

Finance Against Law: The Case of China

Shitong Qiao*

ABSTRACT

Can there be a highly developed financial market without legal protection for investors and creditors? The influential law and finance literature is built on the assumption that legal protection is essential to the development of an impersonal financial market. This Article investigates how two financial markets of trillions of dollars have developed extralegally in the past two decades despite the risk of regulatory enforcement and contract defaults. Specifically, I examine (1) how Chinese internet companies from Sina to Alibaba have designed contracts to circumvent the Chinese government's ban on foreign capital in its internet industry and (2) how Chinese entities and foreign investors contract out of China's stringent regulations on the issuance of international bonds. These extralegal contracts incur significant legal risks and are unlikely to be enforced in Chinese courts. Nevertheless, numerous international investors have invested in China through such contracts, providing capital essential to the country's economic growth over the past two decades. My research reveals that (1) the extralegality of both the international capital market supporting China's internet companies and the market of Chinese-issued international bonds originates from China's struggle between development, which requires access to the international capital market, and control, which requires keeping both Chinese enterprises and foreign capital on a short leash; and (2) networks of Chinese state actors, market intermediaries, and Chinese corporations concentrated in certain industries replace judicial enforcement in supporting financial development of a remarkable duration and scale.

Based on the above case studies, this Article coins the term "finance against law," challenging the necessity of law to developing impersonal and sophisticated financial markets. Law and finance scholars are right that impersonal finance needs the backing of the state, but wrong to assume that the state can only back impersonal finance with legal institutions. China's approach, "governing by extralegality," sheds light on the role of the state and politics in extralegality, pointing to a new direction that scholars of law and social norms who mainly focus on private ordering should attend to. The Chinese experience also demonstrates an approach of developing markets by circumventing existing legal and regulatory barriers, further complicating the relationship between law and development.

* Professor of Law and Ken Young-Gak Yun & Jinah Park Yun Research Scholar, Duke Law School. Email: qiao@law.duke.edu. The author thanks Sherry Zhang, Jiang Sifan, Wu Runling, Sarah Tinaphong, and Yao Ziyi for superb research assistance; Will Xu, Hu Haifan, Andy Chang, Jiang Wenxi, and Miao Yinzhi for discussions; Rick Hills, Don Clarke, Steven Schwarcz, Lior Strahilevitz, and Frank Upham for detailed comments on earlier drafts; Matt Adler, Lawrence Baxter, Stuart Benjamin, Rachel Brewster, Kevin Davis, Elisabeth de Fontenay, Deborah Demott, Ofer Eldar, Yiqin Fu, Li Guo, Paul Haagen, Larry Helfer, Colin Hawes, Jamie Horsley, William H. J. Hubbard, Ke Li, Ben Liebman, Rory Van Loo, Darrell Miller, Tamar Groswald Ozery, Sarah Bloom Raskin, Barak Richman, Emily Strauss, Neal Siegel, Jonathan Wiener, Katherine Wilhelm, Margaret Woo, James Zeng, Taisu Zhang, Wei Zhang, and participants of the 2022 American Law and Economics Association Annual Meeting, a zoom talk at NYU U.S.-Asia Law Institute, Duke Law School Faculty Workshop, and the Northeastern Chinese Law Works-in-Progress Workshop for comments and suggestions. The author is also very grateful for superb editing suggestions from editors of Harvard International Law Journal. All errors are my own.

TABLE OF CONTENTS

INTRODUCTION	432
I. LAW VS. STATE IN FINANCE.....	436
A. <i>What is Finance Against Law?</i>	438
B. <i>Governing by Extralegality</i>	440
C. <i>State Actors and Intermediaries as Super Nodes of Extralegal Financial Networks</i>	442
II. VARIABLE INTEREST ENTITIES AND “CHINA CONCEPTS STOCK”	447
A. <i>Contracting out of Regulations</i>	447
B. <i>Legality and Risks</i>	450
1. <i>Legality</i>	450
2. <i>The Risk of Regulatory Enforcement</i>	453
3. <i>Contract Risk</i>	456
C. <i>State Actors and Intermediaries as Super Nodes</i>	460
1. <i>Homogeneous and Repeat Players</i>	461
2. <i>Relational Contracts and Individual Reputation</i>	465
3. <i>State Reputation</i>	467
III. KEEPWELL DEEDS AND CHINESE-ISSUED INTERNATIONAL BONDS.....	472
A. <i>Contracting out of Regulations</i>	473
B. <i>Legality and Risks</i>	475
C. <i>State Actors and Intermediaries as Super Nodes</i>	477
1. <i>Homogeneous and Repeat Players</i>	478
2. <i>Relational Contracts and Corporate Reputation</i>	480
3. <i>“In the Chinese Government We Trust”</i>	482
IV. CONCLUSION	485

INTRODUCTION

Can there be a highly developed financial market without the legal protection of investors and creditors? The influential law and finance literature is built on the premise that legal protection is essential to the development of a financial market.¹ Evidence of the premise’s veracity is prevalent. In the seventeenth century, for example, the English monarch was able to borrow

1. See e.g., Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny (“LLSV”), *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997) [hereinafter LLSV, *Legal Determinants of External Finance*]; LLSV, *Law and Finance*, 106 J. POLIT. ECON. 1113 (1998) [hereinafter LLSV, *Law and Finance*]; Thorsten Beck, Asli Demirguc-Kunt & Ross Levine, *Law and Finance: Why Does Legal Origin Matter?*, 31 J. COMPAR. ECON. 653 (2003). For critiques of LLSV, see Daron Acemoglu, Simon Johnson & James A. Robinson, *The Colonial Origins of Comparative Development: An Empirical Investigation*, 91 AM. ECON. REV. 1369 (2001); Daniel Berkowitz, Katharina Pistor & Jean-Francois Richard, *The Transplant Effect*, 51 AM. J. COMP. L. 163–83 (2003). See Part I for more detailed discussions on the literature.

money whereas his French counterpart could not, because the former's creditors were protected by English constitutional rules.² In the contemporary world, common law jurisdictions, which generally provide stronger protection for shareholders and creditors, dominate the international financial market, with the world's three leading financial centers (New York, London, and Hong Kong) all common law jurisdictions.³

This article investigates how two financial markets of trillions of dollars have developed extralegally⁴ in the past two decades despite the risk of regulatory enforcement and contract defaults. Specifically, I examine (1) how Chinese internet companies from Sina to Alibaba have designed contracts to circumvent the Chinese government's ban on foreign capital in high-tech industries and to get listed on overseas stock markets and (2) how Chinese entities and foreign investors contract out of China's stringent regulations on the issuance of international bonds.

In the past two decades, Chinese companies have adopted the variable interest entity ("VIE") structure to circumvent the government's ban on foreign capital in China's internet industry and to get listed on overseas stock markets. The structure has resulted in an era of the so-called "China concepts stock"⁵—a set of stock of companies whose assets or earnings reflect significant activities in mainland China, but a number of which are listed on stock exchanges abroad, particularly in New York and Hong Kong.⁶ Under the VIE structure, foreign investors do not hold equity shares in the Chinese company concerned, but instead hold claims to the control and to financial gains of this company through a multi-layered contractual arrangement. Such contract arrangements are extralegal as their main purpose is to circumvent Chinese restrictions on foreign investment. Nevertheless, all Chinese internet companies listed overseas including Tencent and Alibaba have adopted the VIE structure since its invention in 2000 at the overseas initial public offering ("IPO") of Sina, which was at the time the main internet news website in China. As of May 2021, out of the 261 Chinese companies listed in the U.S., 184, or 70.5%, use the VIE structure,⁷

2. See generally Douglass C. North & Barry R. Weingast, *Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England*, 49 J. ECON. HIST. 803 (1989).

3. CHINA DEV. INSTITUTE & Z/YEN PARTNERS, THE GLOBAL FINANCIAL CENTRES INDEX 4 (24th ed. 2018), https://qfc-cdn.azureedge.net/-/media/project/qfc/qfcwebsite/documentfiles/publications/research-insights-2018/gfci_24_final_report.pdf [<https://perma.cc/2PDV-MP7E>]; U.S. Dep't State, *2019 Investment Climate Statements: Hong Kong* (2019), <https://www.state.gov/reports/2019-investment-climate-statements/hong-kong/> [<https://perma.cc/2YX7-45YZ>].

4. See *infra* the last paragraph at Part I.B for a definition of "extralegal" and how it is different from "illegal."

5. The Government of Hong Kong SAR, *Attracting China Concept Stock Companies to List in Hong Kong*, HKSAR PRESS RELEASES (Apr. 6, 2022), <https://www.info.gov.hk/gia/general/202204/06/P2022040600276.htm> [<https://perma.cc/3ZLC-LYN3>].

6. *Chinese Companies Listed on Major U.S. Stock Exchanges*, U.S.-CHINA ECON. SEC. REV. COMM'N (May 13, 2021), <https://www.uscc.gov/research/chinese-companies-listed-major-us-stock-exchanges> (last visited Dec. 17, 2021) [<https://perma.cc/M3FM-57DA>].

7. *Id.*

representing a combined market capitalization of U.S.\$2.1 trillion.⁸ VIE thus literally raises a “trillion-dollar question”⁹ about law and finance.¹⁰

The market for Chinese-issued international bonds has captured far less attention than that for “China concepts stock,” even though the value of international bonds issued by Chinese entities has exceeded that of the total equity funds raised by Chinese entities from the United States and Hong Kong stock exchanges since 2012.¹¹ China has stringent regulations on cross-border capital flows, including a quota on and approval system for the issuance of overseas debt and limits on the credit support that Chinese companies can provide to overseas entities. Much of the practice in the Chinese-issued international bond market concerns how to circumvent the relevant Chinese regulations, raising questions about their legality and enforceability.¹² This Article focuses on one of the most notable extralegal ways of circumventing regulations called keepwell deeds (“KWDs”), used by on-shore Chinese companies to provide credit support to their overseas subsidiaries, through which the former issues international bonds indirectly.¹³

The VIE market started in the early 2000s¹⁴ and is about the same size as the Nasdaq Nordic and Baltics (2.13 trillion)¹⁵ created in 2003¹⁶ and the Deutsche Boerse AG (1.9 trillion)¹⁷ founded in 1993,¹⁸ and about two-thirds the size of the London Stock Exchange (3.1 trillion)¹⁹ and three-sevenths the size of the Hong Kong Stock Exchange (4.56 trillion).²⁰ The mar-

8. *Id.*

9. Jamie Powell, *VIEs: China's Nuclear Option*, FIN. TIMES (Oct. 9, 2019), <https://www.ft.com/content/36d69b62-1a2e-456d-8a6e-30f1f7142b15> [perma.cc/7737-WH2W].

10. Professors Jesse Fried and Ehud Kamar call the Chinese entities and their founders “law-proof insiders,” focusing on the fact that they are out of the reach of U.S. law enforcement. Jesse M. Fried & Ehud Kamar, *China and the Rise of Law-Proof Insiders* (Eur. Corp. Governance Inst. L., Working Paper No. 557, 2020); see also Donald Clarke, *The Bonding Effect in Chinese Cross-Listed Companies: Is It Real?*, in ENFORCEMENT OF CORPORATE AND SECURITIES LAW: CHINA AND THE WORLD 88 (Nicholas C. Howson & Robin Hui Huang eds., 2017). Amid a number of journal articles on VIEs, only one article explores their implication on law and development. See Perry W. Tyler, *Development and Distrust: A Critique of the Orthodox Path to Economic Prosperity*, 110 NW. UNIV. L. REV. 477 (2015).

11. XIN ZHANG, LAW AND PRACTICE OF DEBT FINANCE IN MODERN CHINA: CROSS-BORDER PERSPECTIVES 153 (2021) (Diagram 5.4).

12. See *infra* Part III.A and Part III.B; for a comprehensive analysis of China’s extralegal overseas debt market, see Shitong Qiao & Feiyu Xu, *Finance Against Law: China's Extralegal Overseas Debt Market* (unpublished manuscript) (on file with author).

13. See *infra* Part III.A.

14. See *infra* Part II.A.

15. STATISTA, *Largest Stock Exchange Operators Worldwide as of May 2022, by Market Capitalization of Listed Companies* (July 2022), <https://www.statista.com/statistics/270126/largest-stock-exchange-operators-by-market-capitalization-of-listed-companies/#:~:text=the%20New%20York%20Stock%20Exchange,Stock%20Exchange%2C%20and%20the%20Euronext> [https://perma.cc/9GNW-SA6J].

16. Ulf Nielsson, *Interdependence of Nordic and Baltic Stock Markets*, 6 BALTIC J. ECON. 9, 11–12 (2007).

17. STATISTA, *supra* note 15.

18. *20th Century: War, Reconstruction, Computer Age and Cross-border Growth*, DEUTSCHE BÖRSE AG (May 2019), <https://www.boerse-frankfurt.de/en/know-how/about/geschichte-der-frankfurter-wertpapierboerse/20th-century-war-reconstruction-computer-age-and-cross-border-growth> [https://perma.cc/7ZWD-BF75].

19. STATISTA, *supra* note 15.

20. *Id.*

ket for Chinese-issued international bonds is of similar scale and longevity (beginning in the early 2010s).²¹ The scale and duration of both markets are remarkable considering challenges in both creating new markets²² and accessing the international bond markets²³ in the past decades.

My in-depth study of the financial markets of VIEs and KWDs, both of which have ongoing significant implications to the Chinese and global economy, reveals that (1) the extralegality of both markets originates from China's struggle between development, which requires access to the international capital market, and control, which requires keeping market and capital on a short leash. Further, (2) networks of the Chinese state, a few market intermediaries, and Chinese corporations concentrated in certain industries replace judicial enforcement in supporting financial development of a remarkable scale and duration. Based on these findings, I coin the term "finance against law" and explain how the state plays a central role in creating and operating such financial markets against its own law. This argument is potentially applicable to both China's domestic financial markets and markets beyond China—for example, the Islamic banking system,²⁴ which controls assets of nearly four trillion U.S. dollars.²⁵

Understanding alternative mechanisms that can support financial development is essential to understanding development, as most developing countries do not have a well-functioning rule of law system. China's development in the past four decades has posed serious questions to the necessity of law to development.²⁶ This article by no means intends to argue that such markets are optimal or risk-free, nor does it predict that such markets are sustainable in the long run.²⁷ In the long run, both VIEs and KWDs are

21. Xingyuan Lu (陆兴元), *Zhongzi Meiyuan Zhai Lishi Faxing Qingkuang Yu Dingjia Yinsu Qianxi* (中资美元债历史发行情况与定价因素浅析) [Analysis on the Historical Issuance and Pricing Factors of Chinese Investment in U.S. Dollar Bonds], DEBANG ZHENGQUAN (德邦证券) [Tebon Securities], 6 (May 10, 2019) (China) (Chinese investment in U.S. dollar bonds grew to more than U.S.\$ 800 billion in 2020).

22. See, e.g., Ronald J. Gilson, Henry Hansmann & Mariana Pargendler, *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the United States, and the European Union*, 63 STAN. L. REV. 475, 502–07 (2011); Katharina Pistor & Chenggang Xu, *Governing Stock Markets in Transition Economies: Lessons from China*, 7 AM. L. ECON. REV. 184 (2005).

23. See, e.g., Barry Eichengreen & Pipat Luengnaruemitchai, *Why Doesn't Asia Have Bigger Bond Markets?*, NBER Working Paper No. 10576 (2004); BOND MARKETS IN LATIN AMERICA: ON THE VERGE OF A BIG BANG? (Eduardo Borensztein et al. eds., 2008); Yibin Mu, Janet G. Stotsky & Peter Phelps, *Bond Markets in Africa*, 3 REV. DEV. FIN. 121 (2013).

24. See, e.g., NABIL A. SALEH, UNLAWFUL GAIN AND LEGITIMATE PROFIT IN ISLAMIC LAW: RIBA, GHARAR AND ISLAMIC BANKING (1986).

25. STATISTA, *Total Value of Islamic Finance Assets Worldwide from 2012 to 2021 with a Projection for 2026* (Jan. 19, 2023), <https://www.statista.com/statistics/1090815/worldwide-value-of-islamic-finance-assets/> [https://perma.cc/W94C-D866].

26. See generally, Donald C. Clarke, *Economic Development and the Rights Hypothesis: The China Problem*, 51 AM. J. COMP. L. 89 (2003); Frank K. Upham, *From Demsetz to Deng: Speculations on the Implications of Chinese Growth for Law and Development Theory*, 41 NYU J. INT'L L. & POL. 551 (2008); SHITONG QIAO, *CHINESE SMALL PROPERTY: THE CO-EVOLUTION OF LAW AND SOCIAL NORMS* (2017); RONALD COASE & NING WANG, *HOW CHINA BECAME CAPITALIST* (2012).

27. See Part IV for my discussions on the limits of such markets.

likely to decline or even disappear into history, just like the *societas publicanorum* (an early form of shareholder company) in the Roman Republic.²⁸ I also do not argue that such finance against law is fair or just, considering the dominance of financial intermediaries, entrepreneurs, and regulatory agencies as well as the lack of participation by individual investors in the process. Nevertheless, the existence of these extra-legal mechanisms deserves a more nuanced understanding of the relationship between law, state, and finance.²⁹

The remainder of the Article is organized as follows. Part I reviews existing law and finance literature and develops my theory of finance against law. Part II investigates the market for “China concepts stock” based on the extralegal VIE structure: why and how market participants contract out of regulations, the legality and risks of VIEs, and the socio-political networks that support the market. Following the same structure, Part III examines the case of Chinese-issued international bonds (primarily U.S.-dollar bonds) based on the extralegal KWDs. Part IV concludes with the implications and limitations of this research.

I. LAW VS. STATE IN FINANCE

Why would an investor purchase shares in or bonds issued by a corporation managed by somebody she does not know? There are two risks at play: the risk that corporate managers may run away with the investor’s money and the risk that the government may expropriate the investment. According to scholars of law and finance, the first risk can be mitigated by legal institutions, particularly courts, which can adjudicate disputes between shareholders and managers or debtors and creditors, and enforce such adjudication through the coercive power of the state.³⁰ Once financial transactions have achieved a certain scale and degree of complexity and occur regularly across different social groups in different geographical locations, it is unlikely that the parties to such transactions can rely on personal connections or community mechanisms to enforce their contracts.³¹ The effectiveness of legal institutions, independent judicial decision-making, and timely judicial enforcement in particular thus determines the development of financial markets.³² According to the law and finance literature, the state can coercively enforce “the (legal) code of capital,”³³ and therefore is essential to contem-

28. Ulrike Malmendier, *Law and Finance at the Origin*, 47 J. ECON. LIT. 1076, 1078 (2009).

29. See *infra* Part I.

30. See, e.g., Daron Acemoglu & Simon Johnson, *Unbundling Institutions*, 113 J. POL. ECON. 949, 953 (2005); Taisu Zhang & John Morley, *The Modern State and the Rise of the Business Corporation*, YALE L. J., forthcoming, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4037726 [<https://perma.cc/9RW9-H5C9>].

31. Zhang & Morley, *id.* at 14.

32. LLSV, *Law and Finance*, *supra* note 1; LLSV, *Legal Determinants of External Finance*, *supra* note 1.

33. KATHARINA PISTOR, *THE CODE OF CAPITAL: HOW THE LAW CREATES WEALTH AND INEQUALITY* 21 (2019).

porary financial markets. In the literature, the main and only function of the state is to create and enforce laws. Law and finance scholars' solution to the second risk, i.e., the risk of expropriation, is also law. Independent courts enforce the law against the state and determine what the state can and cannot do.³⁴

I have two goals in this Article: the first one is to demonstrate that impersonal finance against law exists and how they challenge the mainstream law and finance literature; second to examine how such markets operate. This Article posits a theory of finance against law which provides that the state can engineer sophisticated and impersonal financial markets against the law and reveals the incentives of various stakeholders, particularly those of the state, and mechanisms through which stakeholders are held accountable for the stability of contracts and security of property rights. The law and finance literature does not address the question of state incentives, i.e., why states create and enforce "the legal code of capital"; nor does it examine why the state needs to use law to enforce contracts or what prevents the state from expropriating investment in the absence of independent and well-functioning courts which generally do not exist in developing countries. It is important to note that the state and law are two different things, although they are often connected and treated as the same.³⁵ The state itself is hardly bound by law,³⁶ particularly in developing countries or transnational contexts in which there are often no independent courts or effective enforcement of judicial decisions to hold the state accountable.³⁷ To make it worse, for developing countries, the state and law are often in conflict: the barrier to financial development is often not the absence of law, but rather the presence of bad laws in the form of prohibitions and restrictions on financial investment.³⁸ Finding a way to handle such bad laws poses a challenge to a state interested in financial development.³⁹

34. Acemoglu & Johnson, *supra* note 30, at 950.

35. Nobel Laureate Oliver Williamson argues that law and organizations are alternatives to each other. Extending this line of argument, the state, as a kind of organization, and law are also alternatives to each other. Sovereign states do not have to choose law to govern economic relationships. Oliver E. Williamson, *Comparative Economic Organization: The Analysis of Discrete Structural Alternatives*, 36 ADMIN. SCI. Q. 269 (1991).

