it may avoid state ownership of enterprise altogether. But this "strategy" is akin to recommending that the corporate governance problems of SOEs be "solved" through privatization: however effective the remedy in the abstract, it fails to address the reality on the ground. The challenge is to improve SOE governance even in the presence of a less-than-ideal institutional environment.

It bears noting that any legal strategy to regulate the state in its governance and operation of SOEs faces a fundamental problem: as sovereign, the state can follow the law

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[20] James Crabtree & Sam Jones, *TCI Threat Against Coal India*, FINANCIAL TIMES, March 13, 2012 (quoting a senior manager of the UK hedge fund TCI: "We believe they [Coal India] are destroying value. When you list a company you can't treat it like a government body.").

[21] Nancy Huyghebaert & Lihong Wang, *Expropriation of Minority Investors in Chinese Listed Firms: The Role of Internal and External Corporate Governance Mechanisms*, 20 CORP. GOVERNANCE: INT'L REV. 308 (2012).

[22] *See* Curtis J. Milhaupt & Mariana Pargendler, *Governance Challenges of Listed State-Owned Enterprises around the World: National Experiences and a Framework for Reform*, 50 CORNELL INT'L L. J. (forthcoming 2017).

[23] *Id.* at __.

until it disregards or changes it. Credible commitment, if it exists, must come from *non-legal* constraints on the state, such as reputational considerations. Thus, closely related to the "Governance with a Capital G" point above, the states most likely to consistently abide by legal constraints on SOE governance are the ones least in need of them.

Subject to this rather large caveat, what follows is a survey of possible legal or structural approaches to constraining the behavior of the state in its role as controlling shareholder. One approach is to create a distinct entity to exercise the state's rights and responsibilities as a shareholder. The separation of the state's ownership function in a holding company or dedicated government agency is a cornerstone of the influential OECD Guidelines on the Corporate Governance of State-Owned Enterprises.[24] This mechanism is intended to reduce conflicts of interest and political interference by clearly differentiating the state's role as a shareholder from that of a regulator. In practice, however, even jurisdictions that have a distinct shareholding entity have failed to fully centralize the ownership function.[25] And at any rate, centralization by itself seems neither necessary nor sufficient to eliminate the problems associated with RPTs in SOEs: it does not guarantee isolation from political pressures, nor does it resolve the tension inherent in the state's dual role as owner and regulator of enterprise.[26]

Another possibility is to intervene into firm-level governance mechanisms. The most common prescription is that SOEs should be organized as business corporations and subject to the same legal regime applicable to POEs.[27] This means that the same set of strategies used to police RPTs in private sector firms in any given jurisdiction—such as mandatory disclosure, fiduciary duties, and approval requirements by independent directors and/or minority shareholders—are applied to SOEs as well.[28]

The application of a unitary corporate law regime to both state-owned and private firms is both the norm in practice and a central recommendation of the OECD Guidelines on SOE Governance.[29] This policy stance seems to be based on dual objectives: a unitary legal regime would help both to bond SOEs to the more stringent regime governing private firms, and to avoid legal privileges that could distort the level playing field between state-owned and private competitors.[30]

However, the application of a unitary corporate law regime to SOEs presents several difficulties given the peculiar features of the state as a shareholder. First, a single regime encourages the state, as an inherently powerful political actor, to shape corporate

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[24] OECD GUIDELINES ON CORPORATE GOVERNANCE OF STATE-OWNED ENTERPRISES 36 (2015) (hereinafter "OECD Guidelines").
[25] Milhaupt & Pargendler, *supra* note 22, at __.
[26] *Id.* at __.
[27] *Id*.
[28] For an overview of these strategies, *see* Luca Enriques, Gerard Hertig, Hideki Kanda & Mariana Pargendler, *Related-Party Transactions*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH (Reinier Kraakman et al. eds., 3rd ed., 2017).
[29] OECD Guidelines, *supra* note 24.
[30] *Id.*

law with its interests as a shareholder in mind. Consequently, the legal regime may afford insufficient protection to the interests of non-state (minority) shareholders in both state-owned *and* private firms. This has in fact been the case in Brazil and China.[31]

