Arbitrage for Property Rights: How Foreign Investors Create Substitutes for Property Institutions in China

Weitseng Chen
ARBITRAGE FOR PROPERTY RIGHTS: HOW FOREIGN INVESTORS CREATE SUBSTITUTES FOR PROPERTY INSTITUTIONS IN CHINA

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Abstract: This article revisits the prevailing wisdom regarding property rights based on empirical research on the behavior of foreign investors in China. The Property Law did not exist in China until 2007—four years after China replaced the United States as the most popular foreign direct investment destination worldwide. This seems to contradict the conventional wisdom about the indispensable role of property rights in economic growth. This article argues that China’s experiences in fact do not overrule the orthodox view, but rather shed light on the evolution of the regulatory property regime. Property rights still matter in China, but the structure of property institutions deviates from conventional configurations. Focusing on land tenure, this article demonstrates an institutional substitute strategy adopted by foreign investors to fulfill their institutional needs. This article also identifies the specific forms of substitutes for property rights and conceptualizes two general approaches to establishing such substitutive property institutions—the contract and corporate law approaches. The findings show that the bifurcated notions of “formal/informal” or “property/non-property” institutions cannot characterize the dynamic evolution of property rights in China. Unlike the image conveyed by informal institutions, foreign investors do not operate their businesses under the shadow of law but beyond the shadow of law by piggybacking on various regulatory regimes and areas of law. Nonetheless, the institutional substitute as a development strategy may facilitate economic growth but will not be sustainable in the long term if it fails to address structural problems caused by accelerating changes in market conditions.

I. INTRODUCTION

The current literature on law and development and neo-institutional economics suggests, theoretically and empirically, that the inflow of foreign direct investment (FDI) is associated with the soundness of legal institutions, especially the property rights system. This view gives rise to the

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1 See Andrzej Rapaczynski, The Roles of the State and the Market in Establishing Property Rights, 10 J. ECON. PERSPECTIVES 87 (1996); see also Rafael La Porta et al., Law and Finance, 106 J. POL. ECON.
conventional wisdom emphasizing the crucial role of property rights in economic growth. Investors need to be assured that they will get to secure their investments of capital and assets and preserve a predictable return on their investments.

In the East Asian region, the development trajectories of Hong Kong, Singapore and Taiwan echo this theory, except that of China. While Hong Kong, Singapore, and Taiwan established their modern property systems during the colonial period, well before their economic take-offs, China’s total revolutions wiped out most nascent property institutions. Nonetheless, foreign entrepreneurs have gone to China and established successful businesses since the early 1980s, despite poor property institutions and the still existing state-owned land tenure. What is even more remarkable is that, since 2003, China has taken the place of the United States as the most popular FDI destination in the world. It was not until four years later that China enacted the Property Law (2007).

How can conventional theories be reconciled with China’s seemingly unorthodox experience? This article argues that substitutes established by foreign investors for formal property institutions fulfill various functions that are otherwise supplied by a state-backed property regime. In other words, property rights still matter and China does not fundamentally deviate from the orthodox view. The differences, however, are the exact forms of property rights and the ways in which the rights are secured. This article identifies three major types of substitutes related to property—security, alienability, and dispute resolution—through which foreign investors take advantage of different segments of the legal system to fulfill their institutional demands. In addition to conventional property law approach, this article further conceptualizes two general approaches making these


3 In Taiwan, Singapore and Hong Kong, property institutions and related legal infrastructures had been put in place before recent periods of rapid economic expansion. Hong Kong and Singapore established a well-functioning common law regime during the British colonial period. In Taiwan, a modern property rights regime was transplanted from Germany during both the Japanese colonial period (1895-1945) and the early years of Chiang Kai-Shek’s rule (1945-1949).
substitutes viable, namely, the contract law and corporate law approaches. Both equate the property law to governing the property relationship.