36. Professor Katharina Pistor argues that law is elastic. The elasticity of law is defined as the probability that *ex ante* legal commitments will be relaxed or suspended in the future; the higher that probability, the more elastic the law. The binding nature of legal and contractual commitments tends to be inversely related to the hierarchy of finance. Law tends to be more binding on the periphery and more elastic at the apex of the financial system. To sovereign states, which are at the apex of the financial system, law is elastic, or in other words, not binding. Katharina Pistor, *A Legal Theory of Finance*, 41 J. COMPAR. ECON. 315 (2013).

37. See, e.g., Ronald J. Daniels & Michael Trebilcock, *The Political Economy of Rule of Law Reform in Developing Countries*, 26 MICH. J. INT'L L. 99 (2004).

38. See, e.g., Ross Levine, *Foreign Banks, Financial Development, and Economic Growth*, in INTERNATIONAL FINANCIAL MARKETS: HARMONIZATION VERSUS COMPETITION 224, 245 (Claude E. Barfield ed., 1996). For literature beyond financial markets, see QIAO, *supra* note 26.

39. *Id.* at 248.

A. *What is Finance Against Law?*

Finance against law is not finance without law. There are three kinds of relationships between finance and law. The first one is law-based finance which is the ideal of the law and finance literature.

The second is finance without law, i.e., financial development without judicial enforcement of contracts. The cryptocurrency markets which rely on decentralized technology to secure transactions offer one example.⁴⁰ In the transnational context, the market of sovereign bonds can be considered an example of finance without law, as the possibility of legal enforcement against sovereign states is limited. Other examples include cross-border securitization⁴¹ and the global swap markets.⁴² In the area of corporate governance, an early form of shareholder company, the *societas publicanorum*, flourished in a legally underdeveloped but politically supportive environment (the Roman Republic) and disappeared when Roman law reached its height of legal sophistication but within a less supportive political environment (the Roman Empire).⁴³ The Roman law did not prohibit the *societas publicanorum*, and simply refrained from recognizing its legal status and therefore contracts among the shareholders were not judicially enforceable as in the contemporary world. Other examples of finance without law can be found in China. Pistor and Xu noted China's use of non-legal measures in boosting its stock market;⁴⁴ Pistor further theorized that China relies on its cadre management system to govern its financial system.⁴⁵ Yet, as Pistor wrote in 2013, "it remains to be seen how effective it [i.e., China's cadre management system] can be employed for governing China's exposure to global finance."⁴⁶

The third is finance against law, i.e., financial development against legal prohibitions and restrictions. The risk is not only the lack of judicial enforcement of contracts, but also the expropriation of investment by the state because such investments go against legal prohibition.

There are two subcategories of finance against law. One is private finance against law, such as underground finance of criminal organizations using diamonds⁴⁷ and informal loans provided by individual entrepreneurs in

40. See, e.g., Igor Makarov & Antoinette Schoar, *Cryptocurrencies and Decentralized Finance (DeFi)*, 2022 BROOKINGS PAP. ECON ACT 141 (2022).

41. Tamar Frankel, *Cross-Border Securitization: Without Law, but not Lawless*, 8 DUKE J. COMPAR. & INT'L L. 255 (1997).

42. Annelise Riles, *The Anti-Network: Private Global Governance, Legal Knowledge, and the Legitimacy of the State*, 56 AM. J. COMPAR. L. 605 (2008).

43. Malmendier, *supra* note 28, at 1078.

44. Pistor & Xu, *supra* note 22.

45. Katharina Pistor, *The Governance of China's Finance*, in CAPITALIZING CHINA 35 (Joseph P. H. Fan & Randall Morck eds., 2012).

46. *Id.* at 36.

47. DINA SIEGEL, *THE MAZZEL RITUAL: CULTURE, CUSTOMS AND CRIME IN THE DIAMOND TRADE*, 173-200 (2009).

southern China who often charge higher interest rates than law allows.⁴⁸ Scholars have noted the challenge China poses to the law and finance literature. In a frequently cited article, Allen et al. argue that alternative financing channels and governance mechanisms based on individual reputation and private relationships support the growth of China's private sector.⁴⁹ This is a nice extension of the law merchant literature using medieval merchant guilds and the modern-day diamond industry as classic examples.⁵⁰ In this literature, close-knit merchant communities hold their own members accountable and hold the members of other communities responsible through a kind of hostage-exchange arrangement,⁵¹ resulting in enforceable contracts and the protection of property rights and, in turn, supporting long-distance trade. The literature on law and economic development in China has followed the law merchant literature's lead, generally arguing that reputation-based networks and informal contracts, property rights, and financial arrangements among entrepreneurs and private entities have supported the country's economic growth.⁵² Such private finance against law, however, is limited to members who have long-term, repeated interactions with one another, because of the lack of state backing. In other words, such private finance against law is not impersonal finance.

The second subcategory of finance against law, which is the focus of this Article, is state-engineered finance against law. State backing, but not through "the legal code of capital" as the law and finance literature would prefer, supports impersonal finance against law, therefore directly challenging the law and finance literature. One example of finance against law is the Islamic banking system,⁵³ which controls assets of nearly four trillion U.S. dollars,⁵⁴ and operates with various mechanisms to circumvent the Sharia law's prohibition on *riba*, or usury, defined as interest paid on loans of money.

Differentiating the state from law allows us to explore other means the state can use to support financial development. This Article examines the relationship between law and China's exposure to global finance and reveals a different mechanism that supports finance against law.

48. See, e.g., KELLE S. TSAI, *BACK-ALLEY BANKING: PRIVATE ENTREPRENEURS IN CHINA* (2002).

49. Franklin Allen, Jun Qian & Meijun Qian, *Law, Finance, and Economic Growth in China*, 77 J. FIN. ECON. 57 (2005).

50. See, e.g., Avner Greif, Paul Milgrom & Barry Weingast, *Coordination, Commitment and Enforcement: The Case of the Merchant Guild*, 102 J. POL. ECON. 745 (1994); Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992).

51. Avner Greif, *Impersonal Exchange without Impartial Law: The Community Responsibility System*, 5 CHI. J. INT'L L. 109 (2004).

52. See, e.g., VICTOR NEE & SONJA OPPER, *CAPITALISM FROM BELOW: MARKETS AND INSTITUTIONAL CHANGE IN CHINA* (2012).

53. See, e.g., NABIL A. SALEH, *UNLAWFUL GAIN AND LEGITIMATE PROFIT IN ISLAMIC LAW: RIBA, GHARAR AND ISLAMIC BANKING* (1986).

54. Amna Puri-Mirza, *Islamic Financial Sector – Statistics and Facts*, STATISTA (Mar. 31, 2023), <https://www.statista.com/topics/6345/islamic-financial-sector/> [<https://perma.cc/2KFB-2KTA>].

B. *Governing by Extralegality*

A fundamental dilemma for the Chinese party-state is the tension between two goals: control and development. To achieve control, it imposes restrictions on foreign capital and investment.⁵⁵ To achieve development, it seeks access to credit and must court foreign capital. Within China's domestic political sphere, separate factions are in charge of these two conflicting goals and corresponding departments.⁵⁶ The conservative faction, which worries about losing control of the country to foreign capital and market forces, erects and maintains various regulatory barriers to cross-border capital flows.⁵⁷ This faction is powerful, and its legitimacy is taken for granted, as the fundamental goal of the party-state is to maintain party control. The liberal faction, in contrast, advocates that China needs to become strong and rich, toward which market forces and foreign capital are indispensable.⁵⁸ This faction is also powerful, and its approach has proven to be a successful strategy for the party-state. The strategy requires justification, however, and there is an ongoing need to address concerns that it might weaken rather than strengthen the party-state.⁵⁹ When there is a stalemate between the two factions, which regularly occurs, the imposition of regulatory barriers or an outright ban is the default position. In response, the liberal faction often supports innovative ways to circumvent those barriers.⁶⁰ The liberal faction is often in charge of central government departments responsible for economic development and access to the international capital market. The power and influence of such departments, as well as the careers of bureaucrats in such departments, grow with the success of their delegated tasks. Therefore these departments have a stable incentive to support extralegal practices circumventing the aforementioned regulatory barriers guarded by competing departments.⁶¹ It is often only after a market practice has proven successful in promoting development without endangering the party-state's control that the practice is fully recognized and sanctioned by law.⁶²

55. See *infra* Part II.A and Part III.A.

56. VICTOR C. SHIH, *FACTIONS AND FINANCE IN CHINA: ELITE CONFLICT AND INFLATION* 53–58 (2008).

57. See *infra* Part II.A and Part III.A.

58. *Id.*

59. *Id.*

60. *Id.*

61. Theoretically the corresponding central government departments' vested interests in supporting extralegal market practices are similar to Professor Yuen Yuen Ang's idea of "access money," according to which both the Party and its cadres benefit from China's long-term growth. However, different from Professor Ang's emphasis on "access money" and individual gains, I focus on departmental interests and institutional arrangements. YUEN YUEN ANG, *CHINA'S GILDED AGE: THE PARADOX OF ECONOMIC BOOM AND VAST CORRUPTION* (2020).

62. Shitong Qiao and Frank K. Upham, *China's Changing Property Law Landscape*, in *COMPARATIVE PROPERTY LAW: GLOBAL PERSPECTIVES* 311 (Michele Graziadel & Lionel Smith eds., 2017). The author thanks Professor Rick Hills for this point, among many other comments of his that have made this paper much stronger than it would have been.

I call China's approach "governing by extralegality," which has deep roots in the country's internal political economy and its efforts to strike a balance between development and control. When there is strong demand for development, the party-state can always send signals to assure investors of the security of their (sometimes extralegal) contract arrangements. The market often follows such political signals.⁶³ On the other hand, such extralegality leaves room for control, as the party-state can take over via enforcement against extralegal practices, at least in their early stages. It is for this reason that the conservative faction is often willing to acquiesce to development-oriented practices. I do not mean to suggest that the Chinese state as a unitary organization has consciously designed this approach of "governing by extralegality." Instead, it is more a result of the balancing of the party-state's different governance goals and bargaining among different factions and departments in charge of those goals. Such balancing varies industry by industry and from time to time, which impacts the applicability, stability, and predictability of extralegal arrangements. The state might lose control when regulations on paper are rarely enforced for a long time⁶⁴ and the abovementioned extralegal practices become widely accepted. But such hindsight is often unavailable when a tricky balance between development and control is first struck.⁶⁵

The extralegality of VIEs and KWDs results from the tension between development and control within China's domestic politics. With respect to VIEs, the party-state recognizes the importance of the internet to China's development and has been persuaded that access to international financial markets is essential to the development of the country's internet industry.⁶⁶ At the same time, however, it worries that China's internet, which provides information and news services to the national population, might become subject to foreign control or influence.⁶⁷ This is why the party-state has maintained an outright ban on foreign investment in China's internet industry while allowing Chinese internet companies to list overseas through VIEs. Paul Gillis and Frederik Oqvist describe the paradox as follows: "Companies that use the VIE structure tell two inconsistent stories. To Chinese regula-

63. See *infra* notes 217–19 & 306.

64. Civil law calls the phenomenon that historical regulations have been seldom enforced "desuetude." Re-enforcing such historical regulations can incur due process concerns. See, e.g., Darrell AH. Miller, *Second Amendment Traditionalism and Desuetude*, 14 GEO. J.L. & PUB. POL'Y 223, 226 (2016).

65. This is how institutional change is made possible against opposition from incumbent interests: opponents to institutional change tend to underestimate the potential threat to their interests when a breakthrough is first made. Another example is the spread of the market economy in China from Shenzhen's "special economic zone" in the 1980s to the entire country. See RONALD COASE & NING WANG, *HOW CHINA BECAME CAPITALIST* 59–60, 82–85 (2012).

66. DAVID SHEFF, *CHINA DAWN: THE STORY OF A TECHNOLOGY AND BUSINESS REVOLUTION* 201 (2002).

67. See *infra* Part III.A.

tors they say that the business is owned by Chinese and not by foreigners. Yet, to foreign investors they claim that foreigners own the business.”⁶⁸

A similar rationale applies to overseas debt. China successfully weathered the 2008 financial crisis by implementing an RMB 4-trillion (U.S.\$620 billion) stimulus package, but has been combating a real estate bubble and mounting debt ever since, partly because most of the stimulus money flowed into real estate-related sectors.⁶⁹ The Chinese government needs to contain the bubble without bursting it. To do so, it has limited real estate-related enterprises’ access to credit in the domestic market. At the same time, to avoid bankruptcies and potentially triggering a financial crisis, it has acquiesced to these enterprises gaining access to the international credit market through extralegal contract arrangements that circumvent China’s restrictions on foreign debt and cross-border guarantees.⁷⁰

Accordingly, I would also like to clarify the meaning of “extralegal,” which is broader than “illegal” and has been used to describe both contracts enforced through non-legal means⁷¹ and illegal behaviors such as squatting on federal land in the 19th century U.S.⁷² The existing literature has emphasized the lack of enforceability of extralegal contracts and the lack of judicial protection of property rights for extralegal investment. This article defines extralegal finance as finance against legal prohibition which is therefore not entitled to judicial enforcement of contracts or to protection from state expropriation. I choose to use the word “extralegal” because of the ambiguity about legality in my case studies. Judicial and regulatory authorities have not presented a consistent and uniform definition of legality of the financial practices in my study: these authorities are not ready to formally legalize such practices; nor are they interested in eliminating the practices systematically through law enforcement. Extralegality catches such an in-between situation better than illegality.

C. *State Actors and Intermediaries as Super Nodes of Extralegal Financial Networks*

Nobody has examined finance against law before.⁷³ However, I draw inspiration from studies on finance without law, particularly studies on the

68. Paul Gillis & Fredrik Oqvist, *Variable Interest Entities in China*, GMT RESEARCH 7 (Mar. 13, 2019), <https://www.chinaaccountingblog.com/weblog/2019-03-vie-gillis.pdf> [<https://perma.cc/2R53-KNJ6>].

69. Zhuo Chen, Zhiguo He & Chun Liu, *The Financing of Local Government in China: Stimulus Loan Waves and Shadow Banking Waves*, 137 J. FIN. ECON. 42, 66 (2020).

70. See *infra* Part III.A.

71. See Bernstein, *supra* note 50.

72. HERNANDO DE SOTO, *THE MYSTERY OF CAPITAL: WHY CAPITALISM TRIUMPHS IN THE WEST AND FAILS EVERYWHERE ELSE* 153–205 (2000).

73. Studies of the Islamic banking system and China’s extralegal finance have been conducted mainly from the perspective of practitioners and have not examined their socio-political mechanisms.

sovereign bond market⁷⁴ and the extensive studies on relational contracts. The possibility of legal enforcement against sovereign states is limited, and yet states rarely default on their bonds.⁷⁵ Why? The main reason that states pay their debts is that they care about their reputation.⁷⁶ Sovereign states are long-term, repeat players in the market. Financial intermediaries such as bond underwriters and bond rating agencies help to hold sovereign states accountable by providing the international market with tangible measurement of those states' credibility and threatening to cut off their future access to the international credit market.⁷⁷

The above observation about the sovereign bond market is consistent with more general studies on relational contracts, which multiple generations of lawyers and economists have devoted their careers to.⁷⁸ Classical studies range from earlier research about the medieval merchant law, in which a "community responsibility system" enforces contracts in the absence of legal institutions⁷⁹; to the diamond trade among Jewish middlemen, who opted out of the legal system and relied on private arbitration and reputational mechanisms to enforce contracts; to a "small-world network" which can support long-distance trade beyond close-knit communities.⁸⁰ At the core of this literature is the idea that extralegal contracts, or more generally private ordering, can support trade of various sorts and in different times.

The challenge is, however, whether such trade goes beyond close-knit communities, which scholars generally consider necessary for successful private ordering.⁸¹ The market of sovereign bonds is a market based on close-knit communities: sovereign states are not anonymous to one another and constitute a close-knit community. In contrast, the transnational market of corporate debts and capital is mostly impersonal and loose-knit, given the large number of participants and their anonymity to one another. According

74. See, e.g., JEROME ROOS, WHY NOT DEFAULT? THE POLITICAL ECONOMY OF SOVEREIGN DEBT (2019); Mitu Gulati & George Triantis, *Contracts Without Law: Sovereign Versus Corporate Debt*, 75 U. CIN. L. REV. 977 (2006).

75. *Id.*

76. Gulati & Triantis, *supra* note 74, at 988; W. Mark C. Weidemaier & Mitu Gulati, *International Finance and Sovereign Debt*, in OXFORD HANDBOOK OF LAW AND ECONOMICS VOLUME 3: PUBLIC LAW AND LEGAL INSTITUTIONS 482 (Francesco Parisi eds., 2017).

77. Roos, *supra* note 74, at 228–34.

78. It is hard to give a comprehensive list of scholars who have worked on relational contracts. Here are just a few examples. George Baker, Robert Gibbons & Kevin J. Murphy, *Relational Contracts and the Theory of the Firm*, 117 Q. J. ECON. 39 (2002); Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963); Stewart Macaulay, *Relational Contracts Floating on a Sea of Custom? Thoughts about the Ideas of Ian MacNeil and Lisa Bernstein*, 94 NW. U. L. REV. 775 (1999); Bernstein, *supra* note 50; BARAK D. RICHMAN, STATELESS COMMERCE: THE DIAMOND NETWORK AND THE PERSISTENCE OF RELATIONAL EXCHANGE (2017).

79. Avner Greif, *Impersonal Exchange without Impartial Law: The Community Responsibility System*, 5 CHI. J. INT'L L. 109 (2004).

80. Lisa Bernstein, *Contract Governance in Small-world Networks: The Case of the Magbribi Traders*, 113 NW. U. L. REV. 1009 (2018).

81. *Id.*; see also Lior Jacob Strahilevitz, *Social Norms from Close-knit Groups to Loose-knit Groups*, 70 U. CHI. L. REV. 359 (2003).

to the conventional wisdom of relational contracts, the reputation mechanism works well in a market where participants know one another and engage in long-term, repeat transactions, but it does not work well among strangers engaging in one-off transactions.⁸²

This is where networks come in. Networks are different from close-knit communities in the sense that there are centers and peripheries in a network. Networks economize on information costs by aggregating information in prominent players (“*super nodes*,” using the term of network theories) who occupy relatively central places in the network.⁸³ The number of these prominent players is small and they know one another relatively well. Between this small number of prominent players the same characteristics of the close-knit communities are present, and they can hold one another accountable through reputational mechanisms. Each prominent player also has her own local network which enforces the reputational mechanisms among its local members. Overall, such a network enables transactions among strangers in the sense that not all transactors in the market need to know one another and can get information about an unknown transactor at relatively low information cost through prominent players and their networks.⁸⁴ The network therefore replaces legal institutions in enforcing contracts of impersonal and long-distance trade.⁸⁵

So far, the above network theory has only been used to explain the case of the medieval traders⁸⁶ and informal property transactions in contemporary China.⁸⁷ The Bitcoin market can also illustrate how a few *super nodes* can support an impersonal market of hundreds of billions of dollars. This market of millions of users⁸⁸ is supported by a network of a dozen people, with the founder at the center.⁸⁹ This Article extends the above network theory to explain how finance against law works. Chinese state actors and international financial intermediaries are *super nodes* of the network, enforcing con-

82. See, e.g., Robert Axelrod & William D. Hamilton, *The Evolution of Cooperation*, 211 SCI. 1390 (1981); AVINASH K. DIXIT, LAWLESSNESS AND ECONOMICS: ALTERNATIVE MODES OF GOVERNANCE (2011); Robert Ellickson, *Property in Land*, 102 YALE L.J. 1315 (1992); Ellickson, *Law and Economics Discovers Social Norms*, 27 J. LEG. STUD. 537 (1998).

83. See, e.g., Natalie Stanley et al., *Compressing Networks with Super Nodes*, 8 SCI. REP. 1 (2018).

84. Bernstein, *supra* note 80, at 1013–15.

85. *Id.*

86. *Id.* at 1020–38.

87. Shitong Qiao & Frank Upham, *The Evolution of Relational Property Rights: A Case of Chinese Rural Land Reform*, 100 IOWA L. REV. 2479 (2014).

88. See, e.g., Thomas Frank, *One in Five Adults has Invested in, Traded or Used Cryptocurrency*, NBC News Poll Shows, CNBC (Mar. 31, 2022), <https://www.cnbc.com/2022/03/31/cryptocurrency-news-21percent-of-adults-have-traded-or-used-crypto-nbc-poll-shows.html> [<https://perma.cc/8ANE-96JU>].

89. Siobhan Roberts, *How ‘Trustless’ Is Bitcoin, Really?*, N. Y. TIMES (June 15, 2022), <https://www.nytimes.com/2022/06/06/science/bitcoin-nakamoto-blackburn-crypto.html> [<https://perma.cc/2QBP-QWVC>]. (“Although Bitcoin was designed to rely on a decentralized, trustless network of anonymous agents, its early success rested instead on cooperation among a small group of altruistic founders.”); Alyssa Blackburn et al., *Cooperation Among an Anonymous Group Protected Bitcoin During Failures of Decentralization*, DEEPAI (June 6, 2022), <https://deepai.org/publication/cooperation-among-an-anonymous-group-protected-bitcoin-during-failures-of-decentralization> [<https://perma.cc/QF3L-VJB3>].

tracts and constraining the Chinese state from expropriating international investment as they constitute close-knit communities in which reputational mechanisms work. The concentration of foreign capital in certain industries also helps to form industry-specific communities, further extending the reach of reputational mechanisms.⁹⁰ Millions of market participants, i.e., *nodes* of the network, without a central place in the network or the political connections enjoyed by financial intermediaries, can still rely on super nodes to protect their investments. In Parts II and III, I investigate in depth how the close-knit communities of super nodes work.

