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Introduction

*We came to invest [in the U.S.] for the rule of law; yet our biggest challenge here is also the rule of law.*¹

CEO of a Chinese real estate company in the United States

Merely two decades ago, very few Chinese companies contemplated making investment overseas, and those that did focused mainly on resource-rich developing countries.² Today, thousands of Chinese firms have set up or acquired businesses around the globe. By some measure, outbound direct investment (ODI) from China reached about \$200 billion in 2016.³ The surge of Chinese ODI has triggered many controversies and intense debates, most of which revolve around two novel, albeit important, questions. First, how will soaring investment from the world's largest developing country impact host countries' institutions? For the skeptics, Chinese companies that have thrived in a poor legal and regulatory environment at home would "export China's domestic problems" and trample on the laws of their host countries.⁴ By comparison, those holding a more sanguine view foresee that Chinese companies venturing abroad, much like multinationals based in developed countries, will react rationally to host-country environments.⁵ The optimists also applaud investments from China for the immediate economic and social benefits, such as

¹ Public statement made by the executive at Roads to USA – Greenfield Investment versus Cross-border M & A Forum in Washington, D.C. (June 20, 2017).

² Ivar Kolstad and Arne Wiig, "What Determines Chinese Outward FDI?", 47 *Journal of World Business* 26 (2012).

³ Thilo Hanemann and Mikko Huotari, Record Flows and Growing Imbalances: Chinese Investment in Europe in 2016, Rhodium Group (Jan. 2017), at http://rhg.com/wp-content/uploads/2017/01/RHG_Merics_COFDI_EU_2016.pdf.

⁴ See Chapter 2 for more discussion of the critical views.

⁵ Ji Li, "I Came, I Saw, I . . . Adapted an Empirical Study of Chinese Business Expansion in the U.S. and Its Legal and Policy Implications," 36 *Northwestern Journal of International Law and Business* 143 (2016).

additional employment. For instance, Joe Biden once remarked that “President Obama and I, we welcome, encourage and see nothing but positive benefits flowing from direct investment in the United States from Chinese businesses and Chinese entities. It means jobs. *It means American jobs.*”⁶

Despite growing attention to Chinese ODI and rising temperature of the debate, very few researchers have systematically examined how Chinese investors interact with their host countries’ legal and regulatory institutions. The topic is timely and important as Chinese companies have begun to direct more of their foreign investment to countries featuring robust legal systems. Notably, of all the destination countries for Chinese ODI, the United States has emerged as the largest recipient.⁷ Will Chinese investors, having long conducted business in an environment where law is often secondary to power and social connections,⁸ fully comply with the laws of a developed host state, take an opportunistic approach towards compliance, or defy the host state’s laws and regulations? Put differently, will Chinese companies retain most of their home-state characteristics in coping with host-state laws and regulations? If Chinese investors readily adapt and behave like their local counterparts, ODI from China will not give rise to a disproportionately large number of frictions with host-country legal institutions. But if Chinese companies are in recalcitrant disobedience of the laws and regulations, their increasing presence will undoubtedly spawn a great deal of conflicts that may jeopardize existing host-country institutions.⁹

The second key question underlying many of the debates about Chinese ODI pertains to the Chinese state’s visible hand in promoting development and steering foreign investments. The Chinese government exerts an intricate control over the economy through, among other things, managing state-owned enterprises and implementing industrial policies. Critics have expressed grave concerns that Chinese ODI, heavily influenced or even controlled by the state, will threaten host countries’ national security and wreak havoc on the institutions that have enabled free-market capitalism.¹⁰ State-owned companies (SOEs), featured prominently in Chinese ODI,

⁶ “Remarks by Vice President Biden and Chinese Vice President Xi at a U.S.-China Business Roundtable,” the White House, Office of the Vice President, at www.whitehouse.gov/the-press-office/2011/08/19/remarks-vice-president-biden-and-chinese-vice-president-xi-us-china-busi, last accessed April 19, 2017, added emphasis.