One example demonstrates the lawyering skills of lay market players. When foreign investors and locals are forbidden to transfer land by property law, they may transfer the shares of the companies that own the land through arrangements based on corporate law. In this way, lands become alienable to better serve various business needs. This article refers to this as the “corporate law approach.” In contrast, when neither property nor corporate law approaches are viable and cost-efficient, investors may access and secure their property rights by incomplete or even illegal contractual agreements with locals. Unlike property rights, contractual rights cannot be enforced against the whole world. Such contractual agreements nonetheless provide easy access to land and, ironically, their unenforceability creates functional limited liability for foreign investors in the face of third parties’ claims. This explains why numerous foreign investors have signed land leases with locals, regardless of whether the lands are legally leasable. An official investigation in 2010 indicated that 57.49% of the total number of buildings in Shenzhen, the major commercial hub in southern China, are built on illegally transferred lands.\(^4\) This article refers to this as “the contractual approach.”

As such, foreign investors cleverly switch between property, contract, and corporate law to create functional substitutes in a market where the traditional property law has been largely absent or incomplete. These substitutes explain why China has been able to achieve its impressive economic growth without moving closer to a Western-style legal system. The findings also show that bifurcated notions of “formal/informal” or “property/non-property” institutions cannot entirely capture the dynamics and patterns of the evolution of property rights. In reality each dimension (i.e., formal, informal, property and non-property rules and institutions) is dependent on each other and embedded in the others in various forms of institutional substitution.

To identify the form and mechanism of these substitutes, the author conducted in-depth interviews with 75 foreign investors, mainly in Shanghai, Hong Kong, and Taiwan, as well as their local business partners. While some interviews took longer to complete, most took two to three hours, accompanied by occasional half or whole-day site visits and follow-up interviews. These qualitative interviews uncovered rich evidence and the complex dynamics of various substitutes that the quantitative approach may

The balance of this article will proceed as follows: Part II introduces the notion of institutional substitutes, and how it connects with various literature across disciplines. Compared to different schools of thought, this article contends that institutional substitutes better capture the dynamism of institutional development in China. Parts III, IV, and V discuss the three major types of substitutes in line with three major functions of property rights: substitutes for security of property rights (Part III), substitutes for alienability of property rights (Part IV), and substitutes for formal property rights dispute resolution mechanisms (Part V). Each Part provides case studies for every type of substitute, analyzes how different approaches work for each substitute respectively, and presents the cost-benefit framework through which foreign investors choose between property, contract, and corporate law approaches. Last, before concluding, this article examines the pros and cons of institutional substitute as a development strategy (Part VI). Several factors that may destabilize existing substitutes have been identified, and therefore challenge the institutional substitute as a sustainable development strategy.

II. INSTITUTIONAL SUBSTITUTES FOR PROPERTY INSTITUTIONS

Arbitrage may be used as a metaphor to describe the approach business actors have adopted to deal with institutional deficits in China. Financial arbitrage describes how financial speculators take advantage of differing prices in multiple markets by buying low in one market and selling high in another. Metaphorically, institutional speculators also take advantage of different configurations of multiple regulatory regimes (e.g., domestic or foreign company laws) or various segments of the legal system (e.g., property, contract, or corporate laws), piggybacking on the one with lower transaction costs or lax regulatory standards in order to create substitutes for the other with higher legal risks. In this way, market players compensate for existing institutional deficiencies by leveraging comparative institutional advantages within multiple regulatory regimes, thereby fulfilling their institutional demands.

The end products are various substitutes for conventional property rights institutions. This section demonstrates that these property substitutes have been made possible by a mix of formal and informal institutional settings based not only on property law, but also on contract and corporate law. It explores the inadequacy of prevailing theories in explaining China’s
significant economic growth (Part A), the development of property law in China (Part B), and the institutional substitutes foreign investors utilize to compensate for China’s weak property law regime (Part C).