The vast increase in the concentration of international financial markets in the past few decades has led to an ever-smaller circle of systemically important and politically powerful private banks and financial institutions in the West. Such financial intermediaries can hold not only sovereign states but also firms and households accountable, as these financial intermediaries have the capacity to withhold the short-term credit lines on which all economic actors—states, firms, and households alike—depend for their reproduction.⁹¹ For example, in the 1980s, it was well known that Japanese bankers did not differentiate between the public and private external debt of a developing country.⁹² “Foreign banks that lend to both the public and private sectors of a given country have considerable leverage to convince the government of that country to assume responsibility for *ex-post* bad private debts, especially those of financial intermediaries.”⁹³ Moreover, financial intermediaries define codes of behavior and facilitate the flow of information, which has made the transnational market of both sovereign and corporate debts quite transparent in the sense that behaviors deviating from market norms are indisputably identified, widely reported, and reflected in market prices in a timely fashion.⁹⁴

Chinese state participation in this network is crucial. State participation, even in extralegal contract relations, provides a certain degree of stability and predictability to extralegal private contract relationships.⁹⁵ The state, as the representative of the interests and reputation of all market participants under its jurisdiction, also maintains order in the extralegal financial markets it co-creates with other market participants.⁹⁶ Such state participation, together with the more conventional private reputation mechanism, mitigates the risk of contract defaults in the transnational market of corporate debt and capital.

90. See *infra* Part II.C.1 and Part III.C.1.

91. Roos, *supra* note 74.

92. Carlos Diaz-Alejandro, *Good-Bye Financial Repression, Hello Financial Crash*, 19 J. DEV. ECON. 1, 15 (1985).

93. *Id.*

94. See discussions about VIE and KWD, *supra* Part II, Part III.

95. In a different context, Emily Kaden observes that “Medieval merchants needed more protection than private ordering could afford them, and they looked for it in government intervention.” Emily Kadens, *The Medieval Law Merchant: The Tyranny of a Construct*, 7 J. LEGAL ANALYSIS 251, 278 (2015).

96. See *infra* Part II.C.3, Part III.C.3; *supra* note 79.

State participation also makes it possible for international financial intermediaries to constrain the state from enforcing the law, expropriating international investment that is prohibited by law. If such finance against law had no state participation, there would have been much bigger uncertainty regarding law enforcement, and such private finance against law would have been limited to close-knit communities, such as what is called “illegal crowd-funding” (非法集资) in China.⁹⁷ The Chinese state has a profound interest in suspending the enforcement of bad laws but has yet to formulate new laws to support new financial markets. Whether the state enforces the legal prohibitions involves a delicate balance between two factors: (1) its desire for access to capital and (2) its desire to retain sovereign control over industry, monetary, and other policies. The second factor is kept in check by worries over the first. There are no legal or judicial institutions that guarantee non-law-enforcement, but the state’s commitment to not enforcing the law against extralegal investments is credible to the degree that the state cares about its reputation and access to the transnational financial market.

Regarding both the contract and property risks above, the close-knit communities of super nodes ensure that reputation matters to the Chinese state. (Again, reputation does not work well among strangers or in one-off transactions.) Within the Chinese state, political elites—whose power and interests rely on the state’s access to the transnational financial market—safeguard the fulfilment of the state’s extralegal commitment through repeated acquiescence (silence in the face of flagrant violation of legal prohibition);⁹⁸ long-term administrative cooperation and practices;⁹⁹ communication through political leaders’ remarks in salient forums¹⁰⁰ and even news statements of central government departments;¹⁰¹ and disapproval or even punishment of private enterprises which violate extralegal contracts.¹⁰² International financial intermediaries maintain close communications with the above political elites and closely observe their words and behaviors as described above, rewarding China with continuous investment or punishing China by selling off.

97. Tsai, *supra* note 48, at 120–65. (The book does not use the exact words of illegal crowd-funding, but discusses regulations of and law enforcement against private finance among private entrepreneurs in China.) The most famous case of illegal crowd funding is the case of Wu Ying, who was once sentenced to death penalty for organizing such crowd funding. See *China overturns death sentence of entrepreneur Wu Ying in fraud case*, BBC NEWS (Apr. 20, 2012), <https://www.bbc.com/news/world-asia-china-17787189> [<https://perma.cc/9CV6-LATA>].

98. See *infra* Part II.C.3, Part III.C.3.

99. *Id.*

100. See *infra* Part II.C.3.

101. *Id.*

102. See *infra* Part II.B.2.

II. VARIABLE INTEREST ENTITIES AND “CHINA CONCEPTS STOCK”

The variable interest entity (“VIE”) is a business structure that Chinese companies use to circumvent China’s prohibition on foreign capital in certain industries so as to get listed on overseas stock markets. The VIE structure is employed by such Chinese technology giants as Alibaba, Baidu, Tencent, and every other Chinese internet company listed overseas.¹⁰³ In VIE structures, foreign investors do not hold equity shares in the Chinese company concerned. Instead they hold claims to control and financial gains through a multi-layered contractual arrangement.¹⁰⁴

This section of the paper investigates the origin of the VIE structure, highlighting the role of the state in designing this extralegal contractual arrangement to circumvent its own controls on foreign capital and illustrating how Chinese authorities struggle to achieve a balance between allowing foreign capital to support industrial development and maintaining control over industries that resist foreign influence. Furthermore, this section examines the legality of VIEs, and both the regulatory and contract risks therein, and investigates the mechanisms that supports this two-trillion-dollar market based on extralegal contracts.

A. *Contracting out of Regulations*

Foreign investment has been a key to China’s economic success in the past four decades.¹⁰⁵ Four decades ago, there was little foreign investment in China’s planned economy. Today, China is one of the world’s top destinations for foreign investment.¹⁰⁶ The Chinese government recognizes the importance of foreign capital to economic development but remains concerned about losing control of its industries to foreign capital. As a result, it has imposed institutional barriers or outright bans on foreign capital in industries it deems to have particular importance.¹⁰⁷ The government’s so-called

103. Eamon Barrett, *Beijing Might Finally Close the IPO Loophole that Allowed Didi to List Overseas*, FORTUNE (July 8, 2021), <https://fortune.com/2021/07/08/beijing-loophole-vic-overseas-ipo-didi-crack-down/> [https://perma.cc/47W3-V6NB].

104. See *infra* Part II.C.2.

105. See, e.g., Kevin Honglin Zhang, *How Does Foreign Direct Investment Affect Economic Growth in China?* 9 ECON. TRANSITION 679 (2001); Jai S. Mah, *Foreign Direct Investment Inflows and Economic Growth of China*, 32 J. POL’Y MODEL. 155 (2010).

106. Carlos Sánchez-Muñoz et al., *The World’s Top Recipients of Foreign Direct Investment*, IMF (Dec. 16, 2021), <https://blogs.imf.org/2021/12/16/the-worlds-top-recipients-of-foreign-direct-investment/>.

107. Quanguo Renda Changweihui Guanyu Xiugai Zhonghua Renmin Gongheguo Waizi Qiye Fa de Jueding (全国人大常委会关于修改《中华人民共和国外资企业法》的决定) [Decision of the Standing Committee of the National People’s Congress on Amending the Law of the People’s Republic of China on Foreign-funded Enterprises] (promulgated Oct. 31, 2000, invalidated by the Foreign Investment Law of the People’s Republic of China, effective Jan. 1, 2000) https://www.pkulaw.com.proxy.lib.duke.edu/en_law/2f60b288daffe8bfd8fb.html (China); Quanguo Renmin Daibiao Dahui Changwu Weiyuanhui Guanyu Xiugai Zhonghua Renmin Gongheguo Waizi Qiye Fa deng Sibufalü de Jueding (Han: Zhongwai Hezi Jingying Qiye Fa, Zhongwai Hezuo Jingying Qiye Fa, Taiwan Tongbao Touzi Baohu Fa) (全国人民代表大会常务委员会关于修改《中华人民共和国外资企业法》等四

“negative list” covers a wide range of sectors that foreign investors are prohibited from entering, including the internet, education, health, and news.¹⁰⁸ For example, of particular importance to the internet industry, “no foreign businessman may engage in, or participate in the engagement in, the communications services within China.”¹⁰⁹

Nevertheless, many industries on the negative list need access to foreign capital to support their development. China’s internet industries in the early 2000s are a good example. Sina is a major news website founded with U.S. angel investment funding by Chinese entrepreneurs who had returned from the U.S. and been inspired by the dot-com fever. It was preparing for an initial public offering (“IPO”) in the U.S. when the Ministry of Information and Industry (“MII”) issued a statement reiterating its ban on foreign capital in China’s internet industry. From the government’s perspective, foreign capital could jeopardize its control over the media and news services. Allowing foreigners to control Sina would be unimaginable. This would be similar to how unlikely it would be for a major newspaper in China to be controlled by foreigners.¹¹⁰ The MII’s statement caused panic among Sina’s founders and underwriters, but just three days later, the MII issued another, seemingly contrary, statement saying that the Chinese government supported foreign investment in the internet industry.¹¹¹ These contradictory statements may have been the result of the aforementioned struggle between the liberal faction advocating for the use of foreign capital to promote economic development and the conservative faction concerned about foreign influence. Alternatively, the statements may have simply reflected the Chinese state’s dual, and mutually contradictory, goals of governing the internet: to promote its development but also to keep it under government control.

In the following weeks, Sina’s founders entered into negotiations with the MII to find a solution. They persuaded MII officials that China’s domestic capital market was not yet sufficiently rigorous to support Sina’s develop-

部法律的決定(含: 中外合資經營企業法、中外合作經營企業法、台灣同胞投資保護法)) [Decision of the Standing Committee of the National People’s Congress on Amending Four Laws including the Law of the People’s Republic of China on Wholly Foreign-Owned Enterprises (Including the Law on Chinese-Foreign Equity Joint Ventures, the Law on Chinese-Foreign Contractual Joint Ventures, and the Law on the Protection of Investments by Taiwan Compatriots)] (promulgated Sept. 3, 2016, effective Oct. 1, 2016) https://www-pkulaw-com.proxy.lib.duke.edu/en_law/2e2d4387cebaf88abdfb.html (China).

108. See Waishang Touzi Zhunru Tebie Guanli Cuozhi (Fumian Qingdan) (外商投資准入特別管理措施(負面清單)) [Special Administrative Measures for Foreign Investment Access (Negative List)] (promulgated by Nat’l Dev. Reform Comm. and Ministry of Commerce, Dec. 28, 2021) (China).

109. Guowuyuan Pi Zhuan Youdian Bu Guanyu Jinqiang Dianxin Yewu Shichang Guanli Yijian de Tongzhi (國務院批轉郵電部關於進一步加強電信業務市場管理意見的通知) [Circular of the State Council on the Approval and Transmission of the Views of the Ministry of Post and Telecommunications on Further Strengthening the Administration of Telecom Service Market] (promulgated Aug. 3, 1993, effective Aug. 3, 1993) Art. 5, https://www-pkulaw-com.proxy.lib.duke.edu/en_law/bcf5ca9edb1f3183bdfb.html (China).

110. Sheff, *supra* note 66, at 199.

111. *Id.* at 199.

ment and that access to foreign capital was thus essential to its success. For their part, the officials continued to insist that no foreign capital could be permitted in a major news website but that they still wanted to support the company's development. The MII proposed conducting a study of the issues, as other Chinese internet companies, including Netease and Sohu, were also preparing for IPOs in the U.S.¹¹² Eventually Sina agreed to a proposal made by the MII:

Sina will be divided into two companies. The company on the Mainland will be a separate entity, a Chinese corporation. Sina's U.S., Hong Kong and Taiwanese businesses will be independent. However, it's a smoke-and-mirrors solution. Sina China will buy virtually all of its technology, as well as its business services, from Sina.com, which will be a listed company in the West. Sina.com will be the sole technology and service provider for Sina China. It sounds a lot like everything on paper, but little in reality will change. Nonetheless, the deal is viewed as a triumph for both sides. Whereas it makes investors wary, it breaks the stalemate. The new structure loosely complies with the government regulations—the government can exert its control on the local company, which is exclusively responsible for content on the Mainland site—and Sina's past investors are protected. The IPO can finally go forward.¹¹³

The VIE in the above proposal is a Chinese company that is owned by an individual who holds Chinese nationality—often the founder of the company.¹¹⁴ Foreign investors invest in an offshore listed company, typically incorporated in the Cayman Islands.¹¹⁵ The listed company, in turn, owns a “wholly foreign-owned entity” (“WFOE”) that does not operate in a sector prohibited by the negative list. The VIE holds licenses and assets that cannot be legally owned by or transferred to the WFOE under Chinese restrictions on foreign investment.¹¹⁶ Its shareholders of record are Chinese citizens or companies, typically with the founders retaining majority ownership. The WFOE controls and receives the economic benefits of the domestic company (the VIE) through a series of contractual arrangements. Such contractual arrangements allow the offshore holding company to consolidate the

112. *Id.* at 199.

113. *Id.* at 202–03.

114. Gillis & Oqvist, *supra* note 68, at 4.

115. *Id.* at 3.

116. Scott Murdoch & Kane Wu, *Explainer: The 'VIE' Structure Helping Chinese Firms Float Abroad*, REUTERS (Dec. 30, 2021), <https://www.reuters.com/markets/us/vie-structure-helping-chinese-firms-float-abroad-2021-12-29/> [https://perma.cc/82NV-BLM6].

financials of the VIE into the group's overall financial statements under applicable accounting standards.¹¹⁷

Sina launched the VIE model for Chinese internet companies wishing to list overseas, initiating the era of the so-called "China concepts stock." The MII was a co-conspirator in the scheme to circumvent Chinese restrictions on foreign capital in the internet industry. This demonstrates that extralegality results from China's developing legal and economic system's struggle between development and control. The VIE structure has been primarily used by companies in the internet industry and adopted by a few companies in other industries too.¹¹⁸

B. *Legality and Risks*

Is the VIE structure legal? This subsection examines how Chinese lawyers communicate its legality to U.S. regulators and potential investors, the U.S. Security and Exchange Commission's ("SEC") approach to VIEs, and the risks of regulatory and contract enforcement.

1. *Legality*

The U.S.-China Economic and Security Review Commission ("ESRC") in 2014 published a staff report on its website stating that many U.S. legal experts argued that the VIE structure was technically illegal under Chinese law and advised U.S. investors not to engage in such investments.¹¹⁹ Although the report did not claim to represent the ESRC's attitude on the issue, it demonstrates widespread concern over the legality of VIEs in the past based on incidents in which the Chinese authorities had taken enforcement measures against a VIE or Chinese entrepreneurs had unilaterally revoked contracts between the VIE and the corresponding WFOE.¹²⁰ Before discussing such incidents in detail, let us first examine the questions of what lawyers have to say about the legality of VIEs and how the SEC has allowed Chinese companies to list on the U.S. stock markets using the VIE structure.

In a 2018 letter that Han Kun, a leading Chinese law firm that frequently advises issuing companies or underwriters for overseas listing, filed with the SEC in connection with the Tencent's 2018 prospectus, the following statement appears:

117. O'MELVENY & MYERS, VIE STRUCTURES IN CHINA: WHAT YOU NEED TO KNOW (Nov. 1, 2011), https://www.omm.com/resources/alerts-and-publications/publications/omelveny-myers-publishes-paper-vie-structures-in-china-what-you-need-to-know?sc_lang=ZH-CN [<https://perma.cc/N6BS-FFD9>].

118. *Id.*

119. U.S.-China Economic and Security Review Commission, *supra* note 6.

120. *Id.*

VIE Structure. The ownership structure of the Material PRC Companies, both currently and immediately after giving effect to the Offering, do not and will not contravene applicable PRC Laws. Each of the VIE Agreements is valid and binding upon each party thereto and enforceable against each party thereto in accordance with its terms and applicable PRC Laws. There are, however, substantial uncertainties regarding the interpretation and application of PRC Laws and future PRC laws and regulations, and there can be no assurance that the Governmental Agencies will take a view that is not contrary to or otherwise different from our opinion stated above.¹²¹

This statement is reiterated in the Tencent's 2018 prospectus,¹²² and represents the general approach taken by Chinese law firms representing Chinese companies listing in the U.S. through a VIE. The approach has two core components. First, Chinese law rarely explicitly bans VIEs. Even in the case of the only exception, that is, VIEs are explicitly banned in China's online game industry, a Chinese law firm argued in its statement filed with the SEC that the ban's enforceability was problematic because it was not issued by the authorities regulating foreign capital or the internet industry.¹²³ Moreover, most Chinese administrative measures banning foreign capital in certain industries use the word "equity" or "shareholding," and law firms take narrow interpretations of such measures to argue that contract arrangements are not banned.¹²⁴ These interpretations would not stand up to a more substantive interpretation of the administrative measures,¹²⁵ but is how Chinese law firms arrive at their conclusion that VIEs "do not and will not contravene applicable PRC Laws." Second, legal statements filed with the SEC also make it clear that there are uncertainties surrounding enforcement by the Chinese authorities, and the law firms concerned do not guarantee that the authorities will not make a contrary interpretation. In

121. Opinion of Han Kun Law Offices Regarding Certain PRC Law Matters, to Tencent Music Entertainment Group 4 (Oct. 1, 2018), <https://www.sec.gov/Archives/edgar/data/1744676/000119312518290581/d624633dex992.htm> [<https://perma.cc/KG35-JP7R>].

122. Tencent Music Ent. Grp., Registration Statement (Form F-1) 83 (Oct. 1, 2018), <https://www.sec.gov/Archives/edgar/data/1744676/000119312518290581/d624633df1.htm> [<https://perma.cc/C8VP-UEM3>].

123. Taomee Holdings Ltd., Registration Statement (Form F-1) 23 (June 10, 2011), https://www.sec.gov/Archives/edgar/data/0001507051/000119312511162606/d424b4.htm#rom118192_2 [<https://perma.cc/5JD8-6ZCK>].

124. Yan Liu (刘燕), *Zai "Moren Hefa" Zhong Baofa de Falü Fengxian—Xieyi Kongzhi—VIE Moshi Xia Fengxian Shijian ji Anli Shuping* (在“默认合法”中爆发的法律风险——协议控制-VIE模式下风险事件及案例述评) [Legal Risks in “Implicit Legality” – A Review of Risk Events and Cases under the Agreement Control or VIE Model], 9 ZHENGQUAN FAYUAN (证券法苑) [Securities Law Review] (2013), <http://www.commerciallaw.com.cn/index.php/home/article/info/id/98.html> [<https://perma.cc/448U-PW5H>] (China).

125. *Id.*; U.S.-CHINA ECON. SEC. REV. COMM'N, *supra* note 6. (“Many U.S. legal experts argue that the VIE structure is technically illegal under Chinese law, and advise U.S. investors against engaging in such investments.”)

other words, it is possible that the Chinese authorities will consider a VIE illegal. However, law firms categorize that risk more as a potential change in the regulatory environment (rather than stating directly that the Chinese authorities might consider VIEs illegal, thereby contradicting their filed statement.)

With respect to contract risks, legal statements also make it clear that control through contracts is different from equity control. For example, Alibaba's Form F-1 states,

[d]ue to PRC legal restrictions on foreign ownership and investment . . . our variable interest entities are generally majority-owned by Jack Ma These contractual arrangements collectively enable us to exercise effective control over, and realize substantially all of the economic risks and benefits arising from, the variable interest entities The contractual arrangements may not be as effective in providing operational control as direct ownership."¹²⁶

Chinese lawyers have generally avoided stating that VIEs are illegal, which might preclude the IPO in question, preferring to disclose the possibility of Chinese enforcement against a VIE and foreign investors' weaker control over the VIE than control through equity. Their statements are honest but lawyerly crafted.

What do U.S. regulators think about the legality of VIEs? Despite the aforementioned ESRC staff report, the SEC has taken a disclosure approach.¹²⁷ The rationale is that when companies provide detailed, accurate, and comprehensive information about their business, investors themselves can synthesize that information into a stock price that reflects the companies' expected risks and returns. If the risks are too great, then investors can protect themselves by deciding not to buy the stock.

A recent statement by SEC Chairman Gary Gensler reminds U.S. investors that the stocks they purchase are the stocks of a shell company, not those of the Chinese entity.¹²⁸ With respect to contract risks, the SEC is primarily concerned with accounting disclosure and fraud, taking an ex post rather than ex ante approach, and requesting regulatory collaboration from

126. Alibaba Grp. Holding Ltd., Registration Statement (Form F-1) 72 (May 6, 2014), <https://www.sec.gov/Archives/edgar/data/1577552/000119312514184994/d709111dfl.htm> [<https://perma.cc/Q7ND-A4F7>].

127. See Daniel M. Gallagher, *Remarks at Society of Corporate Secretaries & Governance Professionals*, SEC. EXCH. COMM'N (July 11, 2013), <https://www.sec.gov/news/speech/spch071113dmghtm> [<https://perma.cc/VCK9-HETR>] ("The SEC is first and foremost a disclosure agency."); Paula J. Dalley, *The Use and Misuse of Disclosure as a Regulatory System*, 34(4) FLA. ST. U. L. REV. 1089, 1093 (2007) (explaining the mandates of the securities acts).

