

DEVELOPMENT AND DISTRUST: A CRITIQUE OF THE ORTHODOX PATH TO ECONOMIC PROSPERITY

W. Tyler Perry

ABSTRACT—The dominant strain of law and development theory holds that strong property rights are a necessary condition for economic growth. Nonetheless, China has experienced thirty years of frenetic growth absent strong property rights. This Note explores this phenomenon through an analysis of a unique corporate form that has come to underlie most of the publicly traded Chinese Internet sector—the Variable Interest Entity (VIE). The VIE is, at its core, a series of contracts designed to mimic “true” ownership. As such, the VIE problematizes law and development theory in two primary ways. First, the contract-based ownership system does not provide the clean title envisioned by most law and development theorists, and consequently raises issues related to control. Second, the ownership claim of the investor is likely judicially unenforceable. Accordingly, the increasing prevalence of the VIE structure and the simultaneous economic growth enjoyed by China’s Internet sector naturally leads to a number of interrelated conclusions. First, the VIE shows that weak property rights may be sufficient in situations where they nonetheless provide notice of who “owns” the particular item at issue (i.e., it serves a title-clearing function). Second, culturally specific, extralegal institutions and methods may vindicate rights in the absence of the rule of law. Third, predictability, an implicit purpose of the property rights regime, may allow for economic growth absent strong property rights. Read together, these three conclusions suggest that the academy has taken a good idea—the almost universal emphasis of rule of law and property rights—and stretched it beyond the confines of its natural universe.

AUTHOR—J.D. Candidate, Northwestern University School of Law, 2016; B.A., New York University, 2011. A sincere thanks to Professor Nadav Shoked for his patience in guiding me through the Note-writing process. An additional thanks to everyone else whose suggestions improved this Note immeasurably, particularly Matthew Browne, Brenna Helppie-Schmieder, Ashley Kuempel, and Bethany Pickett. All errors and omissions are my own.

NORTHWESTERN UNIVERSITY LAW REVIEW

INTRODUCTION 478

I. THE VIE AS A POTENTIAL FOIL..... 482

 A. *The General VIE Structure*..... 482

 B. *The Example of Alibaba* 487

 C. *The VIE and Development Dogma* 490

II. ECONOMICS AND THE RULE OF LAW: THE QUESTION OF PROPERTY 495

III. IMPLICATIONS 499

 A. *Notice May Serve a Title-Clearing Function*..... 499

 B. *Culturally Specific Institutions May Vindicate Rights in the Absence of the Rule of Law*..... 500

 C. *Predictability May Lead to Foreign Investment* 504

 D. *Property Rights May Not Be a Silver Bullet*..... 504

IV. ADDITIONAL, FORWARD-LOOKING IMPLICATIONS 505

CONCLUSION 505

[P]roperty rights belong legally to individuals, but their real function is social, to benefit vast numbers of people who do not themselves exercise these rights.[†]

INTRODUCTION

Would you buy a house if the deed remained in someone else’s name? What if your right to live in it was exclusively contractual? What if your ability to earn money from its sale was the same? Would it change your mind if the underlying contracts were unenforceable? What if they were illegal? Consideration of the following example is illuminating.¹

On September 19, 2014, a bell rang and Alibaba went public.² The Initial Public Offering (IPO) shattered the record books, valuing the company at over \$200 billion,³ raising \$25 billion in capital,⁴ and creating

[†] SUSAN E. DUDLEY & JERRY BRITO, REGULATION: A PRIMER 101 (2d ed. 2012) (quoting Thomas Sowell, *The “Takings” Issue*, FORBES, Mar. 2, 1992, at 60).

¹ This example was inspired by an article written by Hernando de Soto. See Hernando de Soto, *What if You Can’t Prove You Had a House?*, N.Y. TIMES (Jan. 20, 2006), http://www.nytimes.com/2006/01/20/opinion/20iht-edsoto.html?pagewanted=all&_r=0 [<http://perma.cc/U9X7-8CQ6>].

² *Alibaba US IPO Launches on NYSE*, CCTV AM. (Sept. 19, 2014), <http://www.cctv-america.com/2014/09/19/alibaba-us-ipo-launches-on-nyse> [<http://perma.cc/YM7F-Y5J2>].

³ Marcus Wohlsen, *Alibaba Is Already Bigger than Facebook, Amazon, and IBM*, WIRED (Sept. 19, 2014, 2:33 PM), <http://www.wired.com/2014/09/alibaba-already-bigger-facebook-amazon-ibm/> [<http://perma.cc/YS34-6RQT>].

⁴ Liana B. Baker, *Alibaba Issues Additional Shares To Raise IPO Total to \$25 Billion: Report*, REUTERS, Sept. 22, 2014, <http://www.reuters.com/article/2014/09/22/us-alibaba-ipo-idUSKBN0HH04H20140922> [<http://perma.cc/QD7U-PWDX>].

thousands of millionaires.⁵ It was an unequivocal financial success. On that day and every day since then, however, investors have not exchanged dollars for stock of Alibaba. Instead, they have purchased something far more amorphous—stock in a Cayman Islands entity that has contractual rights designed to mirror ownership of Alibaba without actually providing for it.⁶ In other words, investors bought the benefit of a contract, not a piece of a company.

The Alibaba IPO and the increasing number of events like it raise serious questions about the dominant strain of law and development theory by questioning the core assumption that property rights are a necessary condition for economic development. Alibaba is listed through a structure called a variable interest entity (VIE). The VIE is, at its core, a series of contracts designed to mimic “true” ownership. The structure is a brilliant slight of hand calculated to circumvent strict regulations on the foreign ownership of Chinese companies located in sensitive industries. While certainly a relatively new phenomenon,⁷ it has grown exponentially in popularity such that today “[a]ll of China’s major Internet companies that list on U.S. exchanges use the VIE structure.”⁸

The VIE structure works by utilizing two types of contracts: one set secures control of the company and the other secures a right to the economic benefit of the company. The actual mechanics of this are more complicated. First, a parent company is incorporated in a tax haven, often the Cayman Islands.⁹ The parent company then creates a Wholly Foreign

⁵ Andrew Jacobs & Neil Gough, *Alibaba IPO Creates Thousands of New Millionaires in China*, BOS. GLOBE (Sept. 19, 2014), <http://www.bostonglobe.com/business/2014/09/19/alibaba-ipo-creates-thousands-new-millionaires-china/fOQ1xwIXJBY76kSVVJpEnJ/story.html> [http://perma.cc/U2TF-SSED].

⁶ Steven Davidoff Solomon, *Alibaba Investors Will Buy a Risky Corporate Structure*, N.Y. TIMES: DEALBOOK (May 6, 2014, 7:46 PM), http://dealbook.nytimes.com/2014/05/06/i-p-o-revives-debate-over-a-chinese-structure/?_php=true&_type=blogs&_r=0 [http://perma.cc/6K47-JS68] (“[Investors] will purchase shares in a Cayman Islands entity named Alibaba Group Holding Limited. . . . The Cayman Islands company has contractual rights to the profits of Alibaba China, but it has no economic interest.”).

⁷ See Jing Li, *Venture Capital Investments in China: The Use of Offshore Financing Structures and Corporate Relocations*, 1 MICH. J. PRIV. EQUITY & VENTURE CAP. L. 1, 47 (2012) (“Because the contractual control concept embodied in the VIE model was first tested successfully in the listing of Sina.com in NASDAQ in 2000, the VIE model is also often referred to as the ‘Sina model.’” (footnote omitted)).

⁸ KEVIN ROSIER, U.S.-CHINA ECON. & SEC. REVIEW COMM’N, THE RISKS OF CHINA’S INTERNET COMPANIES ON U.S. STOCK EXCHANGES 3 (2014), <http://origin.www.uscc.gov/sites/default/files/Research/The%20Risks%20of%20China%E2%80%99s%20Internet%20Companies%20on%20U.S.%20Stock%20Exchanges%20-%20with%20Addendum.pdf> [http://perma.cc/GW6Y-BP9Q].

⁹ Ma Mengwei, *The Perils and Prospects of China’s Variable Interest Entities: Unraveling the Murky Rules and the Institutional Challenges Posed*, 43 H.K. L.J. 1061, 1063 (2013).

Owned Enterprise (WFOE) in China.¹⁰ Next, the WFOE enters into a series of contracts with the local Chinese target,¹¹ the VIE, and the VIE's owners.¹² These contracts provide a right to any and all profits, and deliver a semblance of control. Generally, as discussed further below, the right to profits is secured through exclusive service and asset licensing agreements, while the right to control is ensured through a call option, an equity pledge, a voting rights, and a loan agreement.¹³ Cumulatively, these contracts allow for the VIE to be incorporated into the parent company's accounting statements under generally accepted accounting principles (GAAP).¹⁴ It is important to note, however, that under this arrangement, all of the relevant assets and licenses remain in the hands of the Chinese owners—the investor simply does not *own* a part of the company.¹⁵

In striking contrast to the economic boom in the Chinese technology space fostered through the proliferation of VIEs and their weak property rights, the dominant strain of law and development theory contends that property rights are a necessary condition for economic growth.¹⁶ In

¹⁰ *Id.*

¹¹ For purposes of this Note, the “target” corporation is the local Chinese entity from which the foreign investor derives economic value.

¹² Ma Mengwei, *supra* note 9, at 1063.

¹³ David Roberts & Thomas Hall, *VIE Structures in China: What You Need to Know*, TOPICS IN CHINESE L. (O'Melveny & Myers LLP, Beijing, China), Oct. 2011, at 2–3 (2011), http://iis-db.stanford.edu/evnts/6963/TICL_-_VIE_Structures_in_China.pdf [<http://perma.cc/SK85-BTCZ>].

¹⁴ See generally PWC, ACCOUNTING FOR VARIABLE INTEREST ENTITIES 2013 (2d ed. 2015), <http://www.pwc.com/us/en/cfodirect/assets/pdf/accounting-guides/pwc-guide-variable-interest-entities-second-edition-2015.pdf> [<http://perma.cc/9LVG-P3GJ>] (describing the treatment of VIEs under GAAP).