A. The Missing Dimension: Foreign Direct Investment and Substitutive Institutions

Economics and political science literature generally identifies two primary drivers in China’s economic transition. First, re-configuration of the state-owned land tenure that unleashed tremendous productivity from the communal property. Second, immense FDI that brought in not just capital, but also know-how to run a capitalist economy. Scant studies have examined the relationship between the two drivers, though, which also happen to be the primary parameters for law and development studies, neo-institutional economics, and contemporary property rights theories. This dimension is missing in the legal literature too.

While not directly discussing the role of foreign investors, several schools of thought characterize current studies of China’s property institutions in terms of law and economic development. One common approach focuses on the legality and equality of China’s property rights regime by addressing issues of distributive justice and seizure of land that may impede social and economic developments eventually. Another approach, as illustrated by the title of a recent paper by Robert C. Ellickson at Yale Law School, “The Costs of Complex Land Titles,” typically questions the efficiency of China’s property system, posing doubts on grounds of institutional complexity and the mismatch between property resources and people who can best utilize the resources. In contrast, Frank

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6 NAUGHTON, supra note 5; see generally YASHENG HUANG, CAPITALISM WITH CHINESE CHARACTERISTICS: ENTREPRENEURSHIP AND THE STATE (2008).
Upham of New York University argues that formal property rights are not necessary to growth. He further asserts that China’s growth would have been inhibited if well-defined property rights had existed at the beginning of the reforms. From a different angle, Donald C. Clarke of George Washington University argues that China’s state-owned urban land tenure creates similar incentives that would normally be generated through well-defined private property rights.

However, none of these foregoing conclusions are complete because the most important players in China’s economic growth are largely missing from current literature, i.e., foreign investors. What is the relationship between the two vital drivers of China’s economic reforms (i.e., FDI and property rights) and what is the role of foreign investors in China’s property rights transition? In light of the missing dimension of these debates, this article aims to bridge the gap by examining the role and behavior of overseas Chinese investors, those from Taiwan in particular, during this process. Foreign investors from Taiwan, Hong Kong and Macau have accounted for the majority of FDI in China and been doing business there since the very beginning of economic reforms in 1979. They have brought in not only immense capital but also knowledge of capitalism and how to run Western legal institutions at least one decade earlier than foreign investors from Europe, Japan and the United States.

In contrast to legal studies that leave foreign investors out of account, social science literature has contemplated the role of these early foreign investors in the process of China’s property rights transition. To begin with, the literature often applies the idea of trust as a way to facilitate business

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11 See Upham, Chinese Property Rights, supra note 10; Upham, From Demsetz to Deng, supra note 10.
12 See Donald Clarke, China’s Stealth Urban Land Revolution, 62 AM. J. COMP. L. 323 (2014).
13 It is estimated that more than a half million Taiwanese are currently working and/or living in the greater Shanghai area. According to reports investigated by research institutes both in Taiwan and China, Taiwan has been one of the biggest FDI sources for China. In fact, the real amount of FDI from Taiwan has been underestimated because many Taiwanese firms have been investing through their paper companies in Hong Kong and other jurisdictions due to investment restrictions set by the Taiwan government. See, e.g., NAUGHTON, supra note 5; Jack W. Hou, China’s FDI Policy and Taiwanese Direct Investment (TDI) in China, (Hong Kong Univ. of Sci. and Tech. Ctr. for Econ. Dev., Working Paper No. 0206, 2002).
14 NAUGHTON, supra note 5.
transactions between locals and outsiders. This view emphasizes the importance of these foreign investors’ shared culture and language with their counterparts in the PRC and contends that working relationships have been based on trust instead of legal institutions. Indeed, the conventional property rights theory presumes the non-trusting behavior of the parties to a transaction, an assumption that is so fundamental that economists do not even mention it as an assumption. Given the lack of trust, formal institutions guaranteed by a third-party enforcer such as the state are necessary to reduce opportunistic behavior and induce cooperation. As such, this trust factor may differentiate China’s property institutions from the conventional view, as the existence of a high degree of trust in the Chinese context may have reduced the need for formal institutions and led to the establishment of alternatives.