128. Gary Gensler, *Statement on Investor Protection Related to Recent Developments in China* (July 30, 2021), <https://www.sec.gov/news/public-statement/gensler-2021-07-30> [<https://perma.cc/VY9T-AE9R>].

its Chinese counterpart.¹²⁹ As for regulatory risk on the Chinese side, the SEC also follows a disclosure approach, demanding specific information on whether the Chinese authorities have given their approval, and whether such approval, if given, might be revoked.¹³⁰ Because disclosure is the overarching approach to investor protection, U.S. regulators do not block companies from listing, as long as they provide all of the requisite information. Even when it came to the recent delisting of Chinese companies, the SEC focused on disclosure and access to the companies' books, exhibiting no concern about the legality of VIEs.¹³¹ Research also seems to support this market-based regulatory approach. Hopkins et al. find that risks of contract default and regulatory enforcement significantly discount the valuation of the Chinese VIE firms on U.S. exchanges compared to Chinese non-VIE firms.¹³²

2. *The Risk of Regulatory Enforcement*

The VIE structure provides a way for Chinese companies to contract out of regulations and gain access to foreign capital markets. It is a solution to strike a balance between development and control. However, it does not remove the tension between development and control and VIEs are not a silver bullet rendering Chinese companies immune from regulatory enforcement. To safeguard the integrity of their regulations, various Chinese regulatory authorities have seen the need to stop a given Chinese company from using a VIE to get listed overseas on occasion. Overall, however, the Chinese government recognizes the importance of the VIE structure to China, particularly its internet industry, and has never invalidated a VIE *per se*. In other words, Chinese companies do face heightened regulatory risks, but those risks are not the fault of the VIE structure *per se*. Whether a VIE is allowed depends on specifics, and particularly on the balance between regulatory control and access to the international capital market. The status quo is also generally respected.¹³³

The first (and to date, probably only) case in which a Chinese governmental authority explicitly invalidated a VIE structure was that of the Buddha Steel case. In April 2010, Buddha Steel, a Delaware-registered shell corporation, signed a set of "VIE Agreements" with Baosheng Steel, a Chinese

129. Yinzi Miao (缪子音), *Jingwai Shangshi Jianguan de Shizi Lukou: VIE Nanti Daijie* (境外上市监管的十字路口: VIE难题待解) [The Crossroads of Offshore Listing Regulation: The VIE Conundrum to be Solved], JINJI GUANCHAWANG (经济观察网) [The Economic Observer] (Aug. 6, 2021), <http://m.eeo.com.cn/2021/0806/497731.shtml> [<https://perma.cc/TH7U-H2B8>] (China).

130. Gensler, *supra* note 128.

131. *SEC Adds China's JD.com to List of Over 80 Firms Facing Delisting Risk*, REUTERS (May 5, 2022), <https://www.reuters.com/business/over-80-firms-including-chinas-jdcom-added-us-sec-list-facing-delisting-risk-2022-05-05/> [<https://perma.cc/DT2J-U5SH>]; *Holding Foreign Companies Accountable Act* ("HFCAA") SEC. EXCH. COMM'N (June 30, 2022), <https://www.sec.gov/hfcaa> [<https://perma.cc/PUD2-XMZ3>].

132. Justin J. Hopkins, Mark Lang & Donny Zhao, *The Rise of VIEs in China: Balancing State Control and Access to Foreign Capital*, J. FIN. REPORTING 105, 125 (2022).

133. See *infra* Part II.C.3.

company, and related parties for the purpose of getting an IPO in the U.S.¹³⁴ However, in March 2011, Buddha filed an SEC Form 8-K announcing the termination of these agreements, withdrawing its IPO application. The reason given for the termination was that “Baosheng Steel was advised by local governmental authorities in Hebei Province of the People’s Republic of China that the [VIE] Control Agreements contravene current Chinese management policies related to foreign-invested enterprises and, as a result, are against public policy.”¹³⁵ The steel industry is severely regulated by the Chinese state, which is reluctant to use private capital, let alone foreign capital, to support the industry’s development. The weights of development and control differ from industry to industry and it is in the internet industry where foreign capital is essential, that VIE structures have been mostly used and acquired by the state.

The first Chinese regulatory document to ban the VIE structure was a notice concerning online game companies issued by three Chinese agencies. The notice expressly “prohibits foreign investors from gaining control over or participating in domestic online game operators through *indirect* means, such as establishing other joint venture companies or *contractual* or technical arrangements.”¹³⁶ However, this provision has not been enforced, with a number of online game companies listing in the U.S. through the VIE structure even after its promulgation.¹³⁷ In opinions filed with the SEC, Chinese lawyers have stated that the notice’s enforcement is quite unlikely because none of the three issuing agencies, the General Administration of Press and Publication, National Copyright Administration, and Office of the National Anti-Pornography Working Group, has direct control over cross-border capital flows or the corporate governance of online game companies.¹³⁸

As VIEs provide a way for Chinese companies to contract out of the Chinese ban on foreign capital in certain industries, Chinese regulators have on occasion indicated concern over the potential for their regulations to be circumvented by VIEs. In June 2010, for example, the People’s Bank of China (“PBOC”) announced that non-bank payment companies were required to obtain a license in order to operate in China.¹³⁹ The license applicant must

134. A.G. Volney Ctr., Inc., Current Report (Form 8-K) (Apr. 28, 2010), https://www.sec.gov/Archives/edgar/data/1367777/000114420410023596/v182501_8k.htm [<https://perma.cc/5XT5-KYSA>].

135. Buddha Steel, Inc., Current Report (Form 8-K) (Mar. 28, 2011); *see also* Powell, *supra* note 9.

136. Xinwen Chuban Zongshu Guanyu Jiaqiang dui Jinkou Wangluo Youxi Shenpi Guanli de Tongzhi (新闻出版总署关于加强对进口网络游戏审批管理的通知) [Notice of the General Administration of Press and Publication on Strengthening the Administration of Examination and Approval of Imported Online Games] (promulgated by the Nat’l Press and Publ’n Admin., July 1, 2009, effective July 1, 2009) (China).

137. O’MELVENY & MYERS, *supra* note 117.

138. Taomee Holdings Ltd., *supra* note 123.

139. Fei Jinrong Jigou Zhifu Fuwu Guanli Banfa (非金融机构支付服务管理办法) [Administrative Measures for the Payment Services Provided by Non-financial Institutions] (promulgated by the People’s Bank of China on June 14, 2010, effective Sept. 1, 2010) art. 3 (China).

be a company “legally formed inside the People’s Republic of China.”¹⁴⁰ Further, each “major investor” of an applicant is defined as an investor that “actually controls the applicant or an investor which holds more than 10% of the applicant’s equity.”¹⁴¹ The “actual control” standard here could potentially encompass VIE foreign investors exercising their contractual voting rights. Finally, “[t]he business scope of foreign-funded payment institutions, the eligibilities of overseas investors, the ratio of investments of overseas investors and other such matters shall be determined by the PBOC in other initiatives and be submitted to the State Council for approval.” Jack Ma argued that the PBOC could not grant such a license to companies controlled by foreign capital through contracts,¹⁴² and thus unilaterally revoked contracts between Alipay (the VIE) and Alibaba group (the WFOE), but other companies with a VIE structure, including Tencent, subsequently managed to obtain a license as a Chinese entity.¹⁴³ This example demonstrates both the vagueness and uncertainty of Chinese regulations, as well as the Chinese regulatory authorities’ overall acceptance of VIE structures.

The most recent case—and one that has exacerbated investor concerns over VIEs—is that of Didi. Several days after Didi’s U.S.\$4.4 billion IPO in New York in June 2021, which represented the largest overseas listing of a Chinese company since Alibaba Group’s IPO in 2014, the Cyber Administration of China (“CAC”) launched an investigation into Didi on suspicion that Didi had violated data privacy and national security laws.¹⁴⁴ The same week, the Chinese Communist Party (“CCP”) Central Committee (the party’s leading power organ¹⁴⁵) and the State Council (the chief administrative authority¹⁴⁶) published a set of regulations entitled “Opinions on Strictly Cracking Down On Illegal Securities Activities in accordance with the Law.”¹⁴⁷ Among other provisions, the regulations call for “strict control” over the “legality of securities investment funds,” the strengthening of the “information security of overseas listed companies,” and strengthened

140. *Id.*, art. 8(1).

141. *Id.*, art. 10.

142. *See id.*; *see* Alibaba Grp. Holding Ltd., Amendment No. 3 to Registration Statement (Form F-1) (July 11, 2014), at 10.

143. Shanshan Wang (王姗姗), Yuzhe Zhang (张宇哲), Huawei Ling (凌华薇), Qiong Guo (郭琼), Ziwu Wang (王紫雯), Fei Zheng (郑斐) & Yanyan Fu (符燕楠), *Zhifubao Kaoyan* (支付宝考验) [The Test for Alipay], *Caixin Zhouli* (财新周刊) [CAIXIN MAGAZINE] (June 20, 2011) (China).

144. Clay Chandler, Grady McGregor & Eamon Barrett, *How Didi’s Data Debauch Doomed China’s Love Affair with Wall Street*, *FORTUNE* (July 9, 2021).

145. Constitution of the Communist Party of China, art. 16, 19, http://www.xinhuanet.com/english/download/Constitution_of_the_Communist_Party_of_China.pdf [https://perma.cc/9W54-25CF] (last revised Oct. 24, 2017).

146. *China’s State Organizational Structure*, CONG.-EXEC. COMM’N ON CHINA, <https://www.cecc.gov/chinas-state-organizational-structure> [https://perma.cc/377Q-6WNL] (last visited Dec. 17, 2021).

147. Guanyu Yifa cong Yan Daji Zhengquan Weifa Huodong de Yijian (关于依法从严打击证券违法活动的意见) [Opinions on Strictly Cracking Down on Illegal Securities Activities in accordance with the Law] (promulgated by the General Office of the CPC Central Committee and the General Office of the State Council, July 6, 2021) (China).

supervision of “China Concepts Stock.”¹⁴⁸ In a similar vein, the PBOC announced later that month that non-bank payment firms would have to report both domestic and foreign IPOs, as well as explain the “detailed arrangement” of their VIE structures if pursuing an overseas listing.¹⁴⁹ These dramatic announcements sent shockwaves through global financial circles.¹⁵⁰

However, at the core of the Didi debacle was data security rather than the legal validity of VIEs. In December, the China Securities Regulatory Commission (“CSRC”), China’s securities watchdog, published a new draft regulation stating that companies can list overseas via VIEs if they meet compliance rules to address market concerns over VIEs.¹⁵¹ The Didi case also reflected China’s struggle between control and development. The government did not, and still does not, oppose overseas listing for Chinese companies, as it recognizes that foreign capital is essential to their development, but it needs to maintain control. One reason for the swift crackdown following Didi’s IPO was that Didi advanced with the IPO despite CAC officials’ concerns about the sensitivity of the information displayed on Didi’s mapping function and warnings that the company should delay its listing until a thorough internal security review could be conducted.¹⁵² The company’s actions stand in stark contrast to Sina’s patient negotiations and cooperation with the MII in finding a solution that met the Chinese state’s need for both development and control. Further evidence showing that the Chinese government does not oppose VIEs *per se* is that it has encouraged Didi to launch an IPO in Hong Kong, which Didi plans to do.¹⁵³

3. Contract Risk

VIE contracts are designed to circumvent China’s ban on foreign capital in certain industries. Before China passed the Civil Code in 2020, Chinese law used to stipulate that contracts “concealing an illegal purpose in a legal

148. *Id.*

149. Reuters Staff, *China’s Central Bank Requires Non-Bank Payment Firms to Report Overseas IPOs*, REUTERS (July 23, 2021), <https://www.reuters.com/article/us-china-cenbank-regulation/chinas-central-bank-requires-non-bank-payment-firms-to-report-overseas-ipos-idUSKBN2ET0UC> [<https://perma.cc/G6QF-H55N>].

150. See, e.g., Hudson Lockett & Tabby Kinder, *China’s Crackdown on US Listings Threatens \$2tn Market*, FIN. TIMES (July 7, 2021), <https://www.ft.com/content/299ba00b-dfef-4c53-88a2-e6725d14025d> [<https://perma.cc/3TCJ-3XBN>].

151. Daniel Ren & Coco Feng, *China’s New VIE Rule Eases Concerns about Overseas IPOs Following Months of Uncertainty After Didi Probe*, S. CHINA MORNING POST (Dec. 25, 2021), <https://www.scmp.com/business/china-business/article/3161045/chinas-new-vie-rule-eases-concerns-about-overseas-ipos> [<https://perma.cc/Q3XK-TAAC>].

152. Chandler et al., *supra* note 144.

153. Julie Zhu & Kane Wu, *Didi Shares Plunge More than 20% on Plan to Delist from NYSE*, REUTERS (Dec. 3, 2021), <https://www.reuters.com/technology/didi-global-start-work-delisting-new-york-pursue-ipo-hong-kong-2021-12-03/> [<https://perma.cc/VYL4-PKFN>]; Shiyin Chen & Coco Liu, *Didi’s Move from NYSE to Hong Kong — What to Know*, BLOOMBERG (Dec. 2, 2021), <https://www.bloomberg.com/news/articles/2021-12-03/everything-we-know-about-didi-s-plan-to-delist-from-the-nyse#xj4y7vzkg> [<https://perma.cc/M3P4-TGJQ>].

form” (以合法形式掩盖非法目的) are void.¹⁵⁴ Moreover, contracts that “violate mandatory rules in laws and regulations” (违反法律法规的强制性规定) are also void under Chinese law.¹⁵⁵ The Civil Code of China has removed the first basis for voiding a contract but has kept the second one. As a result, VIE contracts can be adjudicated as void, and therefore unenforceable under Chinese law. As foreign capital providers rely on VIE contracts to “actually control” Chinese operations, the unenforceability of these contracts equates to quite limited, if not zero, legal protection for their investments. Given the difficulty of enforcing U.S. judgements in China, the U.S. courts are also unlikely to be of much help either. As Jesse Fried and Ehud Kamar have argued, “almost every person or thing required to enforce the law—the insiders, the insiders’ assets, the firms’ records, and the firms’ assets—is . . . out of reach both for private plaintiffs and for public prosecutors in the United States.”¹⁵⁶ Fighting over corporate control between founding entrepreneurs, who are also in charge of daily operations, and capital providers is a common problem in corporate governance, a major purpose of which is to solve such disputes.¹⁵⁷ The unenforceability of VIE contracts can potentially exacerbate the problem. There have been in total five reported cases wherein Chinese founders have revoked VIE contracts or withdrawn assets and funds from a VIE against the will of foreign investors.

The most famous such case is the dispute between Alibaba founder Jack Ma and Yahoo. In 2005, Yahoo sold its China operations to the Alibaba Group in return for a 40% stake in Alibaba. Since then, Yahoo’s web search empire has crumbled while the Alibaba Group has become a global force in

154. Contract Law of The People’s Republic of China, art. 52(3) (promulgated by Nat’l People’s Cong. on Oct. 1 1999, invalidated on Jan. 1 2021). After the promulgation of the 2021 Civil Code, the situation of “concealing an illegal purpose in a legal form” as stipulated in the original contract law is no longer considered as a cause of voiding a contract. It is unclear whether this removal is directly related to VIE. In a widely reported case, in 2012 the SPC adjudicated that a contract between a Hong Kong company and a Chinese company to hold shares through the latter in a Chinese bank was void as the contract was to circumvent Chinese regulatory ban on foreign capital in its financial industry and therefore of illegal purposes. Foreign investors were justifiably concerned about this decision’s effect on VIEs as the legal reasoning in this case was potentially applicable to deciding the validity of VIE contracts. However, this decision does not have a binding effect on future disputes as China is not a common law jurisdiction. More importantly, the dispute is not specifically about VIE. The *Ambow* decision in 2016 discussed below in this section is specifically about VIE and better reflects the SPC’s stance on the legality of VIEs. See Huamao Jinrong Fuwu Gongsi Su Zhongguo Zhongxiao Qiye Touzi Fuwu Gongsi Panjue Shu (华懋金融服务公司诉中国中小企业投资服务公司判决书) [Chinachem Financial Services Co. v. China SME Investment Service Corp] (Supreme People’s Court 4th Civil Division No. 30) (2002) (China). Another related article of potential applicability is Article 146 of the Civil Code, which says that “[A] juridical act performed by an actor and the opposite party based on false declaration of will shall be void. [T]he validity of a juridical act hidden behind a false declaration of shall be dealt with in accordance with the relevant provisions of laws.” Arguably foreign investors and their Chinese partners conducted “false declaration of will” as the real purpose of the contracts between VIE and WFOE is to exercise equity control. Whether Article 146 will be applied to VIE disputes depends not on legal reasoning but on political and policy considerations.

155. Civil Code of the People’s Republic of China, art. 153 (promulgated by Nat’l People’s Cong. on May 28, 2020, effective Jan. 1, 2021).

156. Fried & Kamar, *supra* note 10.

157. See, e.g., ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993).

wholesale e-commerce. Ma made several unsuccessful attempts to buy back Yahoo's stake in Alibaba. The Alibaba Group controlled Alipay, whose majority owner is Jack Ma, via a VIE structure. However, in early 2011, Ma unilaterally terminated the VIE arrangement. As a result, Alibaba Group lost control of Alipay, and Alipay profits could no longer be reflected on Yahoo's balance sheet. Alipay was regarded as one of the most valuable investments that Yahoo held and, consequently, Yahoo's stock price dropped 9.8% the day after Yahoo disclosed the information.¹⁵⁸

As explained in a revised Form F-1 filed in 2014 by Alibaba, the termination was in response to the aforementioned new PBOC regulations issued in June 2010 that required non-bank payment companies to obtain a license to operate in China.¹⁵⁹ In light of the "uncertainties relating to the license qualification and application process for a foreign-invested payment company," Alibaba decided to restructure Alipay as a company "wholly owned by PRC nationals" and "obtain a payment business license in May 2011 without delay and without any detrimental impact to our China retail marketplaces or to Alipay."¹⁶⁰

This explanation, however, has been questioned by parties familiar with the new PBOC regulations, including an anonymous PBOC official cited in a detailed report of Caixin, a leading Chinese financial media group.¹⁶¹ The fact that other Chinese companies with a VIE structure have obtained the same kind of license without revoking contracts between VIEs and their overseas capital providers also makes an alternative explanation more persuasive: Jack Ma revoked the VIE contracts to obtain more control over Alibaba. At the time of the Alipay incident in 2011, Yahoo and Softbank were Alibaba's largest shareholders. Yahoo, headquartered in California, owned 43% of the shares in Alibaba Group, a Cayman Island company. Softbank, a Japanese company, owned approximately 30% of shares. Jack Ma owned approximately 25%. The Alibaba Group owned 70% of Alibaba.com. The relationship between Jack Ma and Yahoo had deteriorated after former Yahoo CEO, Jerry Yang, with whom Ma had enjoyed a very good relationship, was replaced by Carol Bartz in 2009.¹⁶² Ma was concerned that his minority stake in Alibaba would be insufficient to protect him from Yahoo and Softbank.

The three parties (Ma, Yahoo, and Softbank) eventually reached an agreement in July 2011 that guarantees Alibaba 37.5% of the total equity value of Alipay or a payment of at least U.S.\$2 billion, and up to U.S.\$6 billion, if

158. Li Guo, *Chinese Style VIEs: Continuing to Sneak under Smog*, 47 CORNELL INT'L L.J. 569 (2014).

159. Alibaba Grp. Holding Ltd., *supra* note 142, at 10.

160. *Id.*

161. Wang et al., *supra* note 143.

162. The two met in 1997 when Ma was assigned as Yang's tour guide during a visit to the Great Wall, and they stayed in touch afterwards. See Aaron Pressman, *Yahoo Co-Founder Jerry Yang Says He's the Luckiest Person Alive*, FORTUNE (July 16, 2018), <https://fortune.com/2018/07/16/yahoo-jerry-yang-alibaba-luckiest/> [https://perma.cc/RJ5W-869X].

the spin-off company goes public or another “liquidity event” occurs.¹⁶³ It also requires Alipay to pay Alibaba royalties for software services and 49.9% of its consolidated pre-tax income and to continue to service Taobao, the group’s consumer e-commerce unit, and other group businesses on preferential terms. In mid-2012, Yahoo sold approximately half of its stake in Alibaba for \$7.1 billion.¹⁶⁴ As part of the deal, Yahoo and Softbank agreed to cap their voting rights in Alibaba at below 50%.¹⁶⁵

For the purpose of this Article, it is important to note that Yahoo chose to settle the dispute with Ma rather than going to court. Although there may have been multiple reasons for that choice, one of the most likely is that the Chinese courts would have been of little help in providing a remedy. The Alipay debacle shocked capital markets and shook investors’ confidence in the so-called “China concepts stock,”¹⁶⁶ prompting Chinese entrepreneurs to publicly criticize Ma for jeopardizing the entire internet industry.¹⁶⁷

There have been four other reported cases involving the VIE structures of overseas-listed Chinese companies.¹⁶⁸ In all four, the founding entrepreneurs disregarded the VIE contracts and took control of the Chinese operation when faced with the risk of being ousted by foreign investors.¹⁶⁹ In a case that went to arbitration in 2010, the Shanghai International Economic and Trade Arbitration Commission invalidated VIE contracts on the grounds that they served “illegal purposes” and violated related Chinese laws and regulations.¹⁷⁰ Because of the private nature of arbitration, the extent to which this arbitration award reflected the official stance of Chinese judicial

163. Nadia Damouni & Jennifer Saba, *Exclusive: Yahoo, Alibaba Reach Deal over Alipay: Sources*, REUTERS (May 31, 2011), <https://www.reuters.com/article/us-yahoo-alipay/exclusive-yahoo-alibaba-reach-deal-over-alipay-sources-idUSTRE74U65120110531> [https://perma.cc/2VJK-6EAD].