⁷ Thilo Hanemann and Cassie Gao, “Record Deal Making in 2016 Pushes Cumulative Chinese FDI in the US above \$100 billion,” Rhodium Group (Dec. 30, 2016), at <http://rthg.com/notes/record-deal-making-in-2016-pushes-cumulative-chinese-fdi-in-the-us-above-100-billion>. The calculation excludes Hong Kong and the EU.

⁸ Ji Li, “The Power Logic of Justice in China,” 68 *American Journal of Comparative Law* 503 (2017); Wei Zhang and Ji Li, “Weak Law v. Strong Ties: An Empirical Study of Business Investment, Law and Political Connections in China,” 13 *Review of Law and Economics* (2016); Yuen Yuen Ang and Nan Jia, “Perverse Complementarity: Political Connections and the use of Courts among Private Firms in China,” 76 *Journal of Politics* 318 (2014).

⁹ Li, “I Came, I Saw, I . . . Adapted,” 143, 146.

¹⁰ See, e.g., Ian Bremmer, “State Capitalism Comes of Age: The End of the Free Market?,” 8 *Foreign Affairs* 40 (2009); Joshua Kurlantzick, *State Capitalism: How the Return of Statism is Transforming the World* (2016); the view is shared by some practitioners; see, e.g., Robert D. Atkinson, “Testimony

have drawn particular suspicion. Some fear that China will use the SOEs “as weapons in conflicts with other countries, as vehicles to control certain types of natural resources, as vehicles for obtaining and stealing sensitive technology from other nations, or as tools for undermining environmental and labor norms in countries where [they] invest.”¹¹

China’s evolving state–business relations have spurred an emerging literature and scholars have attempted to fit the system into one of several familiar theoretical models. For instance, analogies have been made to other East Asian developmental states.¹² True, China resembles them in the way government designs and implements industrial policies to facilitate growth; but equally evident are multiple structural differences, an obvious one being the crucial role SOEs have played and continue to play in China’s economy. Other commentators classify the Chinese system more broadly as state capitalism, variably defined as “a system in which the state functions as the leading economic actor,”¹³ a regime featuring “widespread influence of the government in the economy, either by owning majority or minority equity positions in companies or by providing subsidized credit and/or other privileges to private companies,”¹⁴ or a political economy characterized by the subordination of private capital to the state and the control of national plans over market operations.¹⁵ However, upon close examination, China distinguishes itself from other countries in this broad category by the high concentration of SOEs’ equity interest, the permeation of the ruling party in both state-owned and private enterprises, and the government’s superior administrative capacity.¹⁶ Moreover, China is by far the largest of all of state capitalist economies and arguably the most successful.¹⁷ And in contrast to the widely held post-Cold War belief that China would eventually convert to free-market capitalism,¹⁸ recent signs indicate that the Chinese model will likely endure. While the party-state

before the U.S.–China Economic and Security Review Commission, Hearing on Chinese Investment in the United States: Impacts and Issues for Policymakers” (Jan. 26, 2017), at www.uscc.gov/sites/default/files/Atkinson_USCC%20Hearing%20Testimony012617.pdf, last accessed April 15, 2017.

¹¹ Kurlantzick, *State Capitalism*, 239.

¹² John B. Knight, “China as a Developmental State,” 37 *World Economy* 1335 (2014); Seung-Wook Baek, “Does China Follow ‘the East Asian Development Model?’”, 35 *Journal of Contemporary Asia* 485 (2005).

¹³ Bremmer, “State Capitalism Comes of Age,” 40.

¹⁴ Aldo Musacchio and Sergio Lazzarini, *Reinventing State Capitalism: Leviathan in Business, Brazil and Beyond* (2014), 2.

¹⁵ Alex Dupuy and Barry Truchil, “Problems in the Theory of State Capitalism,” 8 *Theory and Society* 1 (1979).

¹⁶ Mark Wu, “The ‘China, Inc.’ Challenge to Global Trade Governance,” 57 *Harvard International Law Journal* 261 (2016).

¹⁷ Benjamin L. Liebman and Curtis J. Milhaupt, eds., *Regulating the Visible Hand? The Institutional Implications of Chinese State Capitalism* (2015).

