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Who Owns the Chinese Internet?

A glance at the strength and enforceability of contracts in China are among the reasons for why foreign companies don't appear to be holding the stronger hand in the domestic Internet industry

By Donald Clarke

The Chinese government still retains its power over the Chinese internet and has yielded little or nothing of importance to foreign interests

An article recently published in Xuexi Shibao (Study Times), an organ of the Central Party School, has drawn a lot of attention. The authors, from the Chinese Academy of Social Sciences, assert (a) that foreigners ("foreign capital" in the article's terminology) have come to control the Chinese internet, and (b) that this is a bad thing. I'm not going to address the second point here; among other things, if the first point is false, then the second point is irrelevant.

First, it is wrong in thinking that the contracts subjecting Chinese internet operators to the control of foreign companies are robust and enforceable in China. Second, even if the contracts were robust and enforceable, the "foreign" companies exercising the control may in fact be controlled by Chinese individuals – sometimes the same Chinese that are on the other side of the contracts.

Foreigners may hold at most 50 percent of certain specified value-added telecommunications businesses. And this is only in theory; in practice, it's even more difficult than the rules suggest. Thus, Chinese internet businesses with significant foreign interests – and there are a lot of them – are typically structured through what's called a Variable Interest Entity. Because foreigners can't own internet operations directly, an offshore entity is set up (the Baidu that's listed on the New York Stock Exchange, for example, is a Cayman Islands company). Typically, the offshore company ("Offco") is the sole owner of a Chinese subsidiary ("Chisub"). Chinese individuals ("Chiparties") – typically, the entrepreneurs associated with the business – also set up a Chinese company ("Chico").

Because Chico is owned by Chinese, it is able to hold the licenses and operating permits needed to run an internet business. Offco raises money through a listing abroad, and either directly or through Chisub lends the money interest-free to Chiparties. Chiparties then use the money to capitalize Chico. Both Chiparties and Chico sign a series of contracts with Offco and/or Chisub pursuant to which Offco, directly or through Chisub, controls the operations of Chico, reaps the benefits, and suffers the losses. Since control and risk-bearing pretty much define what ownership is about, this structure mimics – or at least attempts to mimic – precisely what is prohibited under Chinese law. These contractual control rights alarm the authors.

Since last March, serious concerns have been raised in the foreign business community about whether this contract-based structure is solid. The contracts exist in order to mimic the features of direct ownership while evading the prohibition, and contracts for the purpose of achieving a prohibited purpose are void in China. Article 52 of the Contract Law spells this out: In any of the following circumstances, a contract is void: ... (3) a lawful form is used to conceal an unlawful purpose; ... (5) there is a violation of mandatory provisions of laws or administrative regulations.

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Moreover, the authorities that now allow these structures to go forward could at any time decide to stop allowing them.

There is evidence that the worries are well founded: GigaMedia had a VIE structure for its China operations. But its Chinese manager – the type of person who is described in the article as a passive puppet-like agent sought out by foreign capital to do its bidding – recently decided to cut the strings, and GigaMedia essentially lost all its China business (about 20 percent of its consolidated revenues) as a result. It has apparently not been able to enforce the contracts that purported to give it control.

Buddha Steel's planned IPO in the United States was cancelled last March. It used a VIE structure to exercise control over a Hebei cold-rolled steel company. Apparently the Hebei provincial authorities advised the onshore operating company that the VIE agreements contravened Chinese policies related to foreign-invested enterprises and were against public policy.

Finally, it is puzzling that the authors also use the Alipay dispute as an example in support of their point, since in fact it undermines it. Jack Ma has gone his own way. If he is supposed to be an obedient puppet of foreign capital, I think somebody forgot to inform him.

But let's suppose the contracts are all valid and readily enforceable, so that the offshore entities really can exercise control. That still leaves open the question of who controls the offshore entities. Is it "foreign capital"? Not necessarily.

Take Baidu (the Cayman Islands company listed on the NYSE), for example. 52 percent of the voting power is owned by Robin Li, either directly or through a BVI company he owns and controls. Another 16 percent is owned by his wife. Except for a Scottish partnership that holds 2.49 percent, the rest of the voting power appears to be widely held. Foreign capital is helping out Robin Li, but exercises no control. Robin Li, to the best of my knowledge a patriotic citizen of China, controls the offshore company and the money.

Dangdang presents another model

The recent Alibaba spat with Yahoo and Softbank highlighted risks in the foreign ownership of Chinese entities

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of control. In this case, the Chinese entrepreneurs – Li Guoqing and Peggy Yu – don't have absolute, majority control. They do, however, control more than 45 percent of the company's voting power and occupy the top management and board positions. This doesn't look very much like control by foreign capital.

Sina.com presents a third model. The president and CEO, Charles Chao, is of PRC origin. According to Sina's latest annual report, he appears to be the largest single shareholder, controlling over 8.66 percent of voting rights. Only one other shareholder holds more than 5 percent of the voting rights. In other words, the shareholding is largely dispersed and there is no controlling shareholder. Since Jing and Wang admit in a 2009 article that Sina.com has no controlling shareholder, how then can they claim at the same time (as they do) that the company is "controlled by international capital"? They state that ownership of more than 50 percent of the shares constitutes absolute control, but this means that some unified will – a single person or a unified group – has to control all those shares.

In grammatical terms, the subject of the verb "to own" has to be an entity capable of thinking and expressing a will. "International capital" is not a person with a unified will. The authors appear to believe that in a 10,000,000-share company, if 5,000,001 foreigners each own one share, that is "foreign control" just as much as if one foreigner holds 5,000,001 shares. It is not. One can always identify a group of random and unconnected shareholders in any company whose holdings add up to more than 50 percent; that does that mean that they control the company. When a company has no controlling shareholder, the actual controller is management. And in the case of Sina.com, management appears to be predominantly in the hands of Chinese nationals.

Of course, there may be Chinese internet businesses using the VIE structure in which the offshore company really is controlled by foreigners. I have just looked here at some random prominent examples, including one discussed by the authors themselves, and discovered that the so-called foreign control is an illusion.

Moreover, as argued above, even if the offshore company is genuinely under foreign control, it is still far from clear that its contractual relations with the onshore company and the onshore company's Chinese investors are solid and enforceable under Chinese law. In short, the Chinese government still retains its power over the Chinese internet and has yielded little or nothing of importance to foreign interests. ■