164. Melanie Lee & Soyung Kim, *Yahoo Clears a Hurdle, Sells Alibaba Stake for \$7.1 Billion*, REUTERS (May 20, 2012), <https://www.reuters.com/article/net-us-yahoo-alibaba/yahoo-clears-a-hurdle-sells-alibaba-stake-for-7-1-billion-idUSBRE84H0MV20120521> [https://perma.cc/9UXU-J6DZ].

165. *Id.*

166. Wang et al., *supra* note 143.

167. Jiyong Hou (侯继勇), *VIE Jing Bian Zhenban Wangluo Ye, Gang Jiao Suo Yunniang “Faren Xin Gui”* (《VIE 惊变撼互联网，港交所酝酿“法人新规”》) [VIE Shook the Internet Industry, the Hong Kong Stock Exchange Preparing for “New Rules for Legal Persons”], IFENG (Sept. 22, 2011), <https://finance.ifeng.com/news/special/vie/20110922/4645605.shtml> [https://perma.cc/9QTR-YJEE] (China).

168. In addition to the arbitration award and the SPC decision discussed below, the two other cases are the ChinaCast Education case and the GigaMedia case. Both companies were listed in Nasdaq using a VIE structure. *See e.g.*, Bloomberg staff, *Nasdaq Suspension of ChinaCast Education Highlights Problems of Some Chinese Firms*, BLOOMBERG LAW (Apr. 9, 2012), <https://news.bloomberglaw.com/securities-law/nasdaq-suspension-of-chinacast-education-highlights-problems-of-some-chinese-firms> [https://perma.cc/R58A-7C25]; *GigaMedia Will Survive Current VIE Turmoil*, SEEKING ALPHA (June 3, 2011), <https://seekingalpha.com/article/273166-gigamedia-will-survive-current-vie-turmoil> [https://perma.cc/UW2Y-2ABY].

169. Bloomberg staff, *supra* note 168; *GigaMedia Announces Sale of T2CN, All T2CN Litigation Resolved*, SEC. EXCH. COMM’N (Dec. 14, 2011), <https://www.sec.gov/Archives/edgar/data/1105101/000119312511343031/d272014dex991.htm> [https://perma.cc/CC2J-VMM8].

170. Liu, *Legal Risks in “Implicit Legality,” supra* note 124.

organs is unclear.¹⁷¹ It nevertheless constitutes evidence that there is a risk of those organs invalidating VIE contracts, not to mention failing to enforce them.

Another of the cases, *Ambow*, went to court.¹⁷² In 2016, the Supreme People's Court ("SPC"), i.e., China's highest court, refused to invalidate the VIE contracts concerned. However, it did not explicitly confirm their legality. The SPC distinguished between regulatory documents and laws promulgated by the Chinese legislature and administrative regulations promulgated by the State Council and concluded that only contracts violating laws and administrative regulations are void. Further, the SPC deferred to the corresponding administrative agency in deciding whether to allow foreign capital in a certain industry and whether existing operations under the VIE structure should be allowed.¹⁷³

Because Chinese judicial decisions do not automatically become precedents, there is no guarantee that the SPC or Chinese courts in general would not invalidate VIE contracts in a future dispute. However, the SPC's deference approach indicates that the matter is considered a job for the Chinese regulatory authorities and that the SPC wants to neither enforce or invalidate VIE contracts. In other words, the courts are of little help in mitigating the contract risk of VIEs.

C. State Actors and Intermediaries as Super Nodes

What supports a two-trillion-dollar market in the absence of judicial protection? Without courts to protect foreign capital against regulatory enforcement or opportunistic Chinese entrepreneurs, what mechanisms are in place to contain the regulatory and contract risks? Each case discussed above, most notably the *Alipay* and *Didi* cases, seemed to shake market confidence in the VIE structure. Nevertheless, most VIE structures have not faced such challenges,¹⁷⁴ and such structures are still commonly used today by Chinese companies looking to list overseas, not only in the U.S., but also in other

171. *Id.*

172. Changsha Yaxing Zhiye Fazhan Youxian Gongsu Yu Beijing Shida Anbo Jiayu Keji Youxian Zeren Gongsu Hetong Jiuwen Ershen Minshi Panjueshu (长沙亚兴置业发展有限公司与北京师大安博教育科技有限责任公司合同纠纷二审民事判决书) [Changsha Yaxing Property Development Co., Ltd. and Beijing Normal University Ambo Education Technology Co., Ltd. contract dispute second instance civil case judgment] ((2015) (Min Er Zhong Zi Di 117 Hao) ((2015)民二终字第117号) [SPC Second Civil Circuit Final No. 117 (2015)] (China).

173. Binbin Sun (孙彬彬) & Hab Wen (温晗), VIE Hefa? *Zuigao Yuan Zheme Kan (VIE合法? 最高法院这么看)* [VIE legal? Here's how the Supreme Court sees it], ZHONGLUN (Mar. 21, 2017), <http://www.zhonglun.com/Content/2017/03-21/1818439077.html> [https://perma.cc/784V-B22N] (China).

174. Hou, *supra* note 167.

jurisdictions such as Hong Kong.¹⁷⁵ In other words, the few reported cases cited above represent a deviation from market practice.

Furthermore, the widespread media coverage and immediate government responses constitute evidence that (1) such deviations are difficult to hide for overseas-listed companies; (2) there is a reputation cost for such deviations in a market of repeat players, particularly as a few financial intermediaries control this access to the international capital market, which is essential for Chinese internet companies' success; and (3) the Chinese government closely monitors that market and will face a reputational cost for any regulatory actions that deviate from market expectations.

The extralegal VIE market is supported by a network with Chinese state agencies and a few market intermediaries as super nodes, and relatively homogeneous Chinese companies concentrated in the internet industry. Relational contracts promote a cooperative relationship, and the market imposes reputational costs on opportunistic behaviors. The Chinese government also helps to hold Chinese companies accountable, and is itself held accountable with its own reputation at stake, which is essential to its access to the international capital market and therefore to achieving its development goal. This is by no means to say that such extralegal mechanisms are perfect. Reputational punishment is insufficient to deter opportunistic behaviors at the end of the game, and the Chinese state is in a constant struggle between the goal of development and that of control.

In this section, I firstly present data about the close-knitness of the super nodes, i.e., the Chinese government (regulatory agencies, political elites, etc.) and market intermediaries, and about the homogeneity of China's internet industry, both of which enable the reputational mechanisms, and then discuss contract design on the market and how individual and state reputation work to enforce contracts and protect property rights.

1. *Homogeneous and Repeat Players*

The major participants in the VIE market are (1) Chinese companies, most of which are concentrated in the internet industry and rely on the international capital market for their success; (2) the Chinese government, which relies on the international capital market to achieve its goal of development; and (3) market intermediaries, including the same set of law firms, accounting firms, and, most importantly, less than a dozen underwriters, that regulate this extralegal market and hold both Chinese companies and the Chinese government accountable. There is a rapid flow of information among these repeat market participants, as well as a shared knowledge and

175. WeChat communication with a lawyer with seven years of experience of VIE in the Beijing Office of a leading U.S. law firm (June 8, 2022); WeChat call with a leading expert of financial law in a leading Chinese law school (Sept. 18, 2022).

interpretation of market behaviors, particularly deviant acts that imperil participants' reputations.

Most of the Chinese companies making use of the VIE structure are internet companies.¹⁷⁶ Being in the same industry makes them a relatively homogeneous group with a similar business model and mentality, a group that shares the same group of investors, technology, and executive talents,¹⁷⁷ and deals with the same set of regulatory authorities. As such, it is difficult to keep secrets between companies in such an industry. Timely and accurate information helps the reputation mechanism work properly. For example, in the Alipay case, companies in the same industry using the same VIE structure were quick to tell of their own experience obtaining a license from the same regulatory agency that Jack Ma lied to about his motivation for revoking the contracts between the VIE and the WFOE.¹⁷⁸

The Chinese companies in this group also use the same set of law firms,¹⁷⁹ accounting firms,¹⁸⁰ and, most importantly, underwriters. These professionals are not necessarily guardians of law, but they are guardians of common practices. They regularly advise their clients on what behaviors are and are not acceptable. They also help investors distinguish between Chinese companies and entrepreneurs that are trustworthy and those that are not.¹⁸¹

Underwriters are the most important group of financial intermediaries in ensuring the smooth operation of the market, as they essentially control the access to the international capital market. Accordingly, they hold sway not only with Chinese companies but also with the Chinese government. Less than a dozen underwriters monopolize the market and are long-term, repeat

176. As of June 26, 2022, there are 133 companies self-classified as "internet, e-commerce, telecom, IT" among the 176 listed companies. Data extracted from the SEC website and compiled by the author.

177. For example, Didi's founder worked in Alibaba before. See *Will Wei Cheng*, FORBES (Apr. 5, 2021) <https://www.forbes.com/profile/will-wei-cheng/?sh=1ecd51116619> [<https://perma.cc/6NLA-J654>].

178. Wang et al., *supra* note 143.

179. For *issuing companies'* representation on U.S. law, the law firms in order of frequency were (for 173 IPOs; in two IPOs, multiple law firms were used in this category): Skadden, Arps, Slate, Meagher & Flom LLP (63); Davis Polk & Wardwell LLP (14); Hunter Taubman Fischer & Li LLC (11); Simpson Thacher & Bartlett LLP (11); Ellenoff Grossman & Schole LLP (9); Latham & Watkins LLP (8); Wilson Sonsini Goodrich & Rosati, PC (8); Kirkland & Ellis International LLP (6); Cleary Gottlieb Steen & Hamilton LLP (4). For *issuing companies'* representation on PRC law, the law firms in order of frequency were (for 165 IPOs; one IPO used multiple firms): Han Kun Law Offices (24); Commerce & Finance Law Offices (20); Fangda Partners (12); Tian Yuan Law Firm (12); King & Wood Mallesons (11); Jingtian & Gongcheng (9); Allbright Law Offices (8); Zhong Lun Law Firm (8); JunHe LLP (6). For *underwriters'* representation on PRC law, the law firms in order of frequency were (for 138 IPOs; one IPO used multiple firms): Fangda Partners (19); Commerce & Finance Law Offices (14); Haiwen & Partners (13); Han Kun Law Offices (13); JunHe LLP (13); Jingtian & Gongcheng (11); Tian Yuan Law Firm (11); King & Wood Mallesons (8); Zhong Lun Law Firm (8); Grandall Law Firm (6). Data extracted from the SEC website and compiled by the author, on file with Harvard International Law Journal.

180. For accounting firms, the firms in order of frequency were (for 175 IPOs; one IPO used multiple firms): PricewaterhouseCoopers (52); Deloitte Tohmatsu Certified Public Accountants LLP (37); Ernst & Young (25); Friedman LLP (16); KPMG (12); Marcum Bernstein & Pinchuk LLP (8). Data extracted from the SEC website and compiled by the author, on file with Harvard International Law Journal.

181. See *infra* Part I.I.C.2 on relational contracts.

players with strong connections to the Chinese state. Of the 184 Chinese companies listed in the U.S. using the VIE structure, Morgan Stanley is the lead underwriter for 53 of them, followed by Credit Suisse (44), Goldman Sachs (39), Citigroup (28), Deutsche Bank (25), and Bank of America (23).¹⁸²

Western financial institutions, as represented by the aforementioned investment banks, have aided the Chinese government's reform of its financial system "by creating linkages between the Chinese state and global finance and, in the process, helping to create a vast market of overseas Chinese equities in Hong Kong, New York, and elsewhere."¹⁸³ International investment banks above have also been active in building a network within China, including with China's political elites, through both formal means such as purchasing shares in the country's major state-owned investment bank and informal means such as the notorious practice of hiring Chinese "princelings."¹⁸⁴

China's major state-owned investment bank, China International Capital Corporation ("CICC"), was founded in 1995 as the country's first joint-venture investment bank. Its major shareholders are the China Construction Bank (headed by Wang Qishan, who later became a standing member of the CCP Politburo) and Morgan Stanley.¹⁸⁵ Zhu Yunlai, son of former prime minister Zhu Rongji, served as its CEO from 2008 to 2014.¹⁸⁶ CICC closely tracks the Western heavyweights on the list of lead underwriters for "China concepts stock," being the lead underwriter for 19 of them.¹⁸⁷

Moreover, Western banks have developed personal connections with Chinese political elites to aid their business in China. The most celebrated is probably the relationship between Wang Qishan, former prime minister Zhu Rongji's deputy in reforming China's financial system, and Henry Paulson, the chief executive of Goldman Sachs before becoming U.S. Secre-

182. Data extracted from the SEC website and compiled by the author, on file with Harvard International Law Journal.

183. Antony Malkin, *Agents of Change: The Role of Foreign Financial Institutions in China's Financial Transformation Since the early 1990s I* (2016) (Ph.D. dissertation, Wilfrid Laurier University), <https://scholars.wlu.ca/cgi/viewcontent.cgi?article=2940&context=etd> [<https://perma.cc/A48U-7V8Q>].

184. Richard Podpiera & Lamin Leigh, *The Rise of Foreign Investment in China's Banks: Taking Stock* (IMF, Working Paper No. 06/292, 2007), <https://ssrn.com/abstract=956756> [<https://perma.cc/N7BK-PD9V>]; David J Lynch, Jennifer Hughes & Martin Arnold, *JPMorgan to Pay \$264m Penalty for Hiring 'Princelings'*, *FIN. TIMES* (Nov. 17, 2016), <https://www.ft.com/content/fc32b64e-ac87-11e6-ba7d-76378e4fef24> [<https://perma.cc/G2ZQ-R34X>].

185. David Barboza, *Longtime Chief Leaves C.I.C.C., a Major Chinese Investment Bank*, *N.Y. TIMES* (Oct. 14, 2014), <https://archive.nytimes.com/dealbook.nytimes.com/2014/10/14/longtime-chief-leaves-c-i-c-c-a-major-chinese-investment-bank/> [<https://perma.cc/P85Y-FKGZ>].

186. *Id.*; Engen Tham & Lawrence White, *China Investment Bank CICC's CEO Levin Zhu Resigns*, *REUTERS* (Oct. 13, 2014), <https://www.reuters.com/article/uk-cicc-zhu/china-investment-bank-ciccs-ceo-levin-zhu-resigns-idUKKCN0I30DY20141014> [<https://perma.cc/DQ86-BCST>].

187. Data extracted from the SEC website and compiled by the author, on file with Harvard International Law Journal.

tary of the Treasury.¹⁸⁸ The two men collaborated on a series of issues key to China's financial reform, including Chinese companies going overseas for IPOs.¹⁸⁹ Such personal connections have not always been viewed in a positive light, however. For example, it was previously common practice for Western banks, including many of those mentioned above, to hire so-called princelings who were sons and daughters of Chinese senior government officials, to aid their business in China.¹⁹⁰ A few of these banks, including JPMorgan,¹⁹¹ Credit Suisse,¹⁹² and Deutsche Bank,¹⁹³ were fined by the U.S. authorities for adopting such a business model.

Nevertheless, the formal and informal involvement of Western banks in Chinese finance has contributed to a common understanding of how to "deal with China," an understanding that is based not on legal commitments but on extralegal and often political means. As Henry Paulson wrote in *Dealing with China*:

So, in short, we had just concluded a meeting about doing an initial public offering in which we hadn't said a word about a specific deal, much less its timing, size, or pricing; the powerful senior minister of the business we would work with had not been present; and the company itself did not exist in any real sense: we would have to create it. It was not the kind of deal we could have done, or would have thought about doing, almost anywhere else in the world. But this was China in 1997, and we felt pretty good about where we stood.¹⁹⁴

These formal and informal connections ensure common interests among American and Chinese elites. These interests compel them to invest in the stability of the extralegal market and facilitate a rapid flow of information and a shared understanding and interpretation of market behaviors, ensuring that no deviant behavior goes unnoticed or unpunished. To see these common interests and the specific stake of Chinese and American elites' in the VIE structure, consider again Alibaba's 2014 IPO using that structure: a

188. See HENRY M. PAULSON, JR., *DEALING WITH CHINA: AN INSIDER UNMASKS THE NEW ECONOMIC SUPERPOWER* (2015).

189. *Id.*

190. Jessica Silver-Greenberg & Ben Protess, *JPMorgan Hiring Put China's Elite on an Easy Track*, N.Y. TIMES (Aug. 29, 2013), <https://dealbook.nytimes.com/2013/08/29/jpmorgan-hiring-put-chinas-elite-on-an-easy-track/> [<https://perma.cc/DU2V-S9RQ>]; Ben Protess & Jessica Silver-Greenberg, *On Defensive, JPMorgan Hired China's Elite*, N.Y. TIMES (Dec. 29, 2013), <https://archive.nytimes.com/dealbook.nytimes.com/2013/12/29/on-defensive-jpmorgan-hired-chinas-elite/> [<https://perma.cc/893W-DGPZ>].

191. *Id.*

192. Don Weinland, *Credit Suisse to Pay \$47m to End DoJ 'Princelings' Probe*, FIN. TIMES (June 6, 2018), <https://www.ft.com/content/947e996a-695e-11e8-8cf3-0c230fa67aec> [<https://perma.cc/MD7V-KAVP>].

193. Michael Forsythe, David Enrich & Alexandra Stevenson, *Inside a Brazen Scheme to Woo China: Gifts, Golf and a \$4,254 Wine*, N.Y. TIMES (Oct. 14, 2019), <https://www.nytimes.com/2019/10/14/business/deutsche-bank-china.html> [<https://perma.cc/7CVX-V8HN>].

194. PAULSON, *supra* note 188, at 13.

number of Chinese princelings and their families benefited from it, as did a number of Chinese entrepreneurs and U.S. investment banks.¹⁹⁵ In such a context, the legality of VIEs seems hardly to matter.

2. *Relational Contracts and Individual Reputation*

Various contracts under the VIE structure can be divided into two categories: those providing effective control over the VIE, and those providing for the transfer of substantially all of the economic benefits of the VIE to the WFOE.¹⁹⁶ In the design of such contracts, it is clear that investors do not rely on judicial enforcement of these contracts to achieve the purposes of effective control and the transfer of economic benefits. Instead, there are three mechanisms for achieving those purposes.

First, investors choose entrepreneurs who have both a serious business model and good reputation to control the risk of contract default. As VIEs are typically designed for the purpose of overseas listing, the returns of both the investors and founding entrepreneurs depend on the success of the business, to which cooperation between the capital providers and the founding entrepreneurs is essential. In other words, both parties share a vested interest in building a successful business, and the primary purpose of contract design is to foster cooperative relationships with the prospect of long-term interactions, rather than to deter opportunistic behavior through judicial enforcement. Choosing an entrepreneur with a serious plan, ambitions for business success, and a good reputation constitutes an *ex ante* measure of risk control. One lawyer with long-term experience in helping overseas investors to scrutinize Chinese entrepreneurs told me that these days, overseas investors often prefer entrepreneurs who have already established a successful business and are looking to found a new enterprise. Their reputation and past record on the capital market provide a clear signal of reliability to overseas investors.¹⁹⁷ It is not uncommon for an entrepreneur to require capital multiple times in his or her career. Such repeat plays help entrepreneurs to develop a long-term perspective and pay close attention to their reputation on the capital market. A single contract default often means the end of an entrepreneur's career, as the default quickly becomes public knowledge and no other investor will collaborate with him or her, which serves as a strong deterrent to potential contract defaults.¹⁹⁸ Once a company is listed overseas, robust regulations further promote the rapid flow of information and ensure that no contract default goes unnoticed.¹⁹⁹

195. Michael Forsythe, *Alibaba's I.P.O. Could Be a Bonanza for the Scions of Chinese Leaders*, N.Y. TIMES (July 20, 2014), <https://archive.nytimes.com/dealbook.nytimes.com/2014/07/20/alibabas-i-p-o-could-be-a-bonanza-for-the-scions-of-chinese-leaders/> [https://perma.cc/W6UZ-FSEH].

196. O'MELVENY & MYERS, *supra* note 117.

197. WeChat Interview with a senior associate in a leading American law firm's Hong Kong office (May 25, 2022).

198. *Id.*

199. *Id.*

The Alipay case demonstrates both the strength and weakness of relational contracts. Jack Ma eventually paid substantial compensation to Yahoo and Softbank in exchange for more control over the Alibaba Group. Hence, it is not a story of Ma walking away without any consequences. To a certain degree, we can interpret the whole episode as a case of “efficient breach.”²⁰⁰ Moreover, relational contracts rely on good relations for their maintenance. As noted above, when Jerry Yang, with whom Ma had a very good relationship, was replaced as Yahoo CEO by Carol Bartz in 2009, the relational basis between Jack Ma and Yahoo disappeared. Hence, relational contracts are not effective at handling the end game.