In comparison, this article brings the focus back to legal institutions to address the gap in current literature about FDI and China’s property rights transition. Trust per se is not an independent factor contributing to the development of institutional substitutes, but rather determined by a number of other factors, such as the political economy of the property rights regime, various institutional configurations, and reactions from investors facing practical limits and institutional constraints. As such, the focus on loosely defined trust should not override the role of institutions, which may determine the level of trust and actors’ behaviors. A rational American is unlikely to trust a British stranger and set up a company with her simply because they both speak English and know who William Shakespeare is. It is unlikely that those who share a common Chinese culture are any different. Specifically, there must be additional factors accounting for their business cooperation. As such, this article aims to unveil the structure of these substitutes by examining various institutional factors that affect the behavior of both foreign investors and their local partners. Before discussing the various substitutes in greater detail, the next section provides background and briefly explains the development of China’s property law regime over the past three decades or so.

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17 See Martin L. Weitzman & Chenggang Xu, supra note 16.
18 Id. at 140.
19 See, e.g., Donald Clarke et al., The Role of Law in China’s Economic Development, in CHINA’S GREAT ECONOMIC TRANSFORMATION (Loren Brandt & Thomas G. Rawski eds., 2008).
B. Development of the Property Rights Regime in China

When economic reforms began in 1979, most land was in government hands. This state-owned land tenure still characterizes China’s property system to date. A dual-track land system has also been created and existed since the beginning of the economic transition: urban land and rural land. In general, while urban land is owned by the state, the people own rural land collectively. Nevertheless, the state is the paramount owner of both types of land, as it still effectively owns rural land through the lowest government units, namely, villagers’ committees, which own rural land on behalf of the people. In short, it remains as a state-owned land system.

Some changes in the configuration of the state-owned land tenure have taken place gradually throughout the reform era. In 1988, use rights for state-owned urban land became leasable for a very long term and commercialization officially began. In 1994, local governments were allowed to further commercialize urban lands by selling leases through specified channels (e.g., public auction or negotiation) for a well-defined period of time depending on the purpose of land use. For example, the maximum term for residential land is seventy years, while it is fifty years for industrial land. Rural land is not subject to the foregoing regime and needs to be converted into urban land through an expropriation process before any commercial use. Due to procedural irregularities and a disconnect between the high market value and the actual amount of compensation for land taken for conversion, most land disputes that have occurred in China to date stem from this expropriation process.

A few characteristics of China’s land system evolution should be emphasized for the purpose of this discussion. First, instead of privatization of land tenure, the Chinese government accepted decentralization of land use rights. When economic reforms began right after the end of the Cultural Revolution, the central government aimed to relieve itself from financial

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burdens by decentralizing the land tenure system.\textsuperscript{22} While local governments obtained effective control over the allocation of land use rights, the central government insisted on only a nominal ownership of its land tenure. The central government relied on this decentralized land system as an alternative taxation mechanism through which it extracted rents from local governments.

Second, the dual-track land system also plays the role of a social safety net. Peasants and migrant workers working in the urban areas view their lands at home as not just economic but also psychological insurance against an uncertain future, given the lack of sound social security programs and worsening income disparity. This partially explains why the dual-track system remains in effect.\textsuperscript{23} The history of property indicates that the greater the risk, the greater the possibility that group ownership will be enhanced or created as a risk-sharing institution.\textsuperscript{24} This also explains why privatization of collective ownership has never happened in China. As natural disasters such as droughts, floods and locust outbreaks remain common, the risks and losses can be shared collectively through common ownership.\textsuperscript{25}

Third, while literature suggests China’s household responsibility system (HRS) drove and greatly contributed to China’s property rights reform, China’s experiences are not particularly unique although the scale of its commercialization of land is unprecedented. HRS, which was adopted at the end of 1978, essentially dismantled the command economy and allowed farm households to take over management of the agricultural production on their lands, subject to a contractual agreement that they turn over only a certain amount of procurement after the harvest.\textsuperscript{26} In this way, HRS greatly improved the incentive structure for land users. This is similar to, for example, the pattern of Japan’s land reform in the Meiji period. Like Chinese peasants in pre-reform years, Japanese peasants in Tokugawa era


\textsuperscript{23} The other explanation is that both the central and local governments maintain this dual-track system mainly because they do not want to give up their monopoly over the rural land, which serves as a land bank. Consequently, the more the urban real estate market develops, the more the government can make a profit by converting rural land to urban land.