¹⁸ Garry D. Bruton, Mike W. Peng, David Ahlstrom, Ciprian Stan, and Kehan Xu, “State-Owned Enterprises around the World as Hybrid Organizations,” 29 *Academy of Management Perspectives* 92 (2015), 95.

lately renewed its pledge to press on with the market reform,¹⁹ it has at the same time advocated the use of both the “visible hand” and the “invisible hand.”²⁰ A radical transformation being unlikely, how, then, do China’s rather unique, yet enduring, state–business relations influence the adaptation of Chinese companies to host-country institutions? Do state-owned Chinese investors exhibit different compliance behavior in liberal market economies such as the United States?

In short, surging Chinese ODI raises two sets of important yet underexplored questions: how Chinese investors react to host-country legal institutions; and whether and how the rather unique state–business relations matter. This book attempts to answer these questions by investigating how Chinese companies in the United States react to U.S. legal and regulatory institutions, and whether state ownership in Chinese investors makes a difference in their reactions. Drawing on insights from selected theories of compliance and international business, I construct an analytical framework that combines comparative institutional analysis with firm-level research. To be concrete, the framework organizes the analysis of foreign investors’ responses to a host country’s institutions into three parts: (1) the institutional distances between the investors’ home and host states; (2) the investors’ desire to conform to the host-country institutions; and (3) the investors’ ability to make the requisite adaptation. Put in plain English, the framework guides the analysis through three inquiries about the *need* for, and the *desire* and the *ability* of, foreign investors to adapt and conform to a host country’s legal and regulatory environment.

Let me briefly expand on the first inquiry, *the need* for foreign investors to adapt to host-country legal institutions. In areas of significant cross-country learning and institutional transplant, there will be no pressing need for foreign investors to make material behavioral adjustments. For instance, few Canadian companies investing in the United States would have to markedly alter the way they conduct business (e.g., how they set prices and collaborate with other firms), in order to comply with U.S. antitrust law. In areas where substantial institutional gaps exist across different countries, foreign investors’ adaptation and compliance with host-country rules will then hinge on their *desire* and *ability* to make the necessary adjustments. If the investors show adequate inclination as well as capacity, they will cross the institutional gaps and their business expansion in the host state will not entail surging frictions. On the other hand, if they possess neither the desire nor the ability to adapt, numerous conflicts will follow. Applying this analytical framework, this book examines how Chinese companies doing business in the United States react to the general U.S. institutional environment as well as how they cope with U.S. legal and regulatory institutions in three subject matter areas (i.e., tax, employment discrimination, and national security review of foreign investments). For

¹⁹ Cary Huang, “Party’s Third Plenum Pledges ‘Decisive Role’ for Markets in China’s Economy,” *South China Morning Post* (Nov. 12, 2013), at www.scmp.com/news/china/article/1354411/chinas-leadership-approves-key-reform-package-close-third-plenum.

²⁰ James Stent, *China’s Banking Transformation: The Untold Story* (2016), 6.

instance, do Chinese firms cautiously comply with U.S. tax law, aggressively exploit the loopholes in the system, or willfully disregard the law? In addition, this book explores the association, if any, between state ownership in Chinese investors and their adaptation. Are state-owned Chinese investors, for instance, less likely than their privately owned counterparts to engage in opportunistic compliance with U.S. law prohibiting employment discrimination?

To address these questions, the book employs both qualitative and quantitative methods. A unique dataset was compiled from three comprehensive annual surveys (2014, 2015, and 2016) targeting executives of sizable Chinese companies in the United States. The survey was conducted in collaboration with China General Chamber of Commerce—USA (CGCC), by far the largest business association of Chinese companies in the United States. This book presents both descriptive and statistical analysis of the data in a reader-friendly way. Moreover, I personally reached out to dozens of individuals with firsthand knowledge about Chinese investments in the United States, such as managers of the Chinese businesses and the U.S. lawyers who have advised them. From the Rashomonian observations and comments, I extracted insights to formulate the hypotheses for the statistical tests and to supplement or substantiate the institutional and quantitative analyses. Furthermore, information about Chinese ODI was gleaned from secondary materials such as media reports and studies by NGOs, professional service providers, and government agencies.