Second, investors design contracts carefully to fully align the incentives of founding entrepreneurs with those of overseas holding companies and investors. In addition to the aforementioned common goal of building a successful business, specific technical control is also important. In this regard, equity participation in the offshore holding company by the founding entrepreneur is key because it ensures that he or she has a sufficient stake in the company’s success. Such a mechanism is particularly effective once the offshore company has become publicly listed, as the value of the offshore shareholding to the founder would be directly compromised by any attempt to revoke the VIE contracts. In one case shared with me by a practicing lawyer, a founding entrepreneur had a disagreement with investors, but chose to sign a settlement agreement rather than revoke the VIE contracts, as the latter would have significantly affected the value of his stock in the overseas holding company.²⁰¹ The public nature of a listed company also makes contract defaults more public and entails even greater reputational and potential legal risks under the U.S. securities regulations.²⁰² In the Alipay case, the public did not know about the dismantling of the VIE structure until Yahoo disclosed it in a public report. It was not until that point that Jack Ma suffered reputational punishment from the public and fellow entrepreneurs. Ma would have been far less likely to sever VIE ties with the Alibaba Group if it had been a publicly listed company in 2010.²⁰³

Third, detailed contract administration mechanisms are designed to allow overseas investors to monitor the daily operations of VIEs and even veto the decisions of founding entrepreneurs, thereby offering a timely deterrent to potential contract defaults. The contracts focus not only on what is promised but also on the administration mechanisms for achieving what is promised. In this sense, they are an example of what Bernstein calls “managerial contracting,” essentially achieving the purpose of integration without formal

200. See, e.g., Gregory Klass, *Efficient Breach*, in *PHILOSOPHICAL FOUNDATIONS OF CONTRACT LAW* 362 (Gregory Klass, George Letsas, & Prince Saprai eds., 2014).

201. WeChat Interview with a senior associate in a leading American law firm’s Hong Kong office (May 25, 2022).

202. O’MELVENY & MYERS, *supra* note 117.

203. *Id.*

integration.²⁰⁴ The most important mitigating action that can be taken to reduce the risk of losing control of the VIE is to limit the ability of any single person to usurp control. Specific measures include diversifying the shareholding of the VIE, thereby preventing the founding entrepreneur from single-handedly controlling the VIE. A common practice is to install professionals or non-executive personnel on the side of investors as shareholders and board members of the VIE.²⁰⁵

Overall, offshore investors are more concerned about the *ex ante* scrutiny of Chinese entrepreneurs and the design of contract administration measures to align their incentives and to ensure control over the VIE than about relying on *ex post* judicial enforcement to protect their investment. These relational contracts are ultimately designed to make the cooperation a success rather than to deter opportunistic behaviors.

3. *State Reputation*

As discussed at Section II.A, the Chinese government, or more specifically, the MII, was a “co-conspirator” in the design of VIEs to circumvent its own restrictions on foreign capital in China’s internet industry. From 2000 to 2003, the CSRC also required Chinese companies adopting the VIE structure to list overseas to obtain a “non-objection letter” from it.²⁰⁶ Sending foreign capital to the WFOE in China, with the final destination to the Chinese VIE, also requires approval from the State Administration of Foreign Exchange (“SAFE”), which has also given its support to such transactions.²⁰⁷ With one Chinese internet company after another listing in the U.S. and making headlines, and with the participation, approval, and cooperation of the related Chinese authorities, the market does not seem overly concerned about the contract or regulatory risks of VIEs, even though they are clearly designed to circumvent China’s ban on foreign capital in certain industries.

204. Lisa Bernstein & Brad Peterson, *Managerial Contracting: A Preliminary Study* (Feb. 16, 2022), <https://ssrn.com/abstract=4036051> [<https://perma.cc/9AQY-95XX>]; O’MELVENY & MYERS, *supra* note 117.

205. *Id.*

206. Guanyu Sheji Jingnei Quanyi de Jingwai Gongsi zai Jingwai Faxing Gupiao he Shangshi Youguan Wenti de Tongzhi (关于涉及境内权益的境外公司在境外发行股票和上市有关问题的通知) [Circular of China Securities Regulatory Commission on Issues Concerning Stock Issuance and Public Offering Abroad of Overseas Corporations which Involve Domestic Equity] (promulgated by China Sec. Reg. Comm’n, June 9, 2000, expired Nov. 20, 2003), <http://www.mofcom.gov.cn/article/b/bff/200207/20020700031394.shtml> (China).

207. Guanyu Jin Yibu Jianhua he Gaijin Zhijie Touzi Waihui Guanli Zhence de Tongzhi (关于进一步简化和改进直接投资外汇管理政策的通知) [Notice of the State Administration of Foreign Exchange on Further Simplifying and Improving Policies for the Foreign Exchange Administration of Direct Investment] (promulgated by the State Admin. of Foreign Exch., Feb. 28, 2015), <http://m.safe.gov.cn/safe/2015/0228/5548.html> [<https://perma.cc/HBQ9-DXMP>] (China).

Chinese companies' and their law firms' awareness of legal and regulatory risks and their choice to disregard such risks are clearly demonstrated in the F-1 form Alibaba filed with the SEC:

“Any administrative and court proceedings in China may be protracted, resulting in substantial costs and diversion of resources and management attention. Since PRC administrative and court authorities have significant discretion in interpreting and implementing statutory and contractual terms, it may be more difficult to evaluate the outcome of administrative and court proceedings and the level of legal protection we enjoy than in more developed legal systems. . . . Any requirement to obtain prior approval . . . could delay this offering and failure to obtain any such approvals, if required, could have a material adverse effect on our business, operating results and reputation as well as the trading price of our ADSs, and could also create uncertainties for this offering. . . . While the application of the [M&A] Rules remains unclear, we believe, based on the advice of our PRC counsel, Fangda Partners, that the CSRC approval is not required in the context of this offering. . . . However, we cannot assure you that the relevant PRC government agencies, including the CSRC, would reach the same conclusion as our PRC counsel.”²⁰⁸

This disclosure focuses on a rule jointly promulgated by the CSRC and other central government departments in 2006 requiring CSRC approval for an overseas listing through a “special purpose vehicle” (“SPV”), which applies to the VIE structure.²⁰⁹ However, like other Chinese companies,²¹⁰ Alibaba never bothered to obtain such an approval.²¹¹

What is of most interest here is not the regulatory uncertainties themselves, but rather that, despite such uncertainties, the Chinese regulatory authorities have exercised remarkable self-restraint, even risking the explicit circumvention or disregarding of their official rules. In the two decades since the Sina overseas listing, the Chinese government has consistently tried to accommodate the VIE structure and protect its stability and predictability, not necessarily by clarifying the legal rules, but through political statements and regulatory actions, including collaboration with the U.S. regulatory authorities. Informality, or the tension between practice and rules, carries

208. Alibaba Group Holding Limited, Amendment No. 6 to Form F-1 Registration Statement, filed with the Securities and Exchange Commission (Sept. 5, 2014), <https://www.sec.gov/Archives/edgar/data/1577552/000119312514333674/d709111df1a.htm> [<https://perma.cc/AL9E-YFV8>].

209. Guanyu Waiguo Touzizhe Binggou Jingnei Qiye de Guiding (关于外国投资者并购境内企业的规定) [The Provisions on Foreign Investors to Acquire Domestic Enterprises] (promulgated by the Ministry of Commerce and other five ministries, Aug. 8, 2006), art. 39, 40, <http://www.mofcom.gov.cn/article/b/c/200608/20060802839585.shtml> [<https://perma.cc/45Q2-PL6X>] (China).

210. Miao, *supra* note 129.

211. Alibaba Group Holding Limited, *supra* note 208.

risks, particularly in a transnational context. The Chinese government has tried to clarify the rules regarding the VIE structure and formally institutionalize it through the most recent revision to the Foreign Investment Law,²¹² but that clarification did not materialize²¹³ owing to the political stalemate resulting from the long-standing, and inherent, struggle between development and control.

Nevertheless, the Chinese government has made its intention to maintain the stability of the VIE structure explicit. After all, the development of China's internet industry and Beijing's own reputation are at stake. The market, including foreign investors, has received the message. In 2018, a legal advisor for the Sequoia Fund ("one of the best-performing mutual funds in history") remarked that although the VIE structure is "pretty complicated," ultimately "the Chinese government is interested in attracting capital to its capital markets and is [therefore] unlikely to rock the boat there and do something unusual."²¹⁴ In 2019, the *Financial Times* declared that "[r]evoking the VIE structure would be the nuclear option for China. Total capital decimation."²¹⁵ In 2021, a prominent law firm cautioned that although China could regulate VIEs more tightly, perhaps through more "industry-specific restrictions" or by "prohibit[ing] certain aspects of control contracts," it would be "surprising" if it banned domestic companies from using VIEs entirely.²¹⁶ With such stable expectations of non-expropriation, investors are willing to entrust their money to a set of potentially unenforceable contracts.

To defend its reputation of "opening-up" to the outside world, and specifically to protect the Chinese internet industry's access to foreign capital

212. Shangwu Bu Jiu Zhonghua Renmin Gongheguo Waiguo Touzi Fa Cao'an Zhengqiu Yijian Gao Gongkai Zhengqiu Yijian (商务部就《中华人民共和国外国投资法(草案征求意见稿)》公开征求意见) [Ministry of Commerce Solicited Feedback on the Draft of the Foreign Investment Law of the People's Republic of China] (promulgated Jan. 19, 2015), https://www.uschina.org/sites/default/files/2015%20Draft%20Foreign%20Investment%20Law%20of%20the%20People%27s%20Republic%20of%20China_JonesDay_0.pdf [https://perma.cc/F6HV-4579], art. 15 ("Overseas transactions resulting in the transfer of actual control over a domestic enterprise to a foreign investor shall be deemed as investments within the territory of China made by the foreign investor."), art. 19 ("For the purpose of the Law, the term 'actual controllers' refers to natural persons or enterprises that directly or indirectly control foreign investors or foreign-invested enterprises.") (China).

213. See Part I for the discussion on development and control; Zhonghua Renmin Gongheguo Waishang Touzi Fa (《中华人民共和国外商投资法》) [Foreign Investment Law of the People's Republic of China] (promulgated by the Nat'l People's Cong., Mar. 15, 2019, effective Jan. 1, 2020), https://www.pkulaw-com.proxy.lib.duke.edu/en_law/6a88714068b3724dbdfb.html [https://perma.cc/8S6C-5R D5] (China) (The aforementioned art. 15 and art. 19 in the draft are not incorporated in the law passed).

214. Jamie Powell, *Tell Me Lies, Tell Me Sweet Little VIEs*, FIN. TIMES, July 8, 2021, <https://www.ft.com/content/ceb9d46b-5795-4da1-8ac1-50ba9221ff1e> [https://perma.cc/NVA2-AWS9] (citing Ruane, Cuniff, & Goldfarb, *2018 Annual Investor Day Meeting* [Transcript] 23 (May 18, 2018), <https://t.co/Ek8bZhp865?amp=1> [https://perma.cc/F8MN-ZUSS]).

215. Powell, *supra* note 9.

216. Cari Stinebower & Jacob Harding, *Understanding China's Variable-Interest Entities*, WINSTON & STRAWN LLP (Sept. 30, 2021), https://www.winston.com/en/blogs-and-podcasts/notes-from-the-china-desk/understanding-chinas-variable-interest-entities.html#!/closed_state [https://perma.cc/29RF-K9UK].

markets, the Chinese government has not only exercised remarkable self-restraint with respect to regulatory enforcement, but has also responded to market concern over the legal uncertainty of VIEs. After the Alipay case, it was reported that Wang Qishan, a major policy-maker of China's financial reform, had expressed an opinion about "respecting history" and that related central government departments were following his lead.²¹⁷ Around the same time the CSRC circulated a report on its website stating that "invalidating the VIE structure may lead to the result that Chinese enterprises', particularly high-tech enterprises', demand for capital cannot be met, further weakening Chinese enterprises' capacity to innovate."²¹⁸ It is worth noting, however, that such political support is inherently limited due to the "illegal purpose" of VIEs, which is why the CSRC circulated the aforementioned report on its website without a more direct notice to the public, and why, when asked about the VIE structure by a foreign journalist, the then-CSRC chairman would only confirm that the CSRC was conducting research on VIEs.²¹⁹ It is no easy task to balance development and control: although the CSRC may be supportive of VIEs, other government agencies in charge of protecting national security or supervising foreign investment in China may well take a more conservative approach.²²⁰

The Chinese government has also collaborated with the U.S. government in monitoring and regulating Chinese enterprises listed in the U.S. through a VIE, although not to a degree sufficient enough to meet the demands of the U.S. side.²²¹ In the recent case of Luckin Coffee, which was listed on the Nasdaq through a VIE structure, the CSRC investigated the company for potential fraud and issued an RMB 61 million (U.S.\$9 million) fine.²²² The company was eventually delisted by Nasdaq and paid U.S.\$80 million to

217. Hou, *supra* note 167.

218. CSRC, Guanyu VIE Jiegou ji Qi dui Zhongguo Gainiangu de Yingxiang de Baogao (关于VIE结构及其对中国概念股的影响的报告) [Report on VIE Structure and its Impact on China Concept Stocks], cited in Liu, *supra* note 124 (China).

219. Caijing (财经), Zhongguo Zhenjianhui Zheng Yanjiu dui VIE Moshi de Jianguan Guiding (中国证监会证实研究针对VIE模式的监管规定) [CSRC Confirms Its Looking Into VIE], SOHU (Nov. 11, 2011), <http://jingji.cntv.cn/20111111/104946.shtml> [<https://perma.cc/DHK4-SVU4>] (China).

220. PWC, Zhongguo Fabu Waishang Anquan Shencha Banfa Jiaqiang Waishang Touzi Jianguan (中国发布《外商投资安全审查办法》加强外商投资监管) [China Releases "Foreign Investment Security Review Measures" to Strengthen Foreign Investment Supervision] (Jan. 2021), <https://www.pwccn.com/zh/china-tax-news/2021q1/chinatax-news-jan2021-2.pdf> [<https://perma.cc/FZ4Q-993P>] (China).

221. Jonathan Barnett, *Lessons from Luckin Coffee: The Underappreciated Risks of Variable Interest Entities*, THE CLS BLUE SKY BLOG (July 28, 2020), <https://clsbluesky.law.columbia.edu/2020/07/28/lessons-from-luckin-coffee-the-underappreciated-risks-of-variable-interest-entities/> [<https://perma.cc/4FUQ-DS7Y>].

222. Beijing Qingnianbao (北京青年报) [Beijing Youth Daily], 6100 Wan Yuan Chufa dui Ruixing Yiwuizhe Shenme (6100万元处罚对瑞幸意味着什么?) [What Does A Fine of 61 million RMB Mean for Luckin?], PEOPLE (Sept. 23, 2020), <http://finance.people.com.cn/n1/2020/0923/c1004-31871653.html> [<https://perma.cc/Z85L-K6PR>] (China).

settle the accounting fraud charges filed by the SEC.²²³ From the U.S. perspective, the Chinese government's response was far from sufficient, which is why the U.S. Congress is considering delisting Chinese firms from U.S. exchanges if they do not comply with certain auditing oversight requirements.²²⁴ A silver lining in the U.S.-China regulatory bargaining is that neither side intends to invalidate VIEs, and U.S. demand for greater transparency is consistent with China's long-term reform goal. However, how much transparency the Chinese government is willing to allow is decided by the Chinese government's ability to balance its development interests with its concern for control, notably national security in this context.

The most recent reforms in China reflect the Chinese government's consistent approach of supporting VIEs while finding a way to address its concerns for control. In December 2021, for example, the CSRC released draft regulations on overseas listings as an effort to formalize indirect overseas listings, such as through a VIE structure.²²⁵ It also released a public statement related to the above draft regulations, confirming that "overseas listing plays a positive role in integrating Chinese enterprises to the world economy and such enterprises contribute to the country's economic and social prosperity."²²⁶ More importantly, this statement explicitly recognizes the VIE structure, offering the first use of the English term in an official Chinese statement.²²⁷ The statement ends with a sentence stipulating that "on the premise of complying with domestic laws and regulations, VIE-structured enterprises that meet the compliance requirements can go overseas for listing after filing."²²⁸ This one is the government's most explicit acknowledgment to date of the structure as a whole.²²⁹ However, it does not provide a blanket endorsement of VIEs, as permission is conditioned on compliance with domestic laws.²³⁰ Filing with the CSRC and approval from other related regulatory authorities may still be needed if the draft regulations are

223. *Luckin Coffee Agrees to Pay \$180 Million Penalty to Settle Accounting Fraud Charges*, SEC. EXCH. COMM'N, (Dec. 16, 2020), <https://www.sec.gov/news/press-release/2020-319> [<https://perma.cc/JKQ4-VHVR>].

224. Benjamin Bain, *As Chinese Stocks Surge, U.S. Signals Hard Line on Delistings*, BLOOMBERG (Mar. 16, 2022), <https://www.bloomberg.com/news/articles/2022-03-16/as-chinese-stocks-surge-u-s-signals-hard-line-on-delistings> [<https://perma.cc/R36W-JPNF>].

225. *The CSRC Solicits Public Opinions on Rules Regarding Overseas Listings*, SEC. REG. COMM'N (Dec. 24, 2021), http://www.csrc.gov.cn/csrc_en/c102030/c1662393/content.shtml [<https://perma.cc/Q6XH-XS6H>].

226. *Zhengjianhui Youguan Fuzeren Da Jizhe Wen* (证监会有关负责人答记者问) [CSRC Staff Answers Questions from Reporters], CHINA SEC. REG. COMM'N, (Dec. 24, 2021), <http://www.csrc.gov.cn/csrc/c100028/c1662240/content.shtml> [<https://perma.cc/XN92-3KCA>] (China).

227. *Id.*

228. *Id.* (Question 7).

229. For example, a search for "VIE" on the CSRC website returns practically no other results besides this Q&A. There are no results for "VIE" on the NDRC's English website. There is also a lack of public statements by other officials or regulatory bodies.

230. See Zoey Zhang, *China Spells Out Rules for Overseas IPOs of Domestic Companies, VIEs*, CHINA BRIEFING (Jan. 3, 2022), <https://www.china-briefing.com/news/china-spells-out-rules-for-overseas-ipos-of-domestic-companies-vie/> [<https://perma.cc/E5LG-5GLX>].

passed.²³¹ On February 17, 2023, the CSRC formally promulgated its rules regarding VIEs confirming the Chinese approach to balance control and development.²³²

In sum, although the VIE structure flouts Chinese law, the Chinese government has been willing to support and maintain its stability and predictability via political means and de facto regulatory actions, even if it has thus far failed to clarify the legal rules owing to the mutually contradictory concerns of development and control. Over the past two decades, the Chinese state has co-created and acquiesced in an extralegal structure that connects Chinese internet companies with the international capital market. The Chinese state has therefore put its reputation at stake, with implications for how international investors perceive the Chinese market, China's economic development, and even foreign relations, considering the significant presence of "China concepts stock" on the U.S. market.²³³ VIEs might be extralegal, but they are not underground. The Chinese state itself is the reason for this extralegality.

III. KEEPWELL DEEDS AND CHINESE-ISSUED INTERNATIONAL BONDS

In the past decade, a number of Chinese enterprises, including real estate developers and local government finance vehicles ("LGFVs"),²³⁴ have contracted out of China's stringent regulations on foreign debt control and cross-border guarantees by creating so-called keepwell deeds ("KWDs"). KWDs replace the onshore parent company's guarantees, which are prohibited by Chinese law, and support offshore subsidiaries' issuance of international bonds. The market had treated KWDs as having the same binding effect as guarantees on their providers before a significant default occurred in

231. Economics and Trade Bulletin 1, U.S.-CHINA ECON. SEC. REV. COMM'N, (Jan. 28, 2022), https://www.uscc.gov/sites/default/files/2022-01/January_2022_Trade_Bulletin.pdf [<https://perma.cc/R6BH-53BS>].

232. Jingwai Qiye Jingwai Faxing Zhengquan he Shangshi Guanli Shixing Banfa (境内企业境外发行证券和上市管理试行办法) [Trial Measures for the Administration of Overseas Issuance and Listing of Securities by Domestic Enterprises], Zhongguo Zhengquan Jiandu Guanli Weiyuanhui Gonggao [2023] 43 Hao (中国证券监督管理委员会公告(2023)43号) [China Securities Regulatory Commission Announcement [2023] No.43], <http://www.csrc.gov.cn/csrc/c101954/c7124478/content.shtml> [<https://perma.cc/224K-5N3G>] (China); Zhengjianhui jiu "Jingnei Qiye Jingwai Fangxing Zhengquan he Shangshi Guanli Shixing Banfa" Da Jizhe Wen (证监会就《境内企业境外发行证券和上市管理试行办法》答记者问) [The China Securities Regulatory Commission answered reporters' questions on the "Trial Measures for the Administration of Overseas Issuance and Listing of Securities by Domestic Enterprises"], ZHONGGUO JINGJI WANG (中国经济网) [China Economic Network] (Feb. 17, 2023), http://www.ce.cn/xwzx/gnsz/gdxw/202302/17/t20230217_38399481.shtml [<https://perma.cc/2YBY-3CST>] (China).