¹⁵ At this point, it is important to briefly note the divergence between the legal and lay understandings of ownership. The lay understanding of property rights contends that an individual can, and often does, “own” property free and clear of any external encumbrance. See BRUCE A. ACKERMAN, PRIVATE PROPERTY AND THE CONSTITUTION 26 (1977) (“I think it fair to say that one of the main points of the first-year Property course is to disabuse entering law students of their primitive lay notions regarding ownership. They learn that only the ignorant think it meaningful to talk about owning things free and clear of further obligation.”). The common legal understanding of ownership recognizes that ownership is better conceptualized as “the relationships that arise *between people* with respect to things.” *Id.* Accordingly, property is often referred to as a “bundle of sticks,” allowing individuals to choose and trade rights as they see fit. See, e.g., Anna di Robilant, *Property: A Bundle of Sticks or a Tree?*, 66 VAND. L. REV. 869, 871 (2013) (“In the United States, every first-year law student learns that property is a ‘bundle of sticks.’ Introduced by Hohfeld, and further developed by the realists, the bundle of sticks concept characterizes property as a bundle of entitlements regulating relations among persons concerning a valued resource.”). Thus, when I say that VIE investors do not “own” the company in which they invest, I mean that they possess a very limited number of rights (or sticks), which consequently heavily circumscribes their ability to control the object vis-à-vis other social actors. Additionally, the rights that they do have are fairly weak.

¹⁶ See, e.g., Frank K. Upham, *From Demsetz to Deng: Speculations on the Implications of Chinese Growth for Law and Development Theory*, 41 N.Y.U. J. INT'L L. & POL. 551, 557 (2009) (“Property rights are at the heart of the incentive structure of market economies. They determine who bears risk and who gains or loses from transactions. In so doing they spur worthwhile investment, encourage careful monitoring and supervision, promote work effort, and create a constituency for enforceable

particular, the academy has come to believe that “[p]roperty rights encourage productive activity by allowing people to reap the rewards of their labor,” creating growth.¹⁷ A more nuanced conception contends that “[l]egally created titles and stock certificates generate investment; clear property records guarantee credit; documents allow people to be identified and helped; company statutes . . . pool resources for recovery; mortgages raise money; [and] contracts solidify commitments.”¹⁸ It is beautifully simple, and has worked in a number of instances.¹⁹ Most importantly, however, it has achieved near universal support.²⁰

But, as with all great theories, cracks are beginning to appear in law and development dogma. As of yet, these cracks are the result of a series of attempts to determine the exact nature of the relationship between property rights and economic development.²¹ Within this increasingly fractured debate, many scholars still offer wholehearted support for law and development dogma.²² Others have advocated a more nuanced interpretation.²³ I hope to add to this growing discussion. To that end, my geographic focus will be China and my illustrative example will be the VIE.

contracts. In short, fully specified property rights reward effort and good judgment, thereby assisting economic growth and wealth creation.” (quoting WORLD BANK, *WORLD DEVELOPMENT REPORT 1996: FROM PLAN TO MARKET* 48–49 (1996)); see also Larissa Katz, *Governing Through Owners: How and Why Formal Private Property Rights Enhance State Power*, 160 U. PA. L. REV. 2029, 2058 n.88 (2012) (“[L]egal protection of property rights creates incentives to exploit resources efficiently.” (alteration in original) (quoting RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 32 (6th ed. 2003))).

¹⁷ Brian Z. Tamanaha, *The Primacy of Society and the Failures of Law and Development*, 44 CORNELL INT’L L.J. 209, 226 (2011).

¹⁸ de Soto, *supra* note 1.

¹⁹ See, e.g., Jeremy Clift, *Hearing the Dogs Bark: Jeremy Clift Interviews Development Guru Hernando de Soto*, FIN. & DEV., Dec. 2003, at 8, 8, <https://www.imf.org/external/pubs/ft/fandd/2003/12/pdf/people.pdf> [<https://perma.cc/ZPL7-LATJ>] (“In the early 1990s, [de Soto’s] proposed [property] reforms were credited with turning people in Peru against the Shining Path Maoist guerillas . . .”).

²⁰ *Order in the Jungle*, ECONOMIST (Mar. 13, 2008), <http://www.economist.com/node/10849115> [<http://perma.cc/8HKR-ALL2>] (“No other single political ideal has ever achieved global endorsement.”); see also Michael Trebilcock & Paul-Erik Veel, *Property Rights and Development: The Contingent Case for Formalization*, 30 U. PA. J. INT’L L. 397, 399 (2008) (“[I]t has become conventional wisdom . . . that, whatever else the state does, it should provide effective institutions and processes to protect private property rights and enforce contracts, which are regarded as pre-requisites to efficient and dynamic market economies.”).

²¹ See, e.g., Trebilcock & Veel, *supra* 20, at 478.

²² See, e.g., HERNANDO DE SOTO, *THE MYSTERY OF CAPITAL: WHY CAPITALISM TRIUMPHS IN THE WEST AND FAILS EVERYWHERE ELSE* 5–7 (2000).

²³ See, e.g., Donald C. Clarke, *Economic Development and the Rights Hypothesis: The China Problem*, 51 AM. J. COMP. L. 89, 111 (2003) (“[I]t would be profoundly misleading to view the real barrier to economic development in such a society as the lack of an effective formal legal system.”); see also Samuli Seppänen, *Ideological Renewal and Nostalgia in China’s “Avant-Garde” Legal Scholarship*, 13 WASH. U. GLOBAL STUD. L. REV. 83 (2014) (discussing efforts to develop alternatives to law and development dogma).

This Note will argue that the VIE provides a natural foil to those who dogmatically believe that strong property rights are a necessary condition for economic growth while additionally helping to locate and analyze the theory's primary inflection points. Accordingly, my analysis will progress in four parts. First, I will provide a detailed description of the VIE structure, outline the example of Alibaba, and explore how that example presents issues for true believers in the correlation between property rights and economic development. Part II will present an explanation of the property rights and economic growth nexus, the "Property Rights Nexus." Part III will analyze the effects of documented ownership, culture, and predictability on the Property Rights Nexus. Finally, Part IV will present a few closing implications and will qualify my analysis. A brief conclusion will follow. Through my examination, I hope to show that the orthodox view of property rights as a tool of economic development is far too rigid; simultaneously, I suggest that China's recent growth presents a unique locus for further study.

I. THE VIE AS A POTENTIAL FOIL

Years ago, we here at China Law Blog made clear our views on VIEs and nothing about those views has changed. . . . In a nutshell, we don't like them, don't trust them, and don't do them.[‡]

China is a problematic example for true believers in the Property Rights Nexus. Today in the People's Republic of China (PRC), both the rule of law generally, and property rights specifically, are weak; but China has nonetheless experienced thirty years of sustained, frenetic growth.²⁴ Against this background, the VIE presents clear evidence in support of the basic assertion that property rights, at least in their pure form, are not a necessary condition for growth. This Section will proceed in three parts. First, it will explain the VIE and its origins. Second, it will outline the recent example of Alibaba. Finally, it will analyze the problems VIEs pose for the Property Rights Nexus.

A. *The General VIE Structure*

At its core, the VIE is a contractual relationship. Foreign investors buy stock in a company that has an agreement with the target business in China. This arrangement promises a share of the profits earned by the target. The

[‡] Dan Harris, *Buying into a China VIE. What Me Worry?*, CHINA L. BLOG (June 17, 2013), <http://www.chinalawblog.com/2013/06/buying-into-a-china-vie-what-me-worry.html> [<http://perma.cc/QT4Z-4X7Q>].

²⁴ Jane Haltmaier, *Challenges for the Future of Chinese Economic Growth* 1 (Bd. of Governors of the Fed. Reserve Sys., Internal Finance Discussion Paper No. 1072, 2013).

Chinese company receives capital and the foreign investors make money. All parties are satisfied.

The origin of the VIE is generally traced to the IPO of Sina.com in 2000.²⁵ In the years since, it has grown exponentially in popularity such that today, “[a]ll of China’s major Internet companies that list on U.S. exchanges use the VIE structure.”²⁶ The list reads like a roster of China’s biggest and best companies: Sina.com, Baidu, Tencent, and Alibaba.²⁷ They are the dominant players in China’s emerging economy and have the associated political and social connections that one would expect.²⁸ However, prior to the development of the VIE structure, this notable group consistently lacked a means of financing their continued growth.

The reasons for this are largely institutional. Traditionally, companies have three primary means of securing financing: (1) accepting bank financing, (2) entering debt capital markets, or (3) entering equity capital markets. In China, each is problematic. First, Chinese banks will not lend because of ideological considerations and government restrictions.²⁹ Second, the local Chinese stock exchanges are poorly developed, and were designed primarily to restructure state-owned enterprises.³⁰ Moreover, it is almost impossible for Chinese companies to receive permission to list in foreign markets,³¹ and foreign investors are prohibited from owning majority stakes in companies that implicate national security (e.g., Internet companies).³² As a result, the VIE structure has become a convenient, and perhaps necessary, method of circumventing the restrictions—both practical and regulatory—that hamper the growth of Chinese companies by

²⁵ Li, *supra* note 7, at 47.

²⁶ ROSIER, *supra* note 8, at 3.

²⁷ See Sue-Lin Wong, *China Court Ruling Could Threaten Foreign Investments in Country*, N.Y. TIMES: IHT RENDEZVOUS (June 17, 2013, 3:09 AM), http://rendezvous.blogs.nytimes.com/2013/06/17/china-court-ruling-could-threaten-some-foreign-invested-companies/?_php=true&_type=blogs&_r=0 [<http://perma.cc/VHU4-NCRP>].

²⁸ See, e.g., Teddy Ng & Cary Huang, *Xi Jinping Arrives in Seoul with Huge Business Delegation as Beijing Aims to Boost Trade Ties*, S. CHINA MORNING POST (July 3, 2014, 8:32 PM), <http://www.scmp.com/news/china/article/1545181/huge-business-delegation-accompanies-xi-jinping-seoul> [<http://perma.cc/S9Y4-W4RR>] (discussing a Chinese trade delegation sent to South Korea that included many prominent technology CEOs).

²⁹ Ma Mengwei, *supra* note 9, at 1064–65 (“Banks in China usually lack incentives to lend to private enterprises as a result of ideological concerns and government interference in bank lending . . .”).

³⁰ *Id.* at 1065.

³¹ See ROSIER, *supra* note 8, at 2.