The remainder of this book proceeds as follows. To provide readers with necessary background knowledge, Chapter 2 begins by reviewing the incremental changes in China's foreign direct investment (FDI) policies and the long-term growth trajectory of Chinese ODI. It then shifts the focus to Chinese investments in the United States. Besides a synopsis of the topic, the chapter recounts the experiences of three major Chinese companies (Lenovo, Bank of China, and Huawei) that have made or attempted to make substantial investments in the United States. As will be shown, their experiences vary dramatically. Last, the chapter describes the comprehensive surveys of Chinese companies in the United States and presents an overview of the results.

Chapter 3 is divided into two parts. The first part formulates the general analytical framework for researching foreign investors' reactions to a host country's legal institutions. As just noted, to explore this broad topic, one should begin by examining relevant institutional gaps between the investors' home and host countries, and, in cases of large institutional gaps, by further analyzing the investors' desire and ability to conform to the host country's institutions. Applying this framework, the second part of the chapter empirically examines Chinese companies in the United States. It finds that the Chinese investors generally encounter substantial institutional gaps, yet many of them demonstrate both the desire and the ability to cross the gaps. To be more concrete, long-term commercial interests instead of home-state policies drove most of the Chinese investments in the United States, and the managers held in high regard various U.S. social, legal, and business institutions.

Meanwhile, many of the Chinese companies have to a great extent localized decision-making concerning U.S. legal and compliance matters and relied heavily on U.S. professionals to cope with the host country's institutional setting. Consequently, the Chinese companies in general should adapt and comply reasonably well with U.S. law. That being said, significant variations across the Chinese firms are evident.

The variations are empirically explored in Chapter 4. The tests of the chapter concentrate on whether and how state ownership in Chinese investors is associated with the varying institutional distances and the firm-level factors. The connections between state ownership and the institutional distances are complex and context-sensitive. Everything else held constant, Chinese SOEs that bear relatively low noncompliance costs in the domestic setting usually have to traverse longer institutional distances when investing in the United States, because most U.S. laws pertinent to foreign investments either disregard state ownership or discriminate against state-owned or state-controlled investors. However, due to the multilayered agency problem inherent in Chinese SOEs, the managers' interests are not well aligned with those of the firms and their nominal owners.²¹ In addition, senior managers of Chinese SOEs typically multitask, and profit maximization is but one metric for their performance evaluation.²² Hence, despite low noncompliance costs in the home state, managers of Chinese SOEs may still avoid taking the risk. When Chinese SOEs invest in the United States, the same logic applies and it complicates their reactions to U.S. legal institutions. Second, on the desire of Chinese investors to adapt, the chapter finds preliminary evidence that state-owned Chinese investors are more responsive to the home government's policies and less likely than private investors to reinvest their U.S. profits. Yet, on the other hand, managers of state-owned Chinese firms do not differ from private-company managers in holding generally positive views of U.S. institutions. Third, regarding the ability to adapt to U.S. legal institutions, the chapter uncovers evidence that ties Chinese investors' state ownership to more centralized management. At the same time, however, state-owned Chinese investors are indistinguishable from private investors in terms of reliance on local professionals. The mixed empirical findings suggest that,

²¹ See, e.g., Zhou Mi and Xiaoming Wang, "Agency Cost and the Crisis of China's SOE," 11 *China Economic Review* 297 (2001); Bruton et al., "State-Owned Enterprises Around the World as Hybrid Organizations," 92; Yingyu Zhang, Hui Luan, Wei Shao, and Yingjun Xu, "Managerial Risk Preference and Its Influencing Factors: Analysis of Large State-Owned Enterprises Management Personnel in China," 18 *Risk Management* 135 (2016); Alvaro Cuervo-Cazurra, Andrew Inkpen, Aldo Musacchio, and Kannan Ramaswamy, "Governments as Owners: State-Owned Multinational Companies," 45 *Journal of International Business Studies* 919 (2014).