233. See Lianrui Jia & Dwayne Winseck, *The Political Economy of Chinese Internet Companies: Financialization, Concentration, and Capitalization*, 80 INT'L COMM. GAZETTE 30–59 (2018).

234. See Donald Clarke & Fang Lu, *The Law of China's Local Government Debt: Local Government Financing Vehicles and their Bonds*, 65 AM. J. COMP. L. 751–98 (2017) (LGFVs are enterprises founded by Chinese local governments to borrow money and finance projects such as municipal infrastructure construction, public facility management, and real estate development).

2020.²³⁵ Chinese courts have not recognized the validity of such contractual arrangements and Chinese administrative authorities rejected that such contracts were binding on their providers in a bankruptcy proceeding in 2020.²³⁶ By the second half of 2020, there were U.S.\$93 billion worth of KWD bonds outstanding, purchased by both Chinese state institutional investors and international institutional investors, including BlackRock Inc. and Goldman Sachs Group Inc.²³⁷

Section A examines why and how Chinese corporations contract out of stringent regulations on cross-border guarantees. Section B investigates the legal uncertainties and risks of such extralegal contract arrangements, and Section C examines the close-knit communities of super nodes including regulatory agencies and market intermediaries and how private and state reputation mechanisms support this extralegal financial market.

A. Contracting out of Regulations

China's debt level has mounted rapidly since the 2008 financial crisis, with a debt-to-GDP ratio reaching 289.5% in 2020, almost double the level in 2008.²³⁸ Alarmed by the Chinese economy's exposure to the real estate bubble, the government has limited real estate-related enterprises' access to the onshore capital market.²³⁹ As a result, real estate developers, LGFVs, and state-owned debt refinancing companies have turned to overseas markets for capital, with Chinese investment in U.S. dollar bonds growing from less than U.S.\$10 billion in 2010 to more than U.S.\$800 billion in 2020.²⁴⁰ Chinese issuance of international bonds, however, risks violating China's stringent regulations on cross-border capital flows, particularly the quota on

235. Reuters Staff, *Peking Founder Restructuring Shows Limitations of China's Keepwell Deeds - Moody's*, REUTERS (June 29, 2020), <https://www.reuters.com/article/china-bond-keepwell/peking-founder-restructuring-shows-limitations-of-chinas-keepwell-deeds-moodys-idUKL4N2E63CP> [https://perma.cc/HZJ5-GWLF].

236. See, e.g., *Keepwell Deed Structure Faces Enforceability Test*, SIMMONS & SIMMONS (June 4, 2020), <https://www.simmons-simmons.com/en/publications/ckb0iwj9og48g0a79cue42czm/keepwell-deed-structure-faces-enforceability-test> [https://perma.cc/7DAN-DYT7].

237. Rebecca Choong Wilkins, *How "Bad Bank" China Huarong Tested Too Big to Fail: QuickTake*, BLOOMBERG (Apr. 17, 2021), <https://www.bloomberg.com/news/articles/2021-04-17/why-china-bad-bank-huarong-s-fall-is-big-bad-news-quicktake#xj4y7vzkg> [https://perma.cc/9UM9-VB8Y].

238. Yen Nee Lee, *These Charts Show the Dramatic Increase in China's Debt*, CNBC (June 28, 2021), <https://www.cnbc.com/2021/06/29/china-economy-charts-show-how-much-debt-has-grown.html> [https://perma.cc/A6Y9-GGDE].

239. Guowuyuan guanyu Jianjue E'zhi Bufen Chengshi Fangjia Guokuai Shangzhang de Tongzhi (国务院关于坚决遏制部分城市房价过快上涨的通知) [Notice of the State Council on resolutely curbing the excessive rise in housing prices in some cities] (promulgated by State Council, Apr. 17, 2010) (China).

240. Xingyuan Lu (陆兴元), *Zhongzi Meiyuan Zhai Lisbi Faxing Qingkuang Yu Dingjia Yinsu Qianxi* (中资美元债历史发行情况与定价因素浅析) [Analysis on the Historical Issuance and Pricing Factors of Chinese Investment in U.S. Dollar Bonds], DEBANG ZHENGQUAN (德邦证券) [Tebon Securities], 6 (May 10, 2019); Xu Zhang (张旭), *Zhongzi Meiyuan Zhai Xianzhuang Rube* (中资美元债现状如何) [What is the Current State of Chinese Investment in U.S. Dollar Bonds], HUA'ER JIE JIANWEN (华尔街见闻) [Wall Street News] (Sept. 28, 2021, 9:49PM) (China).

and approval system for the issuance of overseas debt and limits on the credit support that Chinese companies can give to overseas entities.

Direct issuance of international bonds has been reserved primarily for large Chinese SOEs and banks, and is largely unavailable to real estate developers or LGFVs. Alternatively, Chinese companies can also issue international bonds indirectly through their overseas subsidiaries. However, such subsidiaries often have little credit themselves, and international investors are interested in their parent companies instead. Legally, the parent company and its subsidiaries are separate entities. To connect their credits, the Chinese parent company can make guarantees about their subsidiaries' debt to international investors or provide a standby letter of credit ("SBLC") from a Chinese bank.²⁴¹ SBLCs are hard to obtain for real-estate-related companies as their access to onshore banks has been severely limited. For guarantees, China's State Administration of Foreign Exchange ("SAFE") requires a non-financial-institution guarantor to register its cross-border guarantee within fifteen business days of signing the contract.²⁴² The rate of success for SAFE registration used to be extremely low. Even after a 2014 reform made such approval easier to obtain, strict restrictions remained on the repatriation of bond proceeds if the outbound guarantee structure was adopted.²⁴³

Chinese real estate developers, LGFVs, and state-owned debt-refinancing corporations have designed complex contract arrangements with investors to circumvent the SAFE restrictions on cross-border guarantees. The essence of KWDs is to hold Chinese parent companies accountable for their overseas subsidiaries' debt despite the SAFE restrictions on cross-border guarantees. To get around the SAFE restrictions, such KWDs make it clear that that they do not constitute guarantees.²⁴⁴ However, they were generally considered as having the same binding effect on Chinese parent companies as guarantees until the recent Peking University Founder Group ("PUFG") case.²⁴⁵ Prior to that case, the market did not differentiate between issuances that used a KWD and guarantees from an onshore parent.²⁴⁶ In the early 2010s, the indirect issuance of international bonds under the KWD structure oper-

241. ZHANG, *supra* note 11, at 163–65. SBLC means that bank credit stands behind international bonds.

242. Guanyu Fabu Kuajing Danbao Waihui Guanli Guiding de Tongzhi (关于发布《跨境担保外债管理规定》的通知) [Notice on the Issuance of "Cross-border Guarantee Foreign Exchange Management Regulations"] (promulgated by China Foreign Exch. Admin., May 15, 2015), art. 9 (China).

243. ZHANG, *supra* note 11, at 168.

244. Andy Liao, *Guarantee or Independent Contract? The Nature of Keepwell Deeds under PRC Law and Remedies for Breach*, HAN KUN LAW OFFICES, <https://www.hankunlaw.com/downloadfile/newsAndInsights/a0108d6eda03b8502de1e13d023ea02b.pdf> [<https://perma.cc/Q79D-R7HU>]; Kai Li et al., *Keepwell Arrangement Faces Test Amid Insolvency and Restructuring Process*, FANGDA PARTNERS, <https://www.fangdalaw.com/wp-content/uploads/2020/07/Keepwell-Arrangement-Faces-Test-Amid-Insolvency-and-Restructuring-Process.pdf> [<https://perma.cc/44DG-CLEN>].

245. *Peking University Ruling Raises Refinancing Risk on US\$93 Billion of Keepwell Bonds*, S&P GLOB. RATINGS (Sept. 2, 2020), <https://www.capitaliq.com/CIQDotNet/CreditResearch/SPResearch.aspx?ArtObjectId=11637011&ArtRevId=1> [<https://perma.cc/N6XK-4F5U>].

246. *Id.* at 1.

ated in a gray zone with little governmental involvement. Then, in 2015, in response to a new environment in which various entities were issuing bonds through their overseas subsidiaries, including SPVs created solely for the purpose of issuing bonds overseas, the Chinese government promulgated a requirement that a Chinese parent company must apply to China's National Development and Reform Commission ("NDRC") for a foreign debt quota prior to bond issuance, and then use the filing certificate issued by the NDRC to handle the inflow of bond proceeds and outflow of funds to repay the bonds.²⁴⁷ In 2020, KWD bonds accounted for nearly fifteen percent of outstanding Chinese offshore dollar bonds.²⁴⁸

B. *Legality and Risks*

KWDs carry two potential risks: First, the Chinese government may take action against such bond issuance and enforce the regulation being circumvented, and second, it is questionable whether such extralegal contracts can be enforced by the Chinese courts.

Thus far, SAFE has been silent on the legality of KWDs. Chinese companies have been able to repatriate back to the mainland the proceeds of keepwell bonds.²⁴⁹ As the SAFE regulation focuses specifically on cross-border guarantees, technically speaking, because KWDs make it clear that they do not constitute guarantees, they are not in direct conflict with that regulation. However, since such contracts fundamentally circumvent China's controls on foreign exchanges and cross-border capital flows, they should be void as contracts designed to "conceal an illegal purpose in a legal form" or "violate mandatory rules in laws and regulations," just like VIEs are.

The enforceability of such extralegal contracts is another issue, but it was not seriously examined by the market until 2020, when a wave of Chinese parent company bankruptcies and defaults occurred.²⁵⁰ To date, however, neither the Chinese courts nor their counterparts in Hong Kong, where KWD bonds are usually issued, have directly addressed the enforceability of KWDs. Two cases are worthy of further examination.

The first is the case of CEFC Shanghai International Group Limited ("CEFC"). CEFC, a Chinese onshore company, entered into a KWD and made an undertaking with bondholders to ensure that its subsidiary would remain solvent with sufficient liquidity to meet its payment obligations.²⁵¹

247. ZHANG, *supra* note 11, at 171.

248. *A Surprise Test for China Offshore Bonds with Keepwell Deeds*, S&P GLOB. RATINGS (May 26, 2020), 3, <https://www.spglobal.com/ratings/en/research/articles/200526-credit-faq-a-surprise-test-for-china-offshore-bonds-with-keepwell-deeds-11499736> [<https://perma.cc/UA45-9UBH>].

249. *Id.* at 4.

250. *Id.*

251. Shihe Quanqiu Touzi Jijin SPC-Shihe Jiazhi Touzi Jijin Yu Shanghai Huaxin Guoji Jituan Youxian Gongsì Hetong Jiufen Shenqing Renke Yu Zhixing Xianggang Tebie Xingzheng Qu Fayuan Caipan Shencha Anjian Minshi Panjue An (时和全球投资基金SPC-时和价值投资基金与上海华信国际集团有限公司合同纠纷申请认可与执行香港特别行政区法院裁判审查案件民事判决案)

The KWD was governed by English law and stipulated that the Hong Kong courts would have exclusive jurisdiction over disputes.²⁵² After the issuer defaulted, the bondholders filed a claim in Hong Kong against CEFC for breach of the KWD.²⁵³ The bondholder obtained a monetary default judgment against CEFC after it failed to respond to the suit.²⁵⁴ The bondholder then proceeded to apply to the Shanghai Financial Court for recognition and enforcement of the Hong Kong court's default judgment.²⁵⁵ In 2020, the Shanghai Financial Court ruled that the KWD in question was not governed by Chinese law, but it recognized the default judgment.²⁵⁶

Although the bondholder in the CEFC case had a positive outcome, that outcome came about through a default judgment, not an assessment of the substantive merits.²⁵⁷ Most notably, the Hong Kong court did not fully consider arguments regarding public policy or Chinese law that may be relevant to KWDs.²⁵⁸ A future case involving a KWD in the Hong Kong courts could very well result in a different outcome.²⁵⁹ The Shanghai Financial Court also did not rule on the legal effect of KWDs in China, only determining that the KWD in question was not governed by Chinese law and that its validity under Chinese law was irrelevant.²⁶⁰ Moreover, China does not have a formal case law precedent system.²⁶¹ Although the "courts are increasingly paying greater attention to past decisions," judicial decisions in China do not guarantee the same result in subsequent cases.²⁶² Thus, the outcome of future cases involving KWDs is unpredictable.

Further, as Chinese courts often defer to corresponding administrative authorities on complicated policy issues, the latter's attitude toward KWDs is more important than that of the courts, which is why the PUFG case had a more significant impact in determining the legal effect of KWDs than did the CEFC case. PUFG, a business conglomerate affiliated with Peking University, owed debt of RMB 162.8 billion (U.S.\$25.3 billion) to 434 creditors. Its overseas subsidiaries had issued five offshore bonds with a total value of U.S.\$1.7 billion with the support of KWDs provided by PUFG.

[Right Time Global Investment SPC - Right Time Value Investment Fund SP and Shanghai Huaxin International Group Co. Contract Dispute Recognition and Enforcement of Hong Kong Special Administrative Region Court Judgment Review Case Civil] (Shanghai Fin. Ct. Oct. 30, 2020) (2019)沪74民二初字第1号 (China); HCA1712/2018.

252. *Peking University Ruling Raises Refinancing Risk on US\$93 Billion of Keepwell Bonds*, *supra* note 245.

253. *Id.*

254. *Id.*

255. *Id.*

256. *Id.*

257. *Id.*

258. *Id.*

259. *Id.*

260. Jay Lee et al., *Keepwell Deeds: A Pathway for Enforcement*, SIMMONS & SIMMONS (Jan. 21, 2021), <https://www.simmons-simmons.com/en/publications/ckk6xamik1crr09927sdfif4s/keepwell-deeds-a-pathway-for-enforcement> [https://perma.cc/8T4H-E5QR].

261. *Id.*

262. *Id.*

The bondholders' claim for repayment was rejected by PUFG's bankruptcy administrator on the grounds that the validity and effectiveness of KWDs have not been established in China.²⁶³ Whether courts in jurisdictions where overseas creditors are based will defer to the decision of the PUFG's bankruptcy administrators is yet to be seen.²⁶⁴ The PUFG case is also significant in that it was the first restructuring involving international investors led by the central government since the 1997–98 Asian financial crisis. Top Chinese government bodies, including the PBOC and the Ministry of Education, administered the restructuring,²⁶⁵ and multiple international rating agencies have responded to the PUFG case by reviewing or adjusting their approaches to rating KWD bonds.²⁶⁶

C. State Actors and Intermediaries as Super Nodes

Why would creditors risk purchasing billions of dollars' worth of Chinese-issued dollar bonds under the KWD structure, which is not enforceable against the onshore KWD providers in the Chinese courts, while the offshore subsidiary-issuers have little credit in the absence of their onshore parent companies' guarantees? It is worth noting that despite claims that China is experiencing a debt crisis and despite a couple of widely reported cases of default, overall, the default rate of Chinese-issued dollar bonds is still lower than the average default rate of international bonds and lower than the default rate of China's domestic bond market.²⁶⁷

In the extralegal Chinese-issued dollar bond market, both market intermediaries and various regulatory agencies of the Chinese state are super nodes of the network supporting the market and have played an essential role in shaping the expectations of both debtors and creditors. First, market intermediaries and the Chinese state together decide which Chinese companies can issue overseas bonds under the KWD structure. Second, KWD contracts are relational and incorporate highly detailed written terms that focus not only on what is promised but also on the details of how it is to be

263. *Id.*

264. *Enforceability of Keepwell Deeds Tested Before Hong Kong Courts*, KIRKLAND & ELLIS (Feb. 8, 2023), <https://www.kirkland.com/-/media/publications/alert/2023/02/enforceability-of-keepwell-deeds-tested-before-hong-kong-courts—publications—kirkland—ellis-llp.pdf> [https://perma.cc/X384-86YA] (“Haris J. has indicated that he will hand down his reasoned judgment – and his judgment in the connected case Nuoxi Capital Ltd v Peking University Fonder Group Co. Ltd. ‘comfortably in advance’ of 3 August 2023.”).

265. *Peking University Ruling Raises Refinancing Risk on US\$93 Billion of Keepwell Bonds*, *supra* note 245.

266. *China Keepwell Structures Require Case-by-Case Analysis for the More than \$12 Billion of Rated Debt*, MOODY'S (Apr. 10, 2014), https://www.moody's.com/research/Moodys-China-keepwell-structures-require-case-by-case-analysis-for-PR_296932 [https://perma.cc/BY43-4W8U]; Fitch Ratings, *What Investors Want to Know: China Offshore Keepwell Bonds* (Jan. 14, 2021), <https://www.fitchratings.com/research/corporate-finance/what-investors-want-to-know-chinese-keepwell-bonds-14-01-2021> [https://perma.cc/8VTS-94R3]; *A Surprise Test for China Offshore Bonds with Keepwell Deeds*, *supra* note 248.

267. Xiaopu Han (韩晓普) & Peng Wang (王鹏), Zhongzi Meiyuan Zhai de Shichang Qianjing yu Touzi Celue (中资美元债的市场前景与投资策略) [Market Prospect and Investment Strategy of China Corporate USD Bonds], 5 YINHANGJIA (银行家) [Chinese Banker] 100–01 (2021) (China).

achieved, as well as how the actions of both the issuer and its parent company will be monitored over the life of the agreement. Relational contracts and super nodes of the network, including state regulatory agencies and market intermediaries, create a contract governance regime that is well-structured to support the construction and maintenance of cooperative relationships, thereby minimizing the need for judicial contract enforcement.

In this section, I first present data about the close-knitness of the super nodes, i.e., the Chinese regulatory agencies and market intermediaries, and the homogeneity of industries issuing dollar bonds, both of which enable the reputational mechanisms, and then discuss contract design on the market and how individual and state reputation work to enforce contracts and protect property rights.

1. *Homogeneous and Repeat Players*

The major players in the KWD bond market include (1) Chinese regulatory authorities, despite the extralegal nature of KWDs; (2) market intermediaries, including “the big three” international rating agencies and a handful of investment banks as underwriters; and (3) Chinese parent companies, which seek to maintain their long-term access to the international credit market, issue bonds multiple times, and belong to one of the three specific types: state-owned debt refinancing corporations, LGFVs, and real estate developers. Among these repeat market participants is a rapid flow of information and a shared understanding and interpretation of market behaviors, particularly deviant behaviors that put the participants’ reputation at risk.

SAFE and the PBOC keep control on cross-border capital flow, but have allowed KWD bond proceeds to cross the border into mainland China.²⁶⁸ The NDRC maintains a system regulating the issuance of international bonds with the purpose of controlling Chinese foreign debt, whether private or public. It also sets out basic requirements for a Chinese entity to qualify for issuing international bonds, including a good credit track record, no prior default on issued bonds or other debts, sound corporate governance and a risk control mechanism for foreign debts, and a relatively strong capacity to discharge debts.²⁶⁹ Chinese entities need to apply for a foreign debt quota to issue international bonds, including “indirect issuance” through their overseas subsidiaries.²⁷⁰ In May 2016, the NDRC published a “Risk Alert for Issuing Bonds by Enterprises Out of the PRC,” which expressly declares that any issuer that fails to obtain an NDRC foreign debt quota before issuing international bonds or fails to complete the post-issuance filing, together with the underwriters and the law firms working on the bond

268. ZHANG, *supra* note 11, at 178.

269. *Id.*, at 170–73.

270. *Id.*, at 171.

issuance deal in question, will be placed on a “blacklist” and recorded on the national credit status information platform.²⁷¹ In June 2018, the NDRC introduced a “three warnings” rule for violations of NDRC rules. For the first violation, the NDRC will require the issuer, underwriters, and law firms to come to the NDRC office for a warning conversation. For the second violation, the NDRC will name such entities on its website and issue a public notice of their violation. For the third, it will hold the entities responsible for these violations and suspend them from attending international bond issuances.²⁷²

Intermediaries control Chinese entities’ access to the international credit market. The big three credit rating agencies, S&P Global Ratings (“S&P”), Moody’s, and the Fitch Group, decide the ratings of Chinese-issued dollar bonds. To obtain such a rating, a Chinese company needs to engage and negotiate with one of these agencies in advance of issuance, and the agencies regularly advise Chinese clients on how to obtain a good rating.²⁷³ The negotiations generally take place between the Chinese parent company and the rating agency.²⁷⁴ Rating agencies tend to give more weight to an overseas issuer’s background—that is, the Chinese parent company involved—than to the issuer’s financial accounts. Simply assessing the financial accounts of an overseas issuer would result in a high-yield bond rating, whereas adding the support of its Chinese parent company leads to an investment-grade rating.²⁷⁵ The big three agencies broadly consider KWDs proof of support from Chinese parent companies in their bond ratings.²⁷⁶ Moreover, Chinese parent companies often set up multiple overseas subsidiaries to issue multiple international bonds. This business practice makes the parent companies repeat players in the market and enables the big three to hold them accountable by threatening to cut off future access to the international credit market.

There are more underwriters than international rating agencies, but for Chinese-issued dollar bonds, the top thirty underwriters have a market share of over eighty percent.²⁷⁷ There are both Chinese and U.S. underwriters in the top ten.²⁷⁸ Chinese investment banks, as discussed earlier in this Article, were often jointly founded with top U.S. investment banks.²⁷⁹ Therefore,

271. *Id.*

272. *Id.* at 177–78.

273. Yixuan Chen (华道集团海外发债首秀), *Hua Yi Jituan Hawaii Fazhan Shouxiu* (上海国资) [Debut of Huayi Group’s Overseas Debt Issuance], *CAPITAL SHANGHAI* (上海国资), no.1, 2015, at 44, 46 (China).