Second, to the extent that the rules do restrict pursuit of the state's interests as a shareholder, there may be differences in enforcement levels against SOEs as compared to POEs, thus reducing the "bonding" advantages of a unitary legal regime. For example, there is evidence that Chinese regulators are less likely to mount enforcement actions against state-owned firms compared to their private counterparts.[32] In Brazil, the securities commission (CVM) failed to scrutinize a major (and highly controversial) RPT by which the Brazilian state transferred exploration rights in oilfields to Petrobras in exchange for shares.[33] More recently, the CVM broke new ground in fining the state for voting to approve a conflicted transaction in violation of self-dealing rules.[34] However, the administrative appeals court voided the sanction, reasoning that the statutory provision authorizing the state as controlling shareholder to "pursue the public interest that justified the company's creation" implicitly prevails over the legal rules prohibiting conflicted shareholders from voting to approve self-dealing transactions.[35] And in the United States, even in the absence of state ownership of their equity, government-sponsored enterprises Fannie Mae and Freddie Mac arguably faced less severe regulatory consequences than would have been appropriate given their role in the subprime mortgage crisis.

Third, but no less important, the general strategies of corporate law are not sufficiently tailored to address the challenges raised by RPTs in the SOE context. Corporate law strategies are generally conceived with the interests of shareholders in mind, who often play a key role in their enforcement. This means that, even when they work well (which is often not the case in jurisdictions where SOEs are prevalent), these strategies may help deter tunneling, which harms shareholders, but not propping, which benefits shareholders but harms constituencies external to the firm.

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[31] Pargendler, *supra* note 5; Mariana Pargendler, *Governing State Capitalism: The Case of Brazil*, *in* REGULATING THE VISIBLE HAND? THE INSTITUTIONAL IMPLICATIONS OF CHINESE STATE CAPITALISM (Benjamin L. Liebman & Curtis J. Milhaupt eds., 2016); Donald C. Clarke, *Corporate Governance in China: An Overview*, 14 CHINA ECON. REV. 494 (2003)

[32] William T. Allen & Han Shen, Assessing China's Top-Down Securities Markets 8 (N.Y. Univ. Sch. of Law, Pub. Law & Legal Theory Research Paper Series, Working Paper No. 10-70, 2010) at 21, available at https://ssrn.com/abstract=1648336 (finding that private firms are more likely to be sanctioned by China's securities regulator than SOEs, though the possibility that SOEs are more law-abiding cannot be ruled out); Henk Berkman, Rebel A. Cole & Lawrence J. Fu, *Political Connections and Minority-Shareholder Protection: Evidence from Securities-Market Regulation in China*, 45 J. FIN. & QUANT. ANALYSIS 1391 (2011) (finding that investors do not expect the state to enforce more stringent regulatory standards against SOEs).

[33] Pargendler, *supra* note 5, at 2941-2.

[34] *See* PAS CVM n. RJ2013/6635, decided on May 26, 2015. Moreover, in another prominent ruling whose appeal is still pending, the CVM fined the state of São Paulo for abuse of control power for failing to prevent an unfair related-party transaction between two of its controlled companies. PAS CVM n. RJ 2012/1131, decided on May 26, 2015, Rel. Luciana Dias.

[35] *See* Appeals Board for the National Financial System (Conselho de Recursos do Sistema Financeiro Nacional), Appeal 14.306, Case 10372.000246/2016-82, decided on June 28, 2017.

Consequently, most regulatory attempts to curb propping have developed in other areas of law, such as common market law (notably in the European Union) or international trade law, which often prohibit state subsidies. For example, although the agreement has no prospect of being concluded in the current political environment, the Trans-Pacific Partnership contained a specific section that sought to prevent SOEs from obtaining non-commercial benefits from home country governments to the detriment of private competitors in other member countries. Yet, from the perspective of SOE shareholders, such outright bans on subsidies to SOEs may be subject to legitimate objections. In practice, these subsidies often serve to indirectly compensate the firm for its pursuit of political or policy objectives that deviate from the maximization of financial returns[36]—a phenomenon that, as we saw above, is often inherent in state ownership of business enterprise.