²² See, e.g., Ji Li, "State-Owned Enterprises in the Current Regime of Investor-State Arbitration," in Shaheela Lalani and Rodrigo Polanco, eds., *The Role of the State in Investor-State Arbitration* (2014); Lin Cui, Klaus E. Meyer, and Helen Wei Hu, "What Drives Firms' Intent to Seek Strategic Assets by Foreign Direct Investment? A Study of Emerging Economy Firms," 49 *Journal of World Business* 488 (2014), 491–2; Jiangyu Wang, "The Political Logic of Corporate Governance in China's State-Owned Enterprises," 47 *Cornell International Law Journal* 631 (2014).

everything else held constant, Chinese state-owned firms may be less efficient in coping with major U.S. legal and regulatory issues than privately owned Chinese investors.

The institutional distances between China and the United States, though large in general, vary across different subject matter areas, and so should the reactions of Chinese companies. Chapters 5 to 7 of this book examine how Chinese companies deal with the U.S. legal institutions governing taxation, employment discrimination, and national security review of foreign investment. I choose these three areas of U.S. law because they implicate, actually or potentially, almost all Chinese companies in the United States, and they relate to some of the core issues in the ongoing debates about Chinese ODI as well as emerging-market FDI.

Chapter 5 examines Chinese companies in the U.S. tax system. Thanks to learning and institutional transplant from the United States to China in the past four decades, the two countries' tax systems share quite a few core concepts and principles. But beyond that, the two differ strikingly. How do Chinese firms respond to the impenetrable U.S. tax system? The chapter finds, quite surprisingly, that Chinese investors on average prefer the complex yet law-based U.S. tax system to the one back home. They also rely extensively on local professionals to handle U.S. tax matters. Moreover, the chapter finds that Chinese companies have in general adopted a conservative approach towards U.S. tax planning and have not experienced extraordinary audits or disputes with the IRS. Furthermore, state ownership in Chinese investors does not correlate significantly with their opinions about U.S. tax institutions, nor is it linked to how the firms handle technical or routine tax matters such as tax planning. However, preliminary test results indicate that Chinese investors with majority state ownership are more likely to experience audits and disputes with the IRS, which serves as initial evidence confirming the finding in Chapter 4, namely that state-owned Chinese investors may be less efficient in dealing with major U.S. legal and regulatory matters.

Chapter 6 explores how Chinese companies respond to the U.S. law prohibiting employment discrimination. Again, thanks to transnational learning and legal transplants, the formal Chinese law against employment discrimination has incorporated the basic principles of the U.S. law, though the latter is undoubtedly more comprehensive and operative. In contrast, the compliance and enforcement gaps remain wide open. How do Chinese companies fair under the elaborate U.S. rules for employment equality? According to the findings of this chapter, Chinese managers hold on average a positive view about U.S. employment laws and rely to a certain extent on local professionals to handle personnel matters. The majority, therefore, have adopted local practices for managing human resources and taken measures to prevent workplace discrimination; and contrary to popular belief, discrimination has not been a major issue for doing business in the United States. At the same time, however, the evidence indicates inadequate compliance efforts and therefore the potential for more workplace friction as Chinese companies

further expand and diversify their U.S. workforces. The chapter also investigates the potential effects of state ownership of Chinese investors on how they view and react to the U.S. rules, and discovers no significant effects.

Chapter 7 explores the reactions of Chinese investors to national security review of foreign investments (also known as CFIUS review). Chinese investors, having no experience with national security review of investment at home, encounter an enormous institutional gap in this subject matter area. Consequently, many of the Chinese managers lack any knowledge about this peculiar U.S. institution. Moreover, the U.S. law governing CFIUS is ambiguous and the interagency body enforcing the law enjoys broad discretion. Hence most of the Chinese managers with knowledge about the system consider it politicized and non-transparent. That is in sharp contrast to their views on U.S. tax and employment institutions. Given the enormous institutional gaps and the negative view, it is no surprise that most of the Chinese investors have either neglected CFIUS review or taken a more opportunistic approach towards the CFIUS risk. Such reactions have led to conflicts with the enforcement agency that culminated in the first and only lawsuit challenging its actions (*Ralls v. CFIUS*), which eventually altered the legal contour of the CFIUS review process. The chapter further examines the effects of state ownership in Chinese investors. Contrary to U.S. tax law and employment law, the CFIUS rules subject foreign government-controlled investments to enhanced agency scrutiny. Unsurprisingly, statistical analysis finds state ownership in Chinese investors to be significant. That is, those working for Chinese companies with significant state ownership think negatively of the regime. In addition, state-owned Chinese investors are more likely to consider notifying CFIUS about their acquisitions of U.S. assets.