274. *Id.* at 46.

275. *Id.*

276. *See infra* Part III.C.2.

277. Xianbing Liang (梁斌), *Zhongzi Jingwai Zhaiquan Chengxiao Shichang Fenxi* (中资境外债券承销市场分析) [Analysis of the Chinese Offshore Bond Underwriting Market], *BOZHAN ZHIKU* (博众智库) (May 17, 2021), <https://mp.weixin.qq.com/s/f7vWIZ2WR8CY9b6WaDBLzg> [https://perma.cc/NH4T-H65F] (China).

278. *Id.*

279. *See supra* Part II.C.1.

together, they have close connections at both the individual and institutional level with the Chinese government. Those connections ensure the flow of information with a common understanding. Over the long term, repeated interactions can hold both individual Chinese entities and the Chinese government accountable.

Chinese issuers using the KWD structure are concentrated in three sectors: state-owned debt refinancing corporations, LGFVs, and real estate developers. The KWD bonds issued by the overseas subsidiaries of state-owned debt refinancing corporations, directly controlled by the Chinese central government, are often rated in the range of “A–” to “A+.” It is hard for the market to believe that the Chinese central government would allow such institutions to default. Doing so would have an impact on China’s sovereign credit rating, as evidenced in the Huarong case discussed below.²⁸⁰ The bonds issued by LGFVs, which are financial vehicles of local governments, generally have a lower rating than those of state-owned financial institutions but are often still rated as investment-grade. Their ratings vary with the financial situation of the local governments behind them.²⁸¹ The international bond ratings of real estate developers, which are often privately owned, are more reliant on their own financial accounts and performance. Still, the top developers were generally welcomed by the market before the recent market crash, as market participants believed them to be “too big to fail.”²⁸²

2. *Relational Contracts and Corporate Reputation*

A KWD might sound like a regular letter of comfort, but it is designed to fulfill the essential function of guarantees. In essence, KWDs ensure equity adequacy and the standby liquidity of the subsidiary. These are agreed among three parties: the parent company, the subsidiary, and the trustee. The subsidiary is the bond issuer, which is usually an orphan special purpose vehicle (“SPV”) set up offshore by the parent company; the parent company is the onshore group that provides credit enhancement; and the trustee is the agent that acts on behalf of the bond investors.²⁸³ In addition, KWDs always come with a supplementary agreement known as an equity interest purchase undertaking (“EIPU”). The EIPU agreement provides that, under certain circumstances, the parent company will purchase the equity of the subsidiary to assist the subsidiary in servicing its outstanding interest and debt principal.²⁸⁴

280. *Peking University Ruling Raises Refinancing Risk on US\$93 Billion of Keepwell Bonds*, *supra* note 245.

281. Clarke & Lu, *supra* note 234.

282. Peter Hoskins, *Evergrande: China Property Giant Misses Debt Deadline*, BBC (Dec. 9, 2021), <https://www.bbc.com/news/business-58579833> [https://perma.cc/L6VW-33YL].

283. ZHANG, *supra* note 11, at 167–68.

284. *Id.*

KWD and EIPU credit support packages usually consist of the following core terms: (1) the parent company shall use its best endeavors to maintain a certain level of ownership in the subsidiary (such as controlling shares or 100% ownership) during the debt term; (2) the parent company shall use its best endeavors to maintain the net wealth of the subsidiary above zero and provide sufficient liquidity to service the debt; and (3) in the event of a default or other agreed conditions being triggered, the parent company shall use its best endeavors to utilize its offshore standby credit facility to support the subsidiary.²⁸⁵

Legally, all of these sophisticated contract arrangements do not make KWDs guarantees. The word usage of “best endeavors” is meant to convey such a message.²⁸⁶ However, by focusing not only on what is promised but also on the details of how it is to be achieved, including specific triggering events, these arrangements, similar to VIEs, constitute the aforementioned “managerial contracting.”²⁸⁷ Such contracts allow creditors to monitor the finances of offshore subsidiaries and their links with their onshore parent companies. They are also designed to foster cooperative relationships with the prospect of long-term interactions, rather than focus on judicial enforcement. Such relational contracts do not derive significant value from the threat of legal enforcement and are supported almost entirely by reputational sanctions and the threat of losing access to the international credit market.

From the outset, international rating agencies made it clear that KWDs do not constitute a direct debt liability for the bond issuers’ Chinese parent companies. However, they opined that “the existence of a keepwell structure demonstrates an entity’s willingness to extend support.”²⁸⁸ The degree to which the market can rely on such willingness depends on the “linkage”²⁸⁹ or “strategic importance”²⁹⁰ of offshore issuers to the parent company. Fundamentally, this relies on the reputational cost to the parent company of a default.²⁹¹ To measure the reputational cost, international rating agencies consider not only the legal linkage between the offshore issuer and the onshore parent company, but also the degree of integration between the offshore and onshore entities.²⁹²

Fitch rates most KWD bonds at the same level as the KWD providers, and specifically commented that the deemed legitimacy of the KWD structure is supported by its use by many Chinese SOEs to issue international

285. *Id.*

286. KWD sample, on file with author.

287. Bernstein and Peterson, *supra* note 204; David Frydinger & Oliver Hart, *Overcoming Contractual Incompleteness: The Role of Guiding Principles* (unpublished manuscript) (on file with author).

288. Fitch Ratings, *supra* note 266, at 2.

289. *Id.*

290. Moody’s, *supra* note 266.

291. Fitch Ratings, *supra* note 266, at 2.

292. *Id.*

bonds in Hong Kong.²⁹³ S&P Global and Moody's have been more cautious, but they have taken a similar reputational approach in rating KWD bonds.²⁹⁴

Are these international rating agencies wrong to rely on reputation mechanisms, particularly in light of the PUFG case? No. As one lawyer and expert on China's international bond issuance commented, "based on [my] experienc[e] . . . working on Chinese issuers' international bond transactions over one decade, . . . no issuer (or its Chinese parent company) [has] intended to use the keepwell structure in such [a] way that the parent company . . . contemplated [not] performing the undertakings under the keepwell deed or the EIPU from the beginning."²⁹⁵ However, no matter how strong the willingness of a parent company to perform the undertakings promised under a KWD or EIPU, bondholders would still fall into an awkward position if the company went bankrupt.²⁹⁶ This caveat should come as no surprise to students of extralegal social controls, which work only in the context of long-term, repeated interactions and become ineffective in the face of an end game²⁹⁷ or structural change.²⁹⁸

3. "In the Chinese Government We Trust"

Despite the extralegal nature of KWDs, market participants tend to believe that the Chinese government acquiesces in or even supports the market based on them. This belief in the Chinese government stems from three observations. First, the regulatory authorities regularly approve transactions based on such contracts, despite tacitly avoiding taking a stance on their legality. Since 2015, all international bond issuances by Chinese companies, including indirect issuances through their overseas subsidiaries backed by the KWD structure, have generally complied with the requirement to obtain a foreign debt quota from the NDRC in advance. The NDRC has never spoken directly about the legality of KWDs, and it does not have to, as it does not have the primary responsibility for implementing SAFE regulations. However, it is reasonable to assume the NDRC acquiesces in such indirect issuance as it grants foreign debt quota to Chinese parent companies using KWDs. It is clear from written communications between Chinese parent companies and the NDRC that the latter is familiar with KWD bonds and has never raised questions about it.²⁹⁹ Second, the extralegal contract

293. Fitch Ratings, *Subordination of Chinese Offshore Debt Issues* (May 9, 2013), on file with the author, at 2.

294. *A Surprise Test for China Offshore Bonds with Keepwell Deeds*, *supra* note 248, at 2; Moody's, *supra* note 266.

295. ZHANG, *supra* note 11, at 169.

296. *Id.* at 168–69.

297. See, e.g., Axelrod & Hamilton, *supra* note 82; Dixit, *supra* note 82.

298. Richman, *supra* note 78.

299. Interview with an employee of a Chinese state-owned investment bank's Hong Kong office, July 8, 2021, Hong Kong.

arrangements support economic activities that are important to China's economic and political interests. Third, many market participants have close connections with the state, including LGFVs and SOEs. Based on all three of the aforementioned observations, international investors believe that a state whose primary focus is economic development is unlikely to take measures against extralegal contract arrangements that have proved so essential to such development.

More than that, international investors believe that the Chinese government would even bail out or provide back-up in the case of individual violation of KWDs. Since the PUFG case, such belief has become rather fragile, but is nevertheless based on a plausible understanding of how the Chinese system works. First, the Chinese central government regularly intervenes in business operations. For SOEs, the state-business connection is straightforward as the state is the owner despite some (partial) attempts to allow SOEs to follow market principles.³⁰⁰ Even among privately-owned enterprises, the government tends to pick champions and intervene in business operations with significant economic, social or even political consequences.³⁰¹ For example, if the bankruptcy of a large company would result in hundreds of thousands of people losing their jobs or investment, the central government might bail it out to safeguard social stability. The deeply-in-debt Evergrande is a case in point.³⁰² Can and will the Chinese central government allow such a large developer to go bankrupt at the risk of creating hundreds of thousands of disgruntled property purchasers? Many investors are betting that the answer is “no.”³⁰³

Second, many creditors believe that offshore debt carries more weight with the Chinese government than onshore debt, as an offshore debt default would harm the reputation and credibility of Chinese sovereignty. For Chinese SOEs, the market considers a default by one Chinese SOE in evaluating the default risks of all Chinese SOEs issuing international bonds. To a certain degree, such assessment operates like the “community responsibility system” which Avner Greif describes in the context of medieval merchants.³⁰⁴ Take the Huarong case as an example. The Chinese Ministry of Finance was the majority and controlling shareholder of China

300. See, e.g., Li-Wen Lin & Curtis J. Milhaupt, *We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China*, 40 STAN. L. REV. 801 (2013).

301. See, e.g., Curtis J. Milhaupt & Wentong Zheng, *Beyond Ownership: State Capitalism and the Chinese Firm*, 103 GEO. L.J. 665 (2014).

302. Reuters Staff, *China's Guangdong to Send Working Group to Indebted Evergrande*, REUTERS (Dec. 3, 2021), <https://www.reuters.com/article/china-property-debt-china-evergrande-gua/chinas-guangdong-to-send-working-group-to-indebted-evergrande-idUSP8N2S902K> [<https://perma.cc/8TUS-6RHB>].

303. Matthew Loh, *Beijing Is Working Behind the Scenes to Pull Evergrande Out of Danger, Urging State-Owned Firms to Buy the Property Developer's Assets*, BUSINESS INSIDER (Sept. 28, 2021), <https://www.businessinsider.com/china-negotiates-state-firm-purchase-of-evergrande-assets-2021-9> [<https://perma.cc/X66C-WK9M>]; Matt Wirtz & Alexander Saeedy, *Investors Bargain Hunt in Evergrande Bonds Amid Default*, WALL STREET J. (Dec. 16, 2021), <https://www.wsj.com/articles/investors-bargain-hunt-in-evergrande-bonds-amid-default-11639650729> [<https://perma.cc/TLZ3-89WQ>].

304. Greif, *Impersonal Exchange Without Impartial Law*, *supra* note 79.

Huarong.³⁰⁵ Owing to corruption and mismanagement, the company suffered a massive financial loss and failed to file its financial statements in May 2021, despite being a publicly listed company.³⁰⁶ By then, it had issued dollar bonds of U.S.\$20 billion.³⁰⁷ The postponement of its release of financial statements triggered market-wide panic, as many investors were unsure whether the Chinese central government would bail the company out.³⁰⁸ China Huarong's offshore U.S. dollar-denominated bond price fell by more than forty percent,³⁰⁹ with the negative risk sentiment then spreading rapidly to other Chinese issuers.³¹⁰ For example, the bond price of China Cinda, another SOE comparable to and of the same kind as Huarong, also dropped sharply.³¹¹ The Chinese government announced a recapitalization plan in August 2021: A group of SOEs injected equity of US\$6.6 billion into China Huarong despite the latter's record-high losses.³¹² After the announcement, the U.S. dollar bond price of China Huarong instantly surged back to its original trading range of 95–100%.³¹³ Fitch's comment on the bailout was that “we regard the coordinated effort of state-owned enterprises, most of which are under the Ministry of Finance's direct control, as a form of extraordinary support,”³¹⁴ and the *Wall Street Journal* quoted Liu Li-gang, the chief China economist at Citi Bank, as saying that “the too big to fail” argument finally wins in the case of Huarong's restructuring.³¹⁵

In sum, Chinese enterprises and their overseas investors design KWDs to hold the former accountable for international bonds they have issued

305. Huawei Ling et al., *The Herculean Task of Bailing out China Huarong*, NIKKEI ASIA (Aug. 31, 2021), <https://asia.nikkei.com/Spotlight/Caixin/The-herculean-task-of-bailing-out-China-Huarong> [https://perma.cc/262S-8C8T].

306. George Calhoun, *Beijing Embraces 'Moral Hazard'—The Huarong Bailout Was The Right Move*, FORBES (Aug. 23, 2021), <https://www.forbes.com/sites/georgecalhoun/2021/08/23/beijing-embraces-moral-hazard—the-huarong-bailout-was-the-right-move/?sh=6082b8104fd6> [https://perma.cc/W3KQ-X83N].

307. *Id.*

308. Lisa Lee & Ye Xie, *China Huarong Panic Eases after Government Breaks Silence*, BLOOMBERG (Apr. 18, 2021), <https://www.bloomberg.com/news/articles/2021-04-18/china-huarong-bond-panic-eases-after-government-breaks-silence?leadSource=UVerify%20wall> [https://perma.cc/VLB3-GMNR].

309. *Id.*

310. Bloomberg News, *Huarong Contagion Risk Resurfaces at Peers That Owe \$454 Billion*, BLOOMBERG (June 1, 2021), <https://www.bloomberg.com/news/articles/2021-06-02/huarong-contagion-risk-resurfaces-at-peers-that-owe-454-billion?leadSource=UVerify%20wall> [https://perma.cc/6TEA-GBDS].

311. *Id.*

312. Bloomberg News, *China Huarong Gets \$6.6 Billion Equity Injection in Bailout*, BLOOMBERG (Nov. 17, 2021), <https://www.bloomberg.com/news/articles/2021-11-17/china-huarong-gets-6-6-billion-equity-injection-in-bailout?leadSource=UVerify%20wall> [https://perma.cc/96B8-TTS6].

313. Calhoun, *Beijing Embraces 'Moral Hazard' – The Huarong Bailout Was the Right Move*, *supra* note 306.

314. Fitch Rating, *Fitch Revises China Huarong's Rating Watch to Positive, from Watch Negative*, FITCH RATINGS (Aug. 23, 2021), <https://www.fitchratings.com/research/international-public-finance/fitch-revises-china-huarong-rating-watch-to-positive-from-watch-negative-23-08-2021> [https://perma.cc/FV74-52H9].

315. Xie Yu & Serena Ng, *Bad-Debt Manager Huarong to Be Bailed Out by State-Owned Companies*, WALL ST. J. (Aug. 19, 2021), <https://www.wsj.com/articles/chinese-bad-debt-manager-huarong-to-be-bailed-out-by-state-owned-firms-11629353827> [https://perma.cc/XK4P-9ARB].

through their overseas subsidiaries. Rather than judicial enforcement, which is fraught with uncertainty and remains to be seen, it is the network's super nodes, including Chinese regulatory agencies and financial intermediaries, that have maintained the market's stability and predictability of Chinese-issued international bonds through reputational mechanisms.

IV. CONCLUSION

Can there be a highly developed financial market in the absence of legal protection for investors and creditors? This Article offers two case studies, the Chinese-issued international bonds and the Chinese overseas listings through VIEs, to answer in the affirmative and to explore how financial markets operate against law. The extralegality of Chinese issuance of international bonds and VIE markets stems from the country's struggle between development, which requires access to the international capital market, and control, which involves keeping market entities and capital on a short leash. Three factors make finance against law possible: (1) the Chinese state plays an essential role in promoting stability and predictability in both markets despite their extralegal contractual basis under Chinese law; (2) financial intermediaries control access to the international capital market and render the market more relational than purely transactional, which facilitates information flows and allows reputation mechanisms to work; and (3) both of the aforementioned markets are public and feature relatively industry-specific communities of Chinese entrepreneurs and corporations in need of access to the international capital market.

Ultimately, all participants in the network of finance against law, particularly the Chinese state and international financial intermediaries, benefit from connecting Chinese enterprises with the international capital market, albeit through extralegal means. Such a network enables its members to hold one another accountable through reputation mechanisms rather than judicial enforcement.

This Article coins the term "finance against law," challenging the necessity of judicial enforcement to developing impersonal and sophisticated financial markets. Different from studies on the sovereign bond markets, a primary example of what I call finance without law, in which states honor their own legally valid commitments, the Chinese state in my case studies choose to act against its laws and hold not only itself but hundreds of enterprises, the numerosity of which makes the markets more impersonal than the sovereign bond market, committed to contracts designed to circumvent the above laws. We should understand the relationship among participants of the above markets as networks rather than close-knit communities which are conventionally regarded as necessary for the functioning of reputational mechanisms. Super nodes in the above networks, particularly Chinese state and international financial intermediaries, form a close-knit community and

maintain the functioning of reputational mechanisms not just among themselves but also in networks considerably larger than their own close-knit communities.

Law and finance scholars are right that impersonal finance needs the backing of the state, but wrong to assume that the state can only back impersonal finance with legal institutions. The state, whose reach goes beyond personal connections, can also back impersonal finance with its own reputation, even against its own laws that are barriers to development but hard to reform due to political opposition. China's approach, "governing by extralegality," sheds light on the role of the state and politics in extralegality, pointing to a new direction that scholars of law and social norms who mainly focus on private ordering should attend to.

The barrier to financial development in developing countries is not only the absence of supportive legal institutions such as independent courts, but also, and more likely, the prevalence of legal and regulatory barriers. How to reform, or, as the first step, circumvent such legal and regulatory barriers, is a key to financial development in the developing world. In the broader context of development studies, the Chinese approach shares some commonalities to the Brazilian practices of "institutional bypass"³¹⁶ and the Japanese practices of "bucking the system."³¹⁷ My Chinese cases, together with the aforementioned Brazilian and Japanese cases, demonstrate an approach of extralegal development, challenging the necessity of law to development and deepening our understanding of the complicated relationship between law and development.³¹⁸

Finance against law is not limited to the overseas bond and VIE markets. It can be found in China's local government debt market, in which local governments borrowed trillions of dollars against legal prohibition on running a budget deficit,³¹⁹ and Islamic banking system, which operates with various mechanisms to circumvent the Sharia law's prohibition on interests.

This is by no means to say that such markets are optimal, sustainable, or risk-free, as the recent debacles involving Chinese-issued dollar bonds³²⁰ and

316. See Keith S. Rosenn, *The Jeito Brazil's Institutional Bypass of the Formal Legal System and Its Developmental Implications*, 19 AM. J. COMP. L. 514 (1971); Mariana Mota Prado and Michael J. Trebilcock, *INSTITUTIONAL BYPASSES: A STRATEGY TO PROMOTE REFORMS FOR DEVELOPMENT* (2018).

317. See Frank Upham, *The Man Who Would Import: A Cautionary Tale about Bucking the System in Japan*, 17 J. JAPANESE STU. 323 (1991) (examining how Japanese entrepreneurs circumvented their governmental regulations on cross-border trade).

318. For a review of the relationship between law and development, see Kevin E. Davis & Michael J. Trebilcock, *The Relationship Between Law and Development: Optimists Versus Skeptics*, 56 AM. J. COMPAR. L. 895 (2008).

319. Roderick M. Hills Jr. & Shitong Qiao, *Binding Leviathan: Credible Commitment in an Authoritarian Regime*, 102 MINN. L. REV. 1591 (2017).

320. See, e.g., Ameya Karve, *Junk Bond Investors Stung by China Look to India and Southeast Asia*, BUS. STANDARD (June 29, 2022), https://www.business-standard.com/article/international/junk-bond-investors-stung-by-china-look-to-india-and-southeast-asia-122062900106_1.html [<https://perma.cc/VF32-T8TX>]; Hoskins, *supra* note 282; Juanjuan Wang et al., *In Depth: Saving Peking University's Fallen Tech*

“China concepts stock”³²¹ demonstrate. There are three issues worthy of further examination: first, social reputation mechanisms are ineffective at addressing end-game moves; second, private incentives are not perfectly aligned with public interests, and the market can exacerbate rather than mitigate the mismatch;³²² and, third, the reputation mechanism mitigates but does not solve the problem of credible commitment from the Chinese government, whose balance of development and control is inherently political and can be unpredictable depending on factors beyond the market, including geopolitics.³²³ Regardless of the future of the markets considered herein, the duration and scale of such finance against law demand explanation and further analysis of the strength and weakness of such markets.

Conglomerate, CAIXIN (May 28, 2021), <https://asia.nikkei.com/Spotlight/Caixin/In-depth-Saving-Peking-University-s-fallen-tech-conglomerate> [<https://perma.cc/VX9B-7PWR>].

321. SEC. EXCH. COMM’N, *supra* note 131.

322. *See supra* Part III.C.2.

323. Consider the impact of U.S.-China trade war on China’s approach to VIE.