³² Dan Harris, *VIEs in China. The End of a Flawed Strategy.*, CHINA L. BLOG (Oct. 10, 2011), http://www.chinalawblog.com/2011/10/vies_in_china_the_end_of_a_flawed_strategy.html [<https://perma.cc/P3TF-MQJR>].

connecting the willing foreign investor with a willing Chinese investment target.³³

I. Financial Benefit.—The actual mechanics of the VIE process are somewhat more complicated. First, a parent company is incorporated in a tax haven, often the Cayman Islands.³⁴ The parent company then creates a WFOE³⁵ in China to act as a conduit between the tax-haven entity and the Chinese target.³⁶ Next, the WFOE enters into a series of contracts.³⁷ These contracts provide the WFOE, and the associated foreign investor, a right to substantially all profits and a semblance of control.³⁸ The former goal is achieved through two individual contracts: an “exclusive service agreement” and an “asset licensing agreement,” both of which are between the WFOE and the VIE.³⁹ The exclusive service agreement traditionally allows for the “WFOE [to provide] certain services to the VIE for a fee, [which is] typically determined by the WFOE with the intended result of shifting the VIE’s operating profits to the WFOE. The scope of service varies depending on the industry, but typically includes consulting or

³³ While this may seem like a fairly broad statement, there is ample support for its core contention that growth capital is extremely difficult to obtain for many Chinese companies. *See, e.g.*, Neil Gregory & Stoyan Tenev, *The Financing of Private Enterprise in China*, FIN. & DEV., Mar. 2001, at 14, 14, (“Despite its growing importance, at the end of 1999, the private sector accounted for only 1 percent of bank lending, and only 1 percent of the companies listed on the Shanghai and Shenzhen stock exchanges were nonstate firms. The discrepancy between the dynamism of the private sector and its limited use of intermediated financing suggests that the private sector may not be able to sustain its current rate of growth unless it can increase its access to financing.”). This problem continues to the present day. *See* Paul L. Gillis, *Accounting Matters: Variable Interest Entities in China*, GUEST SERIES (Forensic Asia, Hong Kong, China), Sept. 18, 2012, at 1, <http://www.chinaaccountingblog.com/vie-2012septaccountingmatte.pdf> [<http://perma.cc/GD7T-GXB4>] (“Private companies in China have had difficulty in getting access to capital and have looked to foreign investors as a source of funds. Unfortunately, Chinese companies need permission to list overseas and foreign companies are restricted from operating in certain domestic sectors.”); *see also* ROSIER, *supra* note 8, at 2 (“As China’s leading Internet companies expand, they are unable to obtain sufficient capital domestically and are turning to foreign investors by listing on non-Chinese exchanges, most commonly in the United States.”).

³⁴ Ma Mengwei, *supra* note 9, at 1063.

³⁵ To understand the adoption of this investment structure, a bit of background is necessary. Generally, there are two primary means of foreign direct investment: mergers and acquisitions (M&A) and greenfield investments. Hui Huang, *The Regulation of Foreign Investment in Post-WTO China: A Political Economy Analysis*, 23 COLUM. J. ASIAN L. 185, 187 (2009). Traditionally, M&A has been disfavored as a means of investing in China, causing greenfield investments to emerge as the most prominent form of investment. *See id.* at 187–88. Greenfield investments refer to investment through the creation of a new company. Kevin C. Kennedy, *A WTO Agreement on Investment: A Solution in Search of a Problem?*, 24 U. PA. J. INT’L ECON. L. 77, 79 n.5 (2003). Within the range of greenfield investments, WFOEs have emerged as a popular structure, and exist in contrast to other forms of greenfield investment, such as joint ventures, in that they are controlled exclusively by the foreign investor. Huang, *supra*, at 196.

³⁶ Ma Mengwei, *supra* note 9, at 1063.

³⁷ *Id.*

³⁸ Roberts & Hall, *supra* note 13, at 2–3.

³⁹ *Id.* at 3.

strategic services and technical services.”⁴⁰ For example, the Chinese VIE Weibo structured its exclusive service agreement such that the WFOE provided distribution, sale, agency, and technical support services in exchange for substantially all of the economic benefit of the VIE.⁴¹

The asset licensing agreement serves a similar purpose as “the WFOE licenses certain assets, typically including intellectual property, to the VIE for royalty fees . . . [and] usually allows the WFOE to terminate the license at any time.”⁴² Accordingly, the WFOE secures “additional control over the VIE if operation of the VIE relies on the assets that are the subject of the license.”⁴³ Returning to the example of Weibo mentioned above, the asset licensing agreement in that structure provides that the WFOE licensed trademarks in exchange for \$79.2 million in 2013.⁴⁴

2. *Effective Control.*—Effective control is usually achieved through four contracts entered into between the WFOE and the primary (local Chinese) shareholders of the VIE.⁴⁵ They include (1) a “call option agreement,” (2) an “equity pledge agreement,” (3) a “voting rights agreement,” and (4) a “loan agreement.”⁴⁶ The call option agreement allows “the VIE’s shareholders [to] grant an option for the WFOE or the WFOE’s designee to purchase all or a portion of their equity interest in the VIE through one or a series of transactions.”⁴⁷ This provides a contractual mechanism for seizing control if the VIE equity holders fail to live up to their side of the bargain.⁴⁸ In other words, if the VIE equity holders violate their agreements, then the investor can seize the VIE equity holders’ shares, taking control of the company.

The equity pledge agreement requires “the VIE’s shareholders [to] pledge their equity interest in the VIE to the WFOE as a guarantee of the performance of their and the VIE’s obligations under other VIE structure agreements.”⁴⁹ Again, this provides the WFOE with security by threatening

⁴⁰ *Id.*

⁴¹ While there were actually multiple agreements, their cumulative effect is the same as if they were a single document. *See* Weibo Corp., Amendment No. 3 to Form F-1 Registration Statement under the Securities Act of 1933 (Form F-1), at 69 (Apr. 14, 2014) [hereinafter Weibo].

⁴² Roberts & Hall, *supra* note 13, at 3.

⁴³ *Id.*

⁴⁴ In this particular instance, the agreement was referred to as a “trademark license agreement.” Weibo, *supra* note 41, at 69.

⁴⁵ Roberts & Hall, *supra* note 13, at 2. The primary shareholder is usually a company insider, and often the founder. *Id.*

⁴⁶ *Id.* at 2–3.

⁴⁷ *Id.* at 2.

⁴⁸ *See id.*

⁴⁹ *Id.*

the VIE equity holders with possible forfeiture of their shares should they violate the agreement.

Under the voting rights agreement “the VIE’s shareholders delegate their shareholder rights, including voting rights, inspection/information rights, signing rights and election rights, to the designee of the WFOE.”⁵⁰ The agreement thus provides the investor with all of the political rights⁵¹ associated with traditional ownership, further securing the investment.

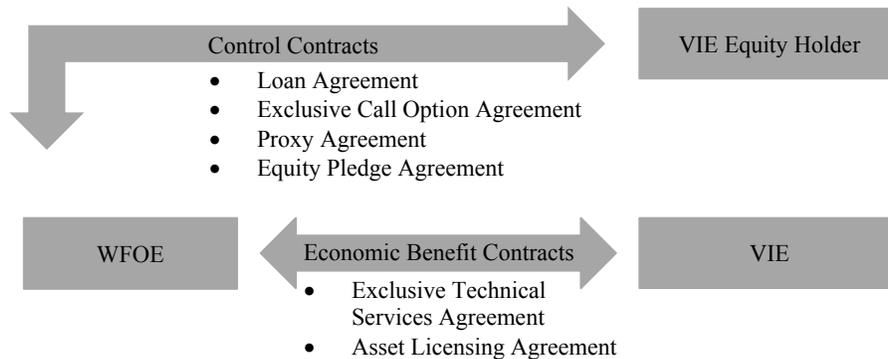
Finally, the loan agreement grants “a loan to the shareholder to use for capitalization of the VIE. The loan agreement typically includes stringent covenants, limits on repayment methods and acceleration clauses designed to help in enforcing the VIE structure as a whole.”⁵² This agreement both capitalizes the VIE and provides an additional, final layer of control.

While the VIE contracts discussed above may appear to provide investors with adequate control—at least in comparison to a traditional investment—under a VIE arrangement, all of the relevant assets and licensing remain legal property of the Chinese VIE. Thus, as discussed further below, it is an investment structure that requires a tremendous amount of faith, understanding, goodwill, and, most importantly, luck. The contours of the structure are outlined in Figure 1 below.

⁵⁰ *Id.* at 3.

⁵¹ By political rights I mean the noneconomic rights that an investor traditionally receives, such as the ability to vote and accordingly exert control.

⁵² Roberts & Hall, *supra* note 13, at 3.

FIGURE 1⁵³:

B. The Example of Alibaba

An examination of the structure used by Alibaba in its September 2014 IPO is both clarifying and illuminating. As background, Alibaba is “the largest online and mobile commerce company in the world in terms of gross merchandise volume.”⁵⁴ For all intents and purposes, it is an ecosystem of online wizardry, encompassing a Chinese eBay, Amazon, PayPal, Twitter, and YouTube.⁵⁵ It is also a clear example of the use of a VIE as a listing mechanism, the mechanics of which are explained below.

As a preliminary matter, it is helpful to understand the relevant players. The company ultimately listed in the United States is a Cayman Islands entity called Alibaba Group Holding Limited. Through a series of subsidiary entities, five WFOEs were created in China, including (1) Taobao (China) Software Co., Ltd., (2) Zhejiang Tmall Technology Co., Ltd., (3) Hangzhou Alimama Technology Co., Ltd., (4) Alibaba (China) Technology Co., Ltd., and (5) Alisoft (Shanghai) Co., Ltd.⁵⁶ The five WFOEs corresponded to five VIEs, which were (1) Zhejiang Taobao Network Co., Ltd., (2) Zhejiang Tmall Network Co., Ltd., (3) Hangzhou

⁵³ Alibaba Grp. Holding Ltd., Prospectus (Form 424(b)(4)), at 90 (Sept. 18, 2014) [hereinafter Alibaba Prospectus].

⁵⁴ *Id.* at 1.

⁵⁵ Chris Wright, *So What Exactly Is Alibaba?*, FORBES (Sept. 16, 2014, 5:00 AM), <http://www.forbes.com/sites/chriswright/2014/09/16/so-what-exactly-is-alibaba/> [http://perma.cc/Y3AJ-SVPZ] (“On top of its core sites it owns alipay.com, a Chinese equivalent of Paypal; and has large stakes in Sina Weibo, China’s version of Twitter; and Youku Tudou, the closest Chinese equivalent to YouTube.”).

⁵⁶ Alibaba Prospectus, *supra* note 53, at 88, 90.