Amidst this general landscape, however, certain policy initiatives have emerged to address the particular challenges associated with SOE governance. The set of best practices advanced by international organizations addresses RPTs, but their content is generic and undemanding. The OECD recommends disclosure of RPTs, advises the government to ensure the "market consistency" of all "transactions between the state and SOEs, and between SOEs," and suggests consideration of the involvement of minority shareholders in the approval process.[37] The World Bank's Toolkit on corporate governance of SOEs prescribes the establishment of "clear policies for related-party transactions" in SOEs (without, however, saying much about their desired content).[38] It also provides that "ex ante controls over such transactions could be imposed," and encourages the development of criteria for disclosure of RPTs among SOEs or between SOEs and the government.[39]

In Brazil, recent scandals involving state-owned firms have prompted the enactment of a new statute containing specific governance rules applicable to SOEs, but the provisions on RPTs remain modest in scope. The 2016 statute requires SOEs to establish and disclose a related-party transactions policy subject to the features of "competitiveness, compliance, transparency, equity, and proportionality," to be reviewed and approved at least annually by the board of directors.[40] It also requires SOEs to have an audit committee that is responsible, among other things, for evaluating and monitoring the adequacy of consideration in RPTs, together with management and the internal audit unit.[41]

In 2015, the São Paulo Stock Exchange (B3, formerly known as BM&FBovespa) created a voluntary accreditation program (*Programa de Governança de Estatais*) for SOEs seeking to comply with corporate governance best practices.[42] The Program, which

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[36] Mariana Pargendler, Aldo Musacchio & Sérgio G. Lazzarini, *In Strange Company: The Puzzle of Private Investment in State-Controlled Firms*, 46 CORNELL INT'L L. J. 569 (2013).
[37] OECD Guidelines, *supra* note 22, at 22-4, 54-6 and 65-7.
[38] THE WORLD BANK, CORPORATE GOVERNANCE OF STATE-OWNED ENTERPRISES: A TOOLKIT 187 (2014).
[39] *Id.* at 224 and 240.
[40] Lei No. 13.303, de 30 de junho de 2016, Art. 8º, VII.
[41] *Id.*, Art. 24, § 1º, VI.
[42] BM&FBOVESPA, SOE GOVERNANCE PROGRAM, Art. 28 (2015), http://www.bmfbovespa.com.br/lumis/portal/file/fileDownload.jsp?fileId=8A828D295048C0EF0150CE2C3F077741

preceded and inspired the statute, requires SOEs to adopt a related-party transaction policy subject to various requirements. The Program is an intriguing (and to our knowledge, the first) attempt by a stock exchange to develop a governance regime specifically targeting the governance challenges of SOEs. And it stands in stark contrast to the approach of the London Stock Exchange, which, in a bid to lure the IPO of Saudi Aramco, has proposed the addition of a new "premium" listing category for SOEs under which the rules on related-party transactions would be dramatically *weakened*.[43] Yet the Brazilian Program's voluntary nature and the lack of real sanctions for noncompliance make it a weak commitment device.

Still, most policy initiatives concerning SOEs have a general focus, and are not tailored specifically to related-party transactions. As discussed above, the OECD Guidelines have pushed for (i) corporatization (i.e., the adoption of the corporate form) by SOEs; (ii) the centralization of the state's shareholding function in a separate ownership entity; and, at times, (iii) the use of management or service contracts with the state. Yet it turns out that each of these mainstream prescriptions—by encouraging the formation of different corporate entities and the establishment of formal contracts between SOEs and the state—effectively *facilitate* the proliferation of related-party transactions between SOEs and other government entities.

Policy channeling raises interesting issues of legal strategy which to our knowledge have not been addressed in depth in the literature. The OECD Guidelines recommend that SOEs be reimbursed for the cost of pursuing policy objectives. If implemented, this recommendation would largely alleviate the problematic aspect of policy channeling. Colombia follows this recommendation by reimbursing listed oil company Ecopetrol for the cost of the subsidized prices practiced by the company.[44] However, in most countries actual reimbursement is rare: unless a government is following the Singaporean strategy discussed above (in which no reimbursement is required because the SOEs are managed with the objective of maximizing profits), a policy of full reimbursement would, in many cases, eliminate the political private benefits of control flowing from state ownership.

The OECD Guidelines sensibly recommend that the policy objectives of SOEs be disclosed.[45] The goal of adequate disclosure is to ensure that private investors in an SOE understand the risk that financial performance may be compromised by the pursuit of public policy objectives. Although this type of disclosure can certainly mitigate the harms of policy channeling to minority shareholders, it is not a complete solution. The policy objectives may be described in very general terms, and there is little to constrain a government from expanding or altering those policies over time.