Chapters 5 to 7 highlight varying institutional distances across different subject matter areas. Among the three studied herein, the institutional gaps between China and the United States are wide in their respective employment laws, wider in tax, and much wider in national security review of foreign investment. Moreover, while U.S. tax law and employment law generally disregard ownership types (e.g., state-owned or private), CFIUS rules single out foreign investors with state ownership for heightened scrutiny. Consequently, most of the Chinese managers see U.S. laws in the areas of tax and employment neutrally or positively; yet the same managers either lack any knowledge or are critical about the CFIUS process. Meanwhile, and to a certain extent related to the varying institutional gaps, Chinese companies have relied heavily on local professionals for handling complex tax matters and CFIUS review, less so in managing human resources in the United States. Overall, the findings of the book suggest that Chinese companies investing in the United States are generally adaptive to host-country legal institutions that are neither discriminatory nor highly discretionary. Yet notable variations exist, and state ownership in Chinese investors makes a difference in areas with large institutional gaps that vary according to ownership types and when major legal and compliance matters are implicated. On the other hand, in dealing with routine and technical legal and

compliance issues, state-owned Chinese investors tend to adopt similar or even more cautious approaches than private Chinese investors in the United States.

This book makes several contributions. First, drawing on insights from various literatures, the book presents a unified analytical framework to investigate how foreign investors comply with host-country laws and regulations. The existing scholarship that has tangentially touched on the topic has either disregarded subnational institutional disparities and cross-national institutional homogeneity, or assumed away certain key firm-level variations in the adaptation to host-state contexts. The analytical frame articulated herein fills the holes. It is also broadly applicable. For instance, one may use it to guide the analysis of how Chinese firms investing in Germany respond to various German laws, or how Brazilian investors in Japan cope with different Japanese laws.

Second, the book contributes to the theoretical debate about Chinese ODI and its impacts on host countries, especially developed countries such as the United States. Ample empirical evidence herein suggests that Chinese business elites have internalized the basic concepts of free-market capitalism and embraced its enabling institutions. Decades of market reform in China may be incomplete, but it has been market-oriented nonetheless. The shared faith in market efficacy among the Chinese business elites, regardless of their employers' ownership type, paves the way for Chinese companies to conform to market-enabling institutions in the United States. Somewhat ironically, in a time when more politicians from the developed world begin to endorse isolationism and protectionism, Chinese companies may take actions, intentionally or not, to sustain the host-country institutions that are crucial to free-market capitalism. The *Ralls v. CFIUS* lawsuit, which will be discussed in Chapter 7, illustrates the point. A Chinese investor's suit against the federal agency and President Obama fortified, at least in theory, the legal protection of property rights for foreign owners of U.S. assets.

Third, the book adds to the discussion of state capitalism. Its findings should ease the fear that Chinese companies, either SOEs or privately owned national champions, will conquer global business. At least in the United States, Chinese companies have not been a formidable force. On average they suffer a loss, and those that survived the fierce competition of the U.S. market and overcame the various liabilities of foreignness have localized and shed nearly all defining Chinese characteristics. In addition, host-state governments have ample regulatory tools (e.g., CFIUS review) to regulate SOEs and other investors subject to their home state's influence.

Fourth, the book contributes to the debate about SOEs. Are they strategic and policy tools of the state owners, as alleged by their detractors, or fully commercialized business organizations identical to private companies in every aspect except for ownership? Also, do SOEs significantly differ from private companies in the way they operate in host countries where many of their home state advantages no longer exist? Moreover, to what extent do they vary from private companies when doing

business in a mature market with relatively less, but more institutionalized, government intervention? This book offers some preliminary answers. Differences certainly exist between Chinese investors with significant state ownership and private Chinese investors, but they are not reflected in the dealings with technical and routine matters in the United States. Overall, Chinese SOEs, especially those subject to multiple capital market regulations, have been commercialized to a great extent and largely adaptive to host-country institutional contexts. Hence soaring Chinese investment in the United States by itself will unlikely trigger a clash of capitalisms.