Ali Technology Co. Ltd., (4) Hangzhou Alibaba Advertising Co., Ltd., and (5) Alibaba Cloud Computing Ltd.⁵⁷ The equity owners of all the VIEs are Jack Ma, Alibaba’s founder, and Simon Xie, a trusted colleague.⁵⁸ The following chart provides a brief summary of the relevant corporate entities.

TABLE 1⁵⁹:

WFOE	VIE	Nature of Business
Taobao (China) Software Co., Ltd.	Zhejiang Taobao Network Co., Ltd.	Offers an online consumer-to-consumer marketplace. ⁶⁰
Zhejiang Tmall Technology Co., Ltd.	Zhejiang Tmall Network Co., Ltd.	Provides a “third-party platform for brands and retailers.” ⁶¹
Hangzhou Alimama Technology Co., Ltd.	Hangzhou Ali Technology Co. Ltd.	Offers a “marketing technology platform, which provides . . . marketing services including valuable data insights.” ⁶²
Alibaba (China) Technology Co., Ltd.	Hangzhou Alibaba Advertising Co., Ltd.	Provide services primarily related to “the operations of [Alibaba’s] wholesale marketplaces.” ⁶³
Alisoft (Shanghai) Co., Ltd.	Alibaba Cloud Computing Ltd.	“[O]ffers a complete suite of cloud computing services, including elastic computing, database services and storage and large scale computing services for our platforms and the platforms of companies integral to [Alibaba’s] ecosystem.” ⁶⁴

The WFOEs traditionally enter into a series of contracts both with the VIE and with the primary equity owners of the VIE in order to gain effective control and receive substantially all economic benefit from the

⁵⁷ *Id.* at 88–89.

⁵⁸ The shares are divided between Ma and Xie on an 80–20 split. *Id.* at 89. The only exception is Zhejiang Taobao Network Co., Ltd., which has a 90–10 split between Ma and Xie. *Id.*

⁵⁹ *See id.* at 88.

⁶⁰ *Id.* at 86.

⁶¹ *Id.* at 1.

⁶² *Id.* at 161.

⁶³ *Id.* at F-39.

⁶⁴ *Id.* at 103.

organization. Alibaba is no different. Here, investor control is secured through the typical four contracts: (1) a loan agreement,⁶⁵ (2) an exclusive call option agreement,⁶⁶ (3) a proxy agreement,⁶⁷ and (4) an equity pledge agreement.⁶⁸ “The parties to the . . . agreement[s] . . . are Jack Ma and Simon Xie on the one hand, and . . . the respective [WFOEs] on the other hand.”⁶⁹ These contracts differ from the benefit contracts, discussed below, in that they are between the WFOE and the VIE equity holders.

The ability to receive substantially all economic benefit is secured through Exclusive Technical Services Agreements. The parties to these agreements, unlike the control contracts, are the VIEs and the WFOEs. The agreements specifically require that:

[T]he relevant [WFOE] provides exclusive technical services to the [VIE]. In exchange, the [VIE] pays a service fee to the [WFOE] which typically amount[s] to what would be substantially all of the [VIE’s] pre-tax profit (absent the service fee), resulting in a transfer of substantially all of the profits from the [VIE] to the [WFOE].⁷⁰

Thus, profits are shuttled from the heavily regulated VIE to the less regulated WFOE, without technically violating Chinese regulations. An illustrative diagram is below.

⁶⁵ According to this contract, the relevant WFOEs have “granted an interest-free loan to the relevant [VIE] equity holders, which may only be used for the purpose of a capital contribution to the relevant [VIE] or as may be otherwise agreed by the [WFOE].” *Id.* at 90.

⁶⁶ This agreement grants “the [WFOE] an exclusive call option to purchase their equity interest in the [VIE] at an exercise price equal to the higher of (i) the registered capital in the [VIE]; and (ii) the minimum price as permitted by applicable PRC laws. Each relevant [VIE] has further granted the relevant [WFOE] an exclusive call option to purchase its assets at an exercise price” *Id.*

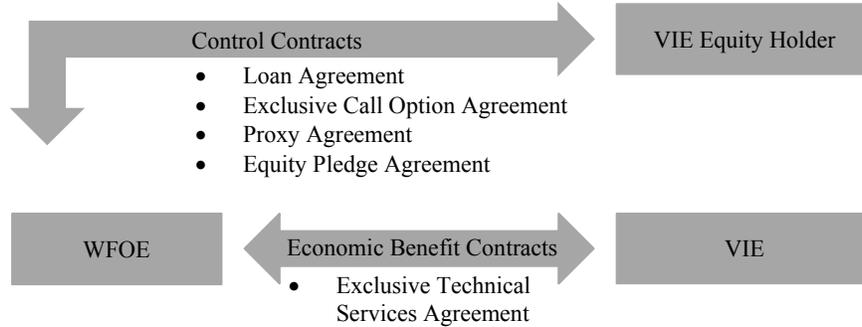
⁶⁷ This contract “irrevocably authorizes any person designated by the [WFOE] to exercise his rights as an equity holder of the [VIE], including the right to attend and vote at equity holders’ meetings and appoint directors.” *Id.* at 91.

⁶⁸ According to this contract, “the relevant [VIE] equity holders have pledged all of their interests in the equity of the [VIE] as a continuing first priority security interest in favor of the [WFOE] to secure the outstanding amounts advanced under the relevant loan agreements described above and to secure the performance of obligations by the [VIE] and/or its equity holders under the other structure contracts.” *Id.*

⁶⁹ *Id.* at 90. The WFOEs include Taobao (China) Software Co., Ltd.; Zhejiang Tmall Technology Co., Ltd.; Hangzhou Alimama Technology Co., Ltd.; Alibaba (China) Technology Co., Ltd.; and Alisoft (Shanghai) Co., Ltd. *Id.*

⁷⁰ *Id.* at 91.

FIGURE 2⁷¹:



The above system of contracts “collectively enable[s investors] to exercise effective control over the [VIEs] and realize substantially all of the economic risks and benefits arising from [them].”⁷² Interestingly, if not troublingly, Alibaba uses this system to “generate the significant majority of [its] revenue directly through [their WFOEs], which directly capture the profits and associated cash flow from operations.”⁷³ That is to say, the economic value of the company launched in September 2015 is tied up in contractually-based control and benefit rights that dramatically differ from traditional ownership. Moreover, this arrangement is further problematized, as discussed below, by the possible unenforceability of the underlying contracts.⁷⁴

C. The VIE and Development Dogma

The VIE structure presents a direct challenge to the Property Rights Nexus. It does so in two ways. First, the contract-based ownership system does not provide the clean title envisioned by most law and development theorists, and consequently raises issues related to control. Second, the ownership claim of the investor is likely judicially unenforceable.

1. *Inability to Control.*—Control rights are implicated in two ways. The first is present in all VIE relationships, while the second need not necessarily be so. Both, particularly when read together, raise serious questions about the ability of the investor to exercise control.

⁷¹ *Id.* at 90.

⁷² *Id.* at 89.

⁷³ *Id.*

⁷⁴ See *infra* Section I.C.2.

First, investors maintain effective control of the various VIEs through a series of four contracts.⁷⁵ Naturally, the effectiveness of the investor's control right is dependent on the cooperation of the equity holders. Returning to the example of Alibaba, the risks of this structure become immediately apparent. As explained in the company's IPO Prospectus, "[t]hese contractual arrangements may not be as effective as direct ownership in providing us with control over our [VIEs]."⁷⁶ According to the proxy agreement, the investor has the right to appoint the directors, providing the appearance of true ownership with the added caveat of a middleman.⁷⁷ However, because of this middleman, "[u]nder [the] contractual arrangements, [the investor] may not be able to directly change the members of the boards of directors . . . and would have to rely on the [VIEs] and the [VIE] equity holders to perform their obligations in order to exercise our control over the [VIEs]."⁷⁸ This type of issue is likely to occur in situations where "[t]he variable interest entity equity holders . . . have conflicts of interest with . . . shareholders, and . . . [do] not act in the best interests of [the] company or [do] not perform their obligations under these contracts."⁷⁹ Simply put, the "[VIEs] and their respective equity holders could breach their contractual arrangements with [the company] by . . . failing to conduct their operations . . . or taking other actions that are detrimental to [the company's] interests."⁸⁰ The incentives for doing so could range from regulatory, as discussed below, to more illicit conduct.⁸¹ As a result, the level of control, and the security of that control, is dependent on the cooperation of the equity-holding middleman.⁸²

Second, according to the articles of association of Alibaba Group Holdings Limited (the Cayman Islands entity), a partnership of insiders,

⁷⁵ See *supra* Sections I.A–B.

⁷⁶ See Alibaba Prospectus, *supra* note 53, at 50.

⁷⁷ See *id.* at 91. Specifically, the VIE equity holders, Jack Ma and Simon Xie, have authorized any person chosen by the WFOE to exercise their rights to attend and vote at equity meetings and to appoint directors. *Id.* The VIE equity holders could, however, become obstructionist by simply appearing at meetings and attempting to exercise their voting and appointment rights as if the proxy agreement did not exist. Understanding the difficulty of enforcing these contracts in Chinese courts, it is a relationship that accordingly requires the cooperation of the VIE equity holder.

⁷⁸ *Id.* at 50.

⁷⁹ *Id.*

⁸⁰ *Id.* A recent example of this issue is that of Yahoo! and Alipay discussed below in Section I.C.2, where substantial assets were transferred in violation of the VIE contracts.

⁸¹ For a general discussion of the dangers of investing in Chinese companies, including VIEs, see Nancy A. Peterman et al., *Recovering Assets in China: Practicalities and Pitfalls*, CLIENT ADVISORY (Greenberg Traurig LLP, Chicago, Ill.), Aug. 2014, <http://www.gtlaw.com/News-Events/Publications/Published-Articles/178831/Recovering-Assets-in-China-Practicalities-and-Pitfalls> [<http://perma.cc/WZQ4-U7NL>] (follow "View Media" hyperlink).

⁸² See *supra* Section I.A.2.

referred to as the Alibaba Partnership, will have the right to nominate a majority of the board of directors.⁸³ Accordingly, “the Alibaba Partnership will forever control the board, regardless of the size of the stake held by the Partnership’s members.”⁸⁴ The Alibaba investor will consequently never be able to gain control of the company, and as a result, enjoys a very weak ownership right.

2. *Judicially Unenforceable.*—Complicating the control issue is the difficulty of enforcing the underlying VIE contracts in Chinese courts if a violation were to occur.⁸⁵ In particular, there is tremendous amount of ambiguity surrounding the VIE’s legality and a healthy level of skepticism as to the objectivity of the Chinese judicial system.