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[43] *See London Reforms Set to Open Door for Listing of Saudi Aramco*, FINANCIAL TIMES, July 13, 2017 (under the proposal, the sovereign shareholder would not be treated as a related party). The Norwegian sovereign wealth fund sharply criticized the proposal.

[44] Milhaupt & Pargendler, *supra* note 22 at __.

[45] OECD Guidelines, *supra* note 24, at 19.

Corporate law is generally ill-equipped to police the merits of corporate decisions in the absence of a conflict of interest. The business judgment rule is highly deferential to informed board decisions, to the effect that even firms promising to maximize shareholder returns enjoy significant discretion to promote the public interest.[46] A fortiori, judicial review under the business judgment rule is unlikely to provide an adequate response to policy channeling in SOEs—corporations with dual profit and public policy objectives.

It is, however, conceivable that strategies drawn from corporate law might be adapted to address policy channeling. In one such modified corporate law strategy, the burden of persuasion in justifying pursuit of the stated policy objective could rest with the SOE's board of directors, rather than being presumed through the application of the business judgment rule. Full disclosure to the non-state shareholders of the nature and expected costs of fulfilling the policy objective could be required, followed by some level of approval by the non-state shareholders. In this fashion, a common approach to RPTs in the private sector might be adapted to address a distinctive form of potential harm to minority shareholders in SOEs.

Another strategy would be to entrust to minority-shareholder-appointed directors the role of policing previously undisclosed or unreasonable instances of policy channeling, in addition to policing the more common mechanisms of minority shareholder wealth extraction. There is partial precedent for this approach: Brazil's constitution mandates the participation of minority shareholders in SOE boards,[47] and Italy requires minority shareholder representation on one-fifth of the board seats of privatized companies.[48] While the laws of neither jurisdiction require minority-appointed directors to separately review and approve RPTs, a recent amendment to the charter of Brazilian SOE Petrobras provides that a "minority committee"[49] must review and opine on related-party transactions with the federal government and instances of policy channeling. It also requires that the costs of policy channeling be compensated by the state. Despite potential shortcomings,[50] the Petrobras charter amendment is a novel and noteworthy development in the governance of policy channeling and RPTs with the state.

Still, it must be acknowledged that existing corporate law mechanisms are not particularly well suited to addressing policy channeling.[51] More fundamentally, there is

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[46] *See* Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 NYU L. REV. 733 (2005).

[47] Constitution of the Federative Republic of Brazil, Art. 173, § 1º, IV.

[48] Law Decree 332/94, as amended, Art. 4.

[49] The minority committee, whose role is merely advisory, is comprised of two board members elected by minority shareholders and one independent director.

[50] In our report to Brazil's stock exchange and in discussions with policymakers, we had previously proposed strengthening the governance role of minority shareholder representatives on SOE boards, as well as the reimbursement of SOEs for policy channeling. *See* Milhaupt & Pargendler, *supra* note 22, at __. However, the adoption of these mechanisms by charter provision in the absence of statutory authorization may be controversial from a legal and constitutional standpoint. There is also a risk that the state, in its capacity as controlling shareholder, may try to remove these protections in subsequent charter amendments.

[51] For example, a majority-of-the-minority condition may effectively result in the rejection of virtually all attempts at policy channeling. It may also incentivize undisclosed or disguised policy channeling to avoid the rule.

still disagreement about whether policy channeling necessarily decreases social welfare, even if it clearly harms minority shareholders.

IV. Conclusion

RPTs are common to both SOEs and POEs. To date, however, policy makers and scholarly commentators have not fully appreciated how the distinctive features of the state as a controlling shareholder limit the effectiveness of corporate law strategies in policing these transactions. Perhaps more importantly, SOEs can be used as tools of public governance in ways that harm minority shareholders—conduct that is conceptually related to, but distinct from, RPTs. This conduct—what we have called policy channeling—has not been thoroughly analyzed in prior literature. This chapter represents a first attempt to point out the problems inherent in straightforward application of corporate law strategies to RPTs in the SOE context, and to extend the analysis to conceptually related conduct that raises equally serious issues for minority shareholders.

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