As a preliminary matter, Chinese law prohibits foreign investors from owning a controlling stake in companies involved in certain sensitive industries.⁸⁶ The technology space is one such industry. This clear legal rule is complicated, however, by two competing forces: (1) judicial dismissal of the VIE contracts as unenforceable and (2) wide-spread toleration of the VIE structure.

The clearest, and perhaps most damning, example of judicial dismissal of the VIE contracts as unenforceable is the 2012 case of Chinachem Financial Services. The facts were simple. Nina Wang, Asia’s richest woman and a Hong Kong resident,⁸⁷ sought to buy a stake in China Minsheng Banking Corporation.⁸⁸ Banking, like the Internet sector, is a heavily regulated space and direct foreign ownership is discouraged by

⁸³ Alibaba Prospectus, *supra* note 53, at 230.

⁸⁴ Lucian Bebchuk, *Alibaba’s Governance Leaves Investors at a Disadvantage*, N.Y. TIMES: DEALBOOK (Sept. 16, 2014, 2:00 PM), http://dealbook.nytimes.com/2014/09/16/alibabas-governance-leaves-investors-at-a-disadvantage/?_r=1 [<http://perma.cc/MV4U-SFM2>].

⁸⁵ The importance of Chinese courts as an enforcement venue is rooted in the fact that the contracts are between three parties: the WFOE, the VIE, and the VIE equity holders, all of whom reside in China. See ROSIER, *supra* note 8, at 5. Moreover, pursuing the enforcement of Chinese contracts abroad has proven consistently ineffective. See Steve Dickinson, *The Three Rules for Your China Contract*, CHINA L. BLOG (Apr. 24, 2013), <http://www.chinalawblog.com/2013/04/the-three-rules-for-your-china-contract.html> [<http://perma.cc/A4NX-LNB3>] (“Chinese courts will **not** enforce US court judgments. Thus, any judgment obtained in a US court cannot be enforced in China. If the Chinese party has no assets located in the United States, the judgment is effectively worthless.”).

⁸⁶ The current list of sensitive industries includes “[n]ew-generation information technology, high-end equipment manufacturing, advanced materials, alternative-fuel cars, energy conservation and environmental protection, alternative energy, and biotechnology.” U.S.-CHINA ECON. & SEC. REVIEW COMM’N, 2011 REPORT TO CONGRESS 91 (2011), http://origin.www.uscc.gov/sites/default/files/annual_reports/annual_report_full_11.pdf [<http://perma.cc/4GXU-WUHS>].

⁸⁷ While Hong Kong is a part of China, Hong Kong residents are considered foreign for purposes of investment. See Neil Gough, *In China, Concern About a Chill on Foreign Investments*, N.Y. TIMES: DEALBOOK (June 2, 2013, 2:15 PM), http://dealbook.nytimes.com/2013/06/02/in-china-concern-of-a-chill-on-foreign-investments/?_r=0 [<http://perma.cc/KVK7-8ZJ7>].

⁸⁸ *Id.*

China's regulatory regime.⁸⁹ Accordingly, Ms. Wang instead used a number of contracts to gain control of the bank⁹⁰ in a way that mirrored in function, but not form, the current VIE structure.⁹¹ Specifically, "Ms. Wang's Hong Kong company, Chinachem Financial Services, used a series of contracts to effectively gain economic control over a mainland Chinese firm, which in turn acted as a proxy to buy and hold the stake in the new bank, the China Minsheng Banking Corporation."⁹²

Chinachem and Ms. Wang soon developed friction over the ownership and dividends of bank shares, and litigation ensued.⁹³ Ms. Wang lost. In handing down an adverse judgment, the Supreme People's Court, the highest judicial body in China, found that the investment structure had "conceal[ed] illegal intentions with a lawful form."⁹⁴ That is to say, ownership structures intended to avoid Chinese regulation were inherently illegal. More relevant to the question at hand, the court's holding appeared to implicate the VIE—a structure specifically designed to circumvent Chinese regulation—and leave it dead in the water.

In addition to the Chinachem case, there have been further indicators of hostility to the VIE. Most notably, in 2011 Shanghai's arbitration board⁹⁵ invalidated the VIE investment structure of a gaming company, GigaMedia, finding the company guilty of concealing "illegal intentions with a lawful form."⁹⁶ Read broadly and recognizing the politicized nature of the Chinese legal and regulatory space, this would seem to suggest that

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ *See id.* ("The loopholes used by foreign investors in China, and by Chinese companies seeking to list on overseas stock markets, have become more sophisticated since Ms. Wang made her play for the stake in Minsheng bank.").

⁹² *Id.*

⁹³ *Id.*

⁹⁴ Shai Oster & Dune Lawrence, *Baidu Forced to Add Warnings as Regulators Focus on China Stocks*, BLOOMBERG (Dec. 15, 2013, 4:27 PM), <http://www.bloomberg.com/news/2013-12-15/baidu-forced-to-add-warnings-as-regulators-focus-on-china-stocks.html> [<http://perma.cc/5ZPJ-XE2T>].

⁹⁵ While China follows a civil law system in which precedent is not binding, the court system, the Communist Party, and the state are so intertwined that a decision by one can be, and is often, viewed as an informed decision by all. *See* Benedict Sheehy, *Fundamentally Conflicting Views of the Rule of Law in China and the West & Implications for Commercial Disputes*, 26 NW. J. INT'L L. & BUS. 225, 234 (2006) ("In China, the CCP, the government, and the people's will are one—at least according to the official view. Therefore, they exist simply as a unified whole and not merely as a collection of three independent parties or interests forced together."); *see also* Donald C. Clarke, *The Chinese Legal System* (July 4, 2005), <http://docs.law.gwu.edu/facweb/dclarke/public/ChineseLegalSystem.html> [<http://perma.cc/9W6K-BGC6>] ("As it rejects the notion of vertical separation of powers, the PRC also rejects the notion of horizontal separation of powers between different branches of government (for example, the traditional troika of legislative, executive, and judicial branches).").

⁹⁶ Charles Comey et al., *China VIEs: Recent Developments and Observations*, CLIENT ALERT (Morrison & Foerster LLP, San Francisco, Cal.) Apr. 13, 2013, <http://media.mfo.com/files/Uploads/Images/130716-Variable-Interest-Entities-China.pdf> [<http://perma.cc/UZC5-WVXA>].

the VIE was no longer a viable investment structure—and yet, as discussed below, money continues to flow into VIEs and economic growth continues.

Further complicating this situation are examples of soft regulation, in which the regulatory enforcement is overtly suggested but never explicitly pursued. The most famous example of this issue is the 2011 Alipay dispute between Alibaba and Yahoo!. The episode began in 2005 when Yahoo! acquired a 40% stake in Alibaba for \$1 billion.⁹⁷ The relationship prospered until 2011 when Alibaba unilaterally announced that it had restructured itself, handing 100% of Alipay, one of the company's most valuable assets, to a Chinese domestic company.⁹⁸ The move was prompted by a fax from the People's Bank of China (PBOC) asking Alipay to declare if it had a VIE relationship with any overseas entities.⁹⁹ The fax was prompted by a series of new regulatory systems implemented by the PBOC, which required nonfinancial institutions that provide payment services to apply for and receive a payment service license.¹⁰⁰ "This fax implicitly indicated that Alipay's application would not be accepted unless it [was] a pure Chinese-owned company without any VIE type of arrangement."¹⁰¹ Left with no choice but compliance, the company transferred Alipay to another Jack Ma controlled entity.¹⁰² Yahoo! and Alibaba eventually settled out of court.¹⁰³

Having explained the unenforceability of the VIE contracts, the widespread toleration of the VIE form is as easy to demonstrate as it is deceptive. Today there are approximately 100 Chinese technology companies that use the VIE structure.¹⁰⁴ Not only does the Chinese government allow VIEs to exist, but with Alibaba's recent IPO, it has allowed them to grow in number and include one of the premier Chinese technology brands. The strength of this observation increases when one considers the chronology of Alibaba's IPO relative to Chinachem. The Chinachem decision was handed down in 2012,¹⁰⁵ yet Alibaba went public

⁹⁷ *Yahoo Buys US \$1 Billion Stake in Alibaba*, CHINADAILY (updated Aug. 11, 2005, 10:01 PM), http://www.chinadaily.com.cn/english/doc/2005-08/11/content_468252.htm [http://perma.cc/PXT6-M8JG]; see also John Foley, *Yahoo's Alibaba Problem*, FORTUNE (July 31, 2013, 6:16 PM), <http://fortune.com/2013/07/31/yahoos-alibaba-problem/> [http://perma.cc/RQQ6-W33Q].

⁹⁸ See Shen Wei, *Will the Door Open Wider in the Aftermath of Alibaba?—Placing (or Misplacing) Foreign Investment in a Chinese Public Law Frame*, 42 H.K. L.J. 561, 562 (2012).

⁹⁹ *Id.* at 563.

¹⁰⁰ *See id.* at 577.

¹⁰¹ *Id.* at 563.

¹⁰² *Id.* at 564.

¹⁰³ *Id.*

¹⁰⁴ See Gough, *supra* note 87.

¹⁰⁵ Oster & Lawrence, *supra* note 94.

in September 2014 using a similar structure.¹⁰⁶ The PRC had plenty of time to act. It instead chose not to. As a result, the concerted silence of the PRC and its regulatory organs has become the norm and is read, by some, as a tacit form of official acceptance.¹⁰⁷

Tellingly, the confusion inherent in this discussion is no less palpable in the current practice of law. Specifically, in the run-up to the IPO, Alibaba's counsel found that:

[T]he ownership structures of our material [WFOEs] and our material [VIEs] . . . do not and will not violate any applicable PRC law, regulation or rule currently in effect; and the contractual arrangements between our material [WFOEs], our material [VIEs] and their respective equity holders governed by PRC law are valid, binding and enforceable However, Fangda Partners has also advised us that *there are substantial uncertainties regarding the interpretation and application of current PRC laws, rules and regulations*. Accordingly, the PRC regulatory authorities and PRC courts may in the future take a view that is contrary to the opinion of our PRC legal counsel.¹⁰⁸

The reality at the core of this observation has led certain commentators to lament that “VIEs are doomed,” recognizing that “[t]hey work until you need them to work and then they won't at any point you need to enforce the agreement because you can't. There's no evidence of anyone successfully enforcing a VIE.”¹⁰⁹

II. ECONOMICS AND THE RULE OF LAW: THE QUESTION OF PROPERTY

[P]roperty law is not a silver bullet, but it is the missing link.^{††}

In contrast to the weak property right presented by the VIE, today there is a dominant consensus that property rights are a necessary condition for economic growth.¹¹⁰ The academy's emphasis on the rule of law is, however, a recent change. Previously the dominant mode of thought was

¹⁰⁶ See Gordon G. Chang, *China Can Expropriate Alibaba's Business—And it Just Might*, FORBES (May 11, 2014, 6:24 PM), <http://www.forbes.com/sites/gordonchang/2014/05/11/china-can-expropriate-alibabas-business-and-it-just-might/> [<http://perma.cc/5S7U-XUQ9>].

¹⁰⁷ See Roberts & Hall, *supra* note 13, at 4 (“Although the structure has never formally been blessed by any PRC regulatory body, its tacit acceptance by key regulators including MOFCOM, the PRC State Administration of Foreign Exchange (‘SAFE’) and MIT has been crucial to its continued prevalence.”); see also ROSIER, *supra* note 8, at 2 (“Chinese Internet companies make no secret of their overseas listings, and Chinese state-run media report on them without questioning their legality under Chinese law.”).

¹⁰⁸ Alibaba Prospectus, *supra* note 53, at 49 (emphasis added).

¹⁰⁹ Oster & Lawrence, *supra* note 94.

^{††} Clift, *supra* note 19, at 11.

¹¹⁰ See, e.g., Kevin E. Davis, *What Can the Rule of Law Variable Tell Us About Rule of Law Reforms?*, 26 MICH. J. INT'L L. 141, 142 (2004) (“It is now widely accepted that markets are unlikely to function in the absence of bodies of contract law and systems of property rights . . .”).

the Washington consensus, which “held that the best way for countries to grow was to ‘get the policies right.’”¹¹¹ However, the “collapse” of certain Asian and former-Soviet economies in the 1990s¹¹² disabused economists of their pure emphasis on policy, as countries that should have worked under the Washington model failed,¹¹³ and failed spectacularly.¹¹⁴ Accordingly, scholars began to shift their focus. They instead hypothesized that the “institutional setting of policymaking” mattered more than they had previously thought.¹¹⁵ They were sold on the rule of law, which has subsequently become dogmatic in the realm of development theory.¹¹⁶

A subset of rule of law advocacy that has risen to particular prominence in recent years—the Property Rights Nexus—hypothesizes that clearly delineated property rights are a necessary condition for economic development.¹¹⁷ The most prominent advocate of this particular theory is the Peruvian economist Hernando de Soto,¹¹⁸ who sees property rights as the “tip of the iceberg” for the rule of law and, consequently, economic development.¹¹⁹ In short, de Soto believes “[i]t is the unavailability of

¹¹¹ *Order in the Jungle*, *supra* note 20; see also Gordon Barron, *The World Bank & Rule of Law Reforms 2* (London Sch. of Econ. & Political Sci., Dev. Studies Inst., Working Paper No. 05-70, Dec. 2005), <http://www.lse.ac.uk/internationalDevelopment/pdf/WP/WP70.pdf> [<http://perma.cc/L6NA-UR7F>] (“The World Bank’s . . . ‘discovery’ of the Rule of Law . . . and [Rule of Law] reforms in the early 1990s is often held to be the result of a convergence of external factors, not least the perceived limitations of the so-called ‘Washington Consensus’ . . .”).

¹¹² *Order in the Jungle*, *supra* note 20.

¹¹³ One of the clearest examples of this phenomenon was the Asian currency collapse of 1997–1998. See *id.* The crisis began with the collapse of the Thai baht. Ramon Moreno, *What Caused East Asia’s Financial Crisis?*, FED. RESERVE BANK OF S.F. (Aug. 7, 1998), <http://www.frbsf.org/economic-research/publications/economic-letter/1998/august/what-caused-east-asia-financial-crisis/> [<https://perma.cc/RWV4-RMMN>]. The collapse caused a crisis of faith in the law and development world as many began to question their ability to correctly determine which policy was in fact correct. See *Order in the Jungle*, *supra* note 20.

¹¹⁴ A uniquely bad example is that of early post-Soviet Russia. See Paul Kirby, *Russia Economy: What is the Risk of Meltdown?*, BBC NEWS (Dec. 17, 2014), <http://www.bbc.com/news/world-europe-30492505> [<https://perma.cc/6ZSJ-QWDP>] (“Russians are reminded of the dark days of 1998, when President Boris Yeltsin’s government defaulted on its debt.”).

¹¹⁵ *Order in the Jungle*, *supra* note 20.

¹¹⁶ *Id.* (“No other single political ideal has ever achieved global endorsement . . .”).

¹¹⁷ See, e.g., Clift, *supra* note 19.

¹¹⁸ While certainly a vocal proponent for the relationship between property rights and economic development, the intellectual origins of de Soto’s theory stretch back to Coase and Demsetz. See Upham, *supra* note 16, at 563 (“This focus on courts and specifically on property law has its theoretical origins in Ronald Coase’s ‘The Problem of Social Cost.’ . . . Demsetz built on Coase’s insights to bring property rights to the foreground. . . . [He] argued that the assignment and nature of property rights are extremely important to the performance of the market.” (footnote omitted)).

¹¹⁹ Hernando de Soto, *Why Capitalism Works in the West but Not Elsewhere*, CATO INST., <http://www.cato.org/publications/commentary/why-capitalism-works-west-not-elsewhere> [<http://perma.cc/EUX4-AU42>] (originally printed in the *International Herald Tribune* on Jan. 5, 2001) (“It is an implicit legal infrastructure hidden deep within their property systems, of which ownership is but the tip of the iceberg.”).

[property rights] that explains why people who have adapted every other Western invention, from the paper clip to the nuclear reactor, have not been able to produce sufficient capital to make their domestic capitalism work.”¹²⁰

The logic of de Soto’s theory is simple. He believes that the primary impediment in the way of economic development is a lack of capital.¹²¹ He places the blame for this issue not on a lack of resources, but rather on the fact that the resources cannot be efficiently utilized—a phenomenon he refers to as “dead capital.”¹²² The reasons for dead capital’s proliferation are legion, although de Soto places particular blame on the inability of the poor to efficiently harness the resources that they currently possess.¹²³ Specifically, de Soto sees “houses built on land whose ownership rights are not adequately recorded, unincorporated businesses with undefined liability, [and] industries located where financiers and investors cannot see them.”¹²⁴ Simply put, de Soto sees economic resources held in “defective forms.”¹²⁵ This hinders the creation of a thriving marketplace and the ability of the population to engage with the public market.¹²⁶

Having thus located the sources of economic stagnation, not in policy, but rather in the lackluster delineation of ownership rights, de Soto’s solution is simple: emphasize and enforce property rights. Once this is done, “[l]egally created titles and stock certificates [will] generate investment; clear property records [will] guarantee credit; documents [will] allow people to be identified and helped; company statutes [will] pool resources for recovery; mortgages [will] raise money; [and] contracts [will] solidify commitments.”¹²⁷ The unassuming truth behind this theory is the idea that before capital can be used for purposes of economic growth, it must first be officially recognized.¹²⁸

A strikingly large number of prominent economists and institutions emphasize a similar regime. In particular, American presidents have been

¹²⁰ *Id.*

¹²¹ DE SOTO, *supra* note 22, at 5.

¹²² *Id.* at 5–7. De Soto defines capital fairly broadly, explaining that “[c]apital is the force that raises the productivity of labor and creates the wealth of nations.” *Id.* at 5.

¹²³ *Id.* at 5–6.

¹²⁴ *Id.*

¹²⁵ *Id.* at 5.

¹²⁶ *Id.* at 6 (discussing the general value of property rights in the marketplace).

¹²⁷ de Soto, *supra* note 1.

¹²⁸ de Soto, *supra* note 119 (“To be useful in an expanded market, capital must first be represented in a property document where it can be assigned a status that allows it to produce additional value.”).

enthusiastic about the theory,¹²⁹ think tanks have exclaimed “[p]rosperity and property rights are inextricably linked,”¹³⁰ and the World Bank has declared that “[p]roperty rights are at the heart of the incentive structure of market economies.”¹³¹ The practical implication of this widespread acceptance has been a sustained effort to foster the growth of legal regimes around the world, relying on the premise that legal regimes protect and foster property rights. For example, by 2004 the World Bank alone accounted for some 600 initiatives aimed at increasing the rule of law globally.¹³² The United States government has allocated resources to similar programs.¹³³ Most importantly, however, many developing economies have adopted rule of law initiatives in order to spur, maintain, and protect their economic growth.¹³⁴

¹²⁹ See, e.g., Clift, *supra* note 19, at 10 (describing President Bill Clinton as “a fan of de Soto’s work”).

¹³⁰ Gerald P. O’Driscoll Jr. & Lee Hoskins, *Property Rights: The Key to Economic Development* 1 (Cato Inst., Policy Analysis No. 482, 2003), <http://object.cato.org/sites/cato.org/files/pubs/pdf/pa482.pdf> [<http://perma.cc/HRY6-SRLL>].

¹³¹ Upham, *supra* note 16, at 557 (quoting WORLD BANK, *supra* note 16, at 48 (1996)); see also *id.* at 569 (“Secure property rights link effort with reward, assuring all firms . . . that they will be able to reap the fruits of their investments; New evidence confirms how important secure property rights can be; [T]he more secure the rights, the faster the growth; [T]he large number of [cross-national studies of hundreds of legal systems] all reaching the same conclusion led one commentator to observe that the link between secure property rights and growth has ‘withstood an unusually large amount of scrutiny.’” (alterations in original) (quoting WORLD BANK, WORLD DEVELOPMENT REPORT 2005: A BETTER INVESTMENT CLIMATE FOR EVERYONE 79–80 (2004))).

¹³² *Id.* at 559. An additional example is the American Bar Association’s Rule of Law Initiative, which partners with foreign organizations to promote the rule of law. See *Our Origins & Principles*, RULE OF LAW INITIATIVE, AM. BAR ASS’N, http://www.americanbar.org/advocacy/rule_of_law/about/origin_principles.html [<http://perma.cc/SJ7B-QSNP>].

¹³³ See, e.g., Paul Gewirtz, *The U.S.-China Rule of Law Initiative*, 11 WM. & MARY BILL RTS. J. 603, 604 (2003) (explaining an intergovernmental rule of law program that emerged under the premise that “[l]egal reform can enhance economic development, advance human rights, contribute to political reform, counter corruption, and improve China’s interactions with the international community”).

¹³⁴ See, e.g., Carl Minzner, *After the Fourth Plenum: What Direction for Law in China?*, CHINA BRIEF, Nov. 20, 2014, at 7, 7 (“On October 23, Chinese authorities concluded their annual Party plenum, focused on ‘ruling China according to law’ (*yifa zhiguo*)—the first time that top Chinese leaders have designated law as the central focus for the meeting.”); see also Gewirtz, *supra* note 133.

III. IMPLICATIONS

*The trouble with you Westerners, is that you've never got beyond that primitive stage you call the 'rule of law.' You're all preoccupied with the 'rule of law.' China has always known that law is not enough to govern a society. She knew it twenty-five hundred years ago, and she knows it today.***

China, and the VIE structure in particular, present a problem for the strong and abiding belief in the Property Rights Nexus.¹³⁵ While it is beyond the scope of this Note to fully dispute the Property Rights Nexus, the VIE implicates four relevant and related conclusions. First, weak property rights may be sufficient in situations where they nonetheless provide notice of who “owns” the particular item at issue (i.e., it serves a title-clearing function). Second, the predictability implicit in the Property Rights Nexus may be achievable through the use of culturally specific, extralegal institutions and methods may vindicate rights in the absence of the rule of law. Third, predictability, an implicit purpose of the property rights regime, may allow for economic growth absent strong property rights. These three conclusions suggest that the academy has taken a good idea and stretched it beyond the confines of its natural universe. In other words, sometimes strong property rights are just one of many factors that might explain a particular instance of economic growth.

A. Notice May Serve a Title-Clearing Function

Property rights have become a one-size-fits-all solution to the issue of economic growth in the third world.¹³⁶ Simultaneously, we have seen sustained economic growth through the VIE, regardless of its speculative ownership structure. One of the reasons for this apparent contradiction may be that the notice, or title-clearing, function of ownership is more important than the underlying property right.¹³⁷

To support this claim, a review of the foundational logic of the growth-through-property-rights regime is helpful. The Property Rights Nexus focuses on the lack of property rights for the poor of the underdeveloped world. The core of this argument is that economic development is spurred forward by freeing the populace from the burden of

** William C. Jones, *Trying to Understand the Current Chinese Legal System*, in UNDERSTANDING CHINA'S LEGAL SYSTEM 7, 7 (C. Stephen Hu ed., 2003) (quoting JEROME ALAN COHEN, THE CRIMINAL PROCESS IN THE PEOPLE'S REPUBLIC OF CHINA 4 (1968)).

¹³⁵ See *supra* Part II.

¹³⁶ See *supra* Part II.

¹³⁷ By title-clearing, I mean that the community is given notice of who can lay claim to a particular piece of property, regardless of the strength of that claim.

dead capital, which is facilitated by recognizing and codifying property rights.¹³⁸ These rights respect the ownership structure that is already recognized socially, but is not fully or officially documented.¹³⁹ Taking what is socially recognized and placing it within the realm of official recognition removes uncertainty and decreases transaction costs, thus allowing the poor to leverage their current wealth more efficiently toward growth.¹⁴⁰ This creates industry, which in turn drives the economic engine of the nation.

The example of the VIE supports the idea that notice may support economic growth, while simultaneously suggesting that the strength of the underlying property right of which notice is given need not be very strong. As we have seen, the VIE investor owns stock in a company that has contractual rights allowing it to control and receive the economic benefit of a target company. Although the ownership right is weak, the desired beneficiary is unambiguous—the ownership is clear. Where the VIE example becomes truly interesting, however, is when one considers what the notice actually expresses. As discussed above, the legality and enforceability of the VIE is suspect, creating a situation where the market is given notice of clear title, but an ambiguous, perhaps weak, property right.¹⁴¹ The success of this system suggests that this is perfectly tenable, and that the allocative function of property rights (i.e., clearing title) may be more important than the underlying right itself.

B. Culturally Specific Institutions May Vindicate Rights in the Absence of the Rule of Law

The function of formal law in the West—as a protector of property rights—may have been served by a more nuanced social system in pre-revolution China, and a corollary system may exist in the PRC today, reducing the value of the Property Rights Nexus as a tool of economic growth. As a preliminary matter, the law of property rights as it is currently understood simply did not exist in ancient China.¹⁴² Society nonetheless

¹³⁸ See DE SOTO, *supra* note 22, at 6–7 (“The poor inhabitants of these nations . . . do have things, but they lack the process to represent their property and create capital. They have houses but not titles; crops but not deeds; businesses but not statutes of incorporation.”).

¹³⁹ See *supra* Part II.

¹⁴⁰ See *supra* Part II.

¹⁴¹ See *supra* Section I.C.

¹⁴² STANLEY B. LUBMAN, *BIRD IN A CAGE: LEGAL REFORM IN CHINA AFTER MAO* 11 (1999) (“The rule of law was alien and unknown throughout thousands of years of authoritarian rule. Concepts central to both contemporary Chinese and Western law, such as the creation of rights and the use of formal legal institutions to vindicate rights, were unknown in traditional Chinese law.”); see also Clarke, *supra* note 95 (“Unlike the legal systems of continental Europe, Chinese law does not trace its

prospered, creating one of the world's great civilizations. How did this happen in the absence of strong law? The answer is simple: the means of control and vindication were extralegal.¹⁴³ In the West, "early separation of secular and sacred authority . . . gave impetus to the notions that the state was founded on law and that the ruler was bound morally and often politically by it. [This] separation . . . is the basis of today's distinction between state and society."¹⁴⁴

China's societal foundation, however, is very different.¹⁴⁵ In particular, China traditionally understood that law was only one of many societal norms, and was generally less important than other normative value regimes.¹⁴⁶ Accordingly, "positive law was meant to buttress, rather than supersede, the more desirable means of guiding society and was to be resorted to only when these other means failed to elicit appropriate behavior."¹⁴⁷ Working within this societal framework, issues of commerce were dealt with, whenever possible, outside the law through the ardent application of customary law and societal pressure.¹⁴⁸ That is to say,

roots to the private-law system of Rome or to any religious basis. Instead, traditional Chinese law centered on state concerns and dealt with private matters incidentally . . . [T]he legal system functions to serve state interests, not to protect individual rights or to resolve disputes among individuals . . ."; Herbert H. P. Ma, *The Chinese Concept of the Individual and the Reception of Foreign Law*, 9 J. CHINESE L. 207, 210 (1995) ("It must be pointed out that the concept of the individual established by the Confucians is an ethical one. . . . This is, of course, different from the Western concept of the individual, which is based on personal rights and freedoms."); RANDLE R. EDWARDS ET AL., HUMAN RIGHTS IN CONTEMPORARY CHINA 21 (1986) ("In traditional China the ideal was not individual liberty or equality but order and harmony, not individual independence but selflessness and cooperation, not the freedom of individual conscience but conformity to orthodox truth.").

¹⁴³ See LUBMAN, *supra* note 142, at 11 ("The domain of activity that is regarded as 'legal' and the way it is differentiated from other domains are unique products of Western History. The Chinese institutions that managed state-society relations and social conflict reflect very different perceptions.").

¹⁴⁴ *Id.* at 13.

¹⁴⁵ *Id.* ("Traditional China, by contrast, was characterized throughout its history by a remarkably close and enduring relationship between the state and the dominant cult . . . of Confucianism.").

¹⁴⁶ *Id.* at 14 ("Law was but one set of norms and was inferior to principles of nature, heavenly reason, religious canons, ethics, and rules of propriety.").

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* at 24 ("Recourse to the magistrate without prior attempts to settle disputes within groups was actively discouraged and sometimes, as in the case of clans and guilds, prohibited by the group's internal regulations. In sum, 'the local group generally required parties to exhaust their remedies within the group before looking to the magistrate for relief.'" (footnote omitted)); see also Clarke, *supra* note 95 ("[L]awsuits would tend to increase to a frightful amount, if people were not afraid of the tribunals, and if they felt confident of always finding in them ready and perfect justice. . . . I desire, therefore, that those who have recourse to the tribunals should be treated without any pity, and in such a manner that they shall be disgusted with law, and tremble to appear before a magistrate." (alteration in original) (quoting the Kangxi Emperor)). Interestingly, the absence of legal remedies continued during the Mao era, although in a somewhat different fashion and for somewhat different reasons. See *id.* ("The legal history of the PRC begins with the abolition in 1949 of all the laws of the predecessor state, the Republic of China. This left a substantial legal vacuum that ultimately had to be filled by whatever authoritative materials decisionmakers had at hand, including Party newspaper editorials, policy documents, and leaders' speeches. At the same time, there was for many years little need for a formal

“practices not characterized as ‘legal’ in the West performed functions similar to those of some Western ‘legal’ institutions, even though they were not specialized or differentiated from other fields of activity in the same way as in the West.”¹⁴⁹ Ultimately, the common Chinese citizen understood that the law did not necessarily exist to serve his interests, but was rather a tool of the realm in service of its stability.¹⁵⁰ Accordingly, they learned to seek recourse in extralegal systems of justice.

Interestingly, this dynamic persists.¹⁵¹ There is little separation between administrative and judicial functions.¹⁵² Cases are actively pushed out of the court system.¹⁵³ Arbitration and mediation are emphasized.¹⁵⁴ Simply put, the adversarial legal process is not the primary means of vindicating individual rights, which largely remains a suspect concept within the PRC.¹⁵⁵

The implications of this history are two-fold. First, it suggests that China, in keeping with its historical roots as a society that maintained social and commercial order through secondary, extralegal means, may

legal system in many areas of national life, since the economy was largely subject to state planning and conflicts could thus be resolved without reference to legal rights and duties.”).

¹⁴⁹ LUBMAN, *supra* note 142, at 33; *see also* JEROME ALAN COHEN, *THE CRIMINAL PROCESS IN PEOPLE’S REPUBLIC OF CHINA, 1949–1963*, at 50–51 (1968) (“Indeed, Max Weber’s appraisal of the traditional system as ‘a type of patriarchal obliteration of the line between justice and administration’ would appear to apply to the Communist system.” (footnote omitted) (quoting Max Weber)); EDWARDS ET AL., *supra* note 142, at 22 (“Civil law was customary, and private disputes were resolved by mediation and appeal to local custom.”).

¹⁵⁰ EDWARDS ET AL., *supra* note 142, at 22 (“The ordinary Chinese person did not expect state protection or state law to serve causes other than the order of the realm.”).

¹⁵¹ *See* Timothy Heath, *Fourth Plenum: Implications for China’s Approach to International Law and Politics*, CHINA BRIEF, Nov. 20, 2014, at 13, 14 (“The Party’s rule through law starts with its policy objectives. Indeed, Chinese officials routinely depict the Party’s policies and the government’s laws as intricately related.”).

¹⁵² *See* Clarke, *supra* note 95.

¹⁵³ Carl Minzner, *China at the Tipping Point? The Turn Against Legal Reform*, 24 J. DEMOCRACY 65, 68 (2013) (“Since the early 2000s, Chinese authorities have shifted citizen disputes away from court trials that are decided according to law. Judges face new pressures to resolve cases through closed-door mediation. Community mediation institutions dating from the era of Chairman Mao Zedong (d. 1976) have been dusted off and revived. New extralegal Party-led ‘coordination sessions’ have been created, under the rubric of mediation, to handle those cases that officials fear are most likely to generate social protest.”).

¹⁵⁴ *See, e.g.*, Rachel E. Stern, *From Dispute to Decision: Suing Polluters in China*, 206 CHINA Q. 294, 295 (2011) (“The vast majority of environmental disputes are handled through government-brokered deals [or] private concessions . . .”).

¹⁵⁵ *See* Hualing Fu, *Mediation and the Rule of Law: The Chinese Landscape*, in *FORMALISATION AND FLEXIBILISATION IN DISPUTE RESOLUTION* 108, 118 (Joachim Zekoll et al. eds., 2014) (“Despite the attempt to legalise social and economic life in the past 30 years, the reach of law is limited and the [judicial] sphere remains severely constrained. There are prevailing social norms that exist and operate in dispute resolution which are independent of legal norms. . . . In this sense, mediation, as practiced in China, may operate in the shadow of law, but, more often than not, it operates independent of, and in competition with, law.”).

have continued to rely on such mechanisms as it evolved from an agrarian society into a sophisticated world economic power. Identifying those specific structures in the modern economic arena is beyond the purview of this Note,¹⁵⁶ but analogous systems have taken hold in many courts,¹⁵⁷ the legislature,¹⁵⁸ the general populous,¹⁵⁹ and the Chinese Communist Party itself.¹⁶⁰ Moreover, even as Chinese authorities have promoted the rule of law (*yifa zhiguo*), they have nonetheless called on “Party authorities to ‘absorb the essence of Chinese legal culture’ and promote ‘traditional Chinese culture to increase the moral content of rule-of-law efforts.’”¹⁶¹ Such statements are a clear indicator of an intention to look within for the answers to today’s legal questions, suggesting a possible return to traditional extralegal remedies.

Second, this history implies that, even in the possible absence of modern extralegal regulatory structures, Chinese society has become accustomed to such societal mechanisms, thus creating an assumption of their existence even in the absence of their realization. In other words, the Chinese may believe that extralegal systems of justice have traditionally protected them and will, naturally, continue to do so in the future.¹⁶² In short, “China will ‘not copy foreign rule-of-law ideas or models.’”¹⁶³

¹⁵⁶ For an interesting and relevant explanation of varying, socially constructed conceptions of property, see generally Abraham Bell & Gideon Parchomovsky, *Property Lost in Translation*, 80 U. CHI. L. REV. 515 (2013) (exploring the concept and implications of “localized” property regimes).

¹⁵⁷ Minzner, *supra* note 153, at 68.

¹⁵⁸ Jerome A. Cohen, *China’s New National Constitution Day: Is It Worth Celebrating?*, CHINA BRIEF, Nov. 20, 2014, at 3, 4 (“Although the NPCSC has in recent years received hundreds of citizens’ complaints alleging constitutional violations and many other citizens’ proposals for constitutional interpretations, it has, at least formally, played the role of the reluctant dragon. It has yet to issue a ruling on any of these requests, preferring instead either to ignore them or to handle them via non-transparent, informal or indirect means.”).

¹⁵⁹ Emily Parker, *The 20-Year-Old Crime That’s Blowing Up on Chinese Social Media*, NEW REPUBLIC (May 4, 2013), <http://www.newrepublic.com/article/113116/zhu-ling-attempted-murder-case-weibo> [<http://perma.cc/5XF2-3U6X>] (describing the netizen-sponsored vigilante justice that has arisen following the poisoning of Zhu Ling).

¹⁶⁰ Andrew Jacobs, *Accused Chinese Party Members Face Harsh Discipline*, N.Y. TIMES (June 14, 2012), http://www.nytimes.com/2012/06/15/world/asia/accused-chinese-party-members-face-harsh-discipline.html?pagewanted=all&_r=0 [<http://perma.cc/2VKK-QFRJ>] (“When party members are caught breaking the rules—or even when they merely displease a superior—they can be dragged into the maw of an opaque Soviet-style disciplinary machine, known as ‘shuanggui,’ that features physical torture and brutal, sleep-deprived interrogations.”).

¹⁶¹ Minzner, *supra* note 134, at 8.

¹⁶² Indeed, Premier Xi Jinping has unequivocally stated, “The appropriate road and methods for solving China’s problems can only be found within China itself.” *Id.*

¹⁶³ *Id.* at 9.

C. *Predictability May Lead to Foreign Investment*

A corollary, dependent explanation to culture¹⁶⁴ is that the foreign investor has observed and analyzed the Chinese system and come to trust that it will act predictably. According to this understanding, the foreign investor studies China and sees a different system than the one she is accustomed to. But, she also recognizes that there are no mass government appropriations of property—at least not recently—and that the economy seems to function sufficiently well. The financier thus decides to invest, having developed trust in the fact that the system has worked, and will continue to do so. This trust causes an influx of capital. Capital leads to economic development, and prosperity is realized.

At its core, this conception holds that perceived stability—which China has achieved—is sufficient for continued growth. This idea, at least in the China field, traces its origins to Donald C. Clarke, who argued that an emphasis on rights was misplaced and predictability is what matters.¹⁶⁵ While the core idea may be entirely sound, the VIE suggests that the level of predictability need not be as absolute as previous articles have suggested.¹⁶⁶ In particular, there is a palpable level of uncertainty surrounding the legality and enforceability of the VIE structure.¹⁶⁷ When read in conjunction with the amount of money that has been raised using the VIE structure, and the attendant economic growth that money has engendered, it becomes clear that the level of predictability required is substantially less than absolute.

D. *Property Rights May Not Be a Silver Bullet*

Understanding the effects of notice, culture, and trust on the Property Rights Nexus, economic development scholarship's emphasis on property rights is suspect. Few will argue that strong property rights are a categorically negative societal occurrence. Nonetheless, given the contradictory information emerging regarding the ability of property rights to fully and completely incentivize economic growth, it makes sense to

¹⁶⁴ See *supra* Section III.B.

¹⁶⁵ Clarke, *supra* note 23, at 96–97 (“Where the [Property Rights Nexus] again goes too far, however, is in failing to distinguish between predictability and rights. Just as investment in agriculture depends on predictability about matters respecting which the farmer has no legal rights—for example, that spring will follow winter, or that seeds, if watered and fertilized, will grow—so we can imagine a legal system that contains no rights but that operates in a predictable manner.”).

¹⁶⁶ See, e.g., *id.* at 107 (“The Chinese example also sheds some interesting light on the question of whether economic development actually requires rights or simply predictability. While China’s legal system does not seem to protect the former very well, it may offer a reasonable degree of the latter.”).

¹⁶⁷ See *supra* Section I.C.2.

push for a more measured, case-specific recommendation when dealing with individual cases of economic stagnation.¹⁶⁸

IV. ADDITIONAL, FORWARD-LOOKING IMPLICATIONS

While VIEs show that property rights may be weakened, yet still allow for economic development, they nonetheless suggest that property rights are still an important factor in the protection of any individual investor's capital. Alibaba is a clear example of this reality, and the Alipay incident encapsulates the core issues.¹⁶⁹ Because of the complicated ownership structure in which economic benefit and effective control are hindered by a middleman—in this case the equity shareholders who have their own incentives and goals—the risks inherent in the VIE ownership structure are greater than they need to be. These risks can result in economic loss when the underlying asset is tampered with, as in the case of Alipay and Yahoo!. Relieving the investor of this obtuse ownership structure would place the investor in a better position and may similarly affect the company as well by decreasing the possibility of ownership disputes, thus incentivizing further investment that might otherwise be viewed as hazardous.

CONCLUSION

A little experience often upsets a lot of theory.^{†††}

Weak property rights are not fatal to economic development in the ways that orthodox law and development theory suggests. Accordingly, when dealing with limited resources, a plethora of problems, and the pernicious reality of economic underdevelopment, governments must place emphasis on the solutions that will uniquely support growth in each exigent situation. In other words, there is a unique tool for each problem, and the current wholehearted academic and political emphasis on property rights is misguided.

This Note has attempted to outline in detail locations where property rights are not as important to economic development as they have been previously thought. To do so, I have explained the VIE as a listing structure, and focused on Alibaba as a historical example. I have

¹⁶⁸ This idea has already begun to take hold in the academy. *See, e.g.*, Trebilcock, *supra* note 21, at 478 (“Rather, the relationship between property rights and development is much more complex, and a more nuanced approach to these issues is required.”).

¹⁶⁹ *See supra* Section I.C.2.

^{†††} GENNADY FAVEL, *THE STOCK MARKET PHILOSOPHER* 29 (2008) (quoting Samuel Parkes Cadman).

demonstrated that notice may be more important than the strength of the underlying property right. Moreover, I have shown that the Property Rights Nexus's value may be culturally specific, and that stability may breed predictability, thus leading to investment in the absence of strong property rights. In doing so, this Note has questioned the dogmatic view of property rights as a cure-all for economic ills, while also exploring and highlighting the Property Rights Nexus's primary points of inflection.

My hope is that through this Note I will encourage further scholarship focused on China and the lessons that its recent development can teach about development economics. The PRC has experienced thirty years of sustained economic growth with little rule of law, little overt protection for property rights, no democracy, and fairly prevalent corruption. How did it do it? This is a question far beyond the confines of this Note, but it is the ultimate question that the VIE and its amorphous ownership structure suggests. I am by no means the first to push for further research, but previous calls have not received the answer they deserve. I offer this Note as an answer and an additional call for the study of China and its precipitous rise.