\textsuperscript{25} These frequent natural disasters have earned China the sobriquet “the land of famine.” Lillian M. Li, \textit{Fighting Famine in North China: State, Market, and Environmental Decline}, 1690s-1990s (2007).

\textsuperscript{26} Naughton, \textit{supra} note 5, at 89.
(immediately prior to the Meiji Restoration in 1868) paid a heavy and fluctuating harvest tax depending on the lords’ short-term financial needs. Hence there was no guarantee that farmers could retain any of the increased output. When the Meiji Restoration began, a newly-introduced land tax greatly changed peasants’ incentive structure and unleashed land productivity, like the HRS has in China.

C. Working Out the Substitutes by Property, Contract, and Corporate

For foreign investors, a property rights regime provides three primary functions that are crucial for their business activities: security of properties, alienability of properties, and dispute resolution regarding property rights. Ideally, investors have the capacity to access and secure their property rights to land in host countries, to transfer their lands when exiting the market, and to resolve land disputes according to clearly-defined property rights. As the literature points out, informal mechanisms and institutional arrangements will fill the gap in a world that is not ideal. That being said, the process in which property rights institutions affect economic outcomes remains unclear. How exactly do property rights institutions affect investment decisions? What are the types of alternative property institutions that market players rely upon? How do individual market behaviors influence institutional changes accordingly? Answers to these crucial questions are highly context dependent. This section explores the use of contract and corporate law approaches to securing property rights.

To explore these questions, one must ponder the original state of property relationships when examining the way property institutions have evolved in China. Hundreds of years of Western common and civil law development were condensed into a period of just three decades when China began its property rights transition in 1979 to support its capitalist economy. Property law is a set of rules defining and regulating a bundle of rights held by various owners. Some of them serve as default rules so that rights holders may contract out, while others are immutable rules reflecting public

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28 Id.
When property law does not exist or is insufficient, rights holders may simply resort to other basic legal principles or whatever institution is available for governing their property relationships. There are generally two options.

First, contract law is a natural option. By nature, property relationships are often based on contractual relationships, from which property rights further develop distinctive rules for facilitating the use of assets. One typical example is lease. Viewed as a property right, especially in common law, lease used to be categorized as a normal contract right in civil law. To better protect tenants against subsequent transferees of the property, the civil law world has incrementally transformed lease into a “propertized contract” with third-party effects similar to that of a property right. Even to date, the relationship between contract and property law in both civil and common laws remains in a state of flux in some subject matters (e.g., whether covenants bind successors of the original promisor). Nevertheless, the bottom line is that a property owner cannot benefit from protection under property laws if he or she opts for using contracts to govern an underlying property relationship. For example, as a rule, contractual rights do not run with assets and cannot be enforced against the whole world. Without the support of property registration system, it is also costly for parties in a transaction to verify and process information about the property in question.

The other option is the corporate law regime, which is devised to govern the relationship between multiple stakeholders of business enterprises regarding their tangible or intangible property interests and duties to manage such properties. The form of limited liability company facilitates corporate operations by protecting the properties of owners that have opted out of the company assets. Similar to the primary goal of property law, which is to facilitate the use of property through fairly and efficiently allocating rights and duties to various rights holders, the goal of corporate law is to fashion doctrines that produce honest dealings between multiple

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33 Generally speaking, lease is categorized as a contract right in the civil law, but as a property right in the common law.
actors (e.g., managers, officers, directors, shareholders, creditors and investors) in a way that would not interfere with the business’ efficiency. Like the contract law approach, owners of the company cannot directly benefit from the statutory protection under property law in land; they have to resort to the company law to seek protection of their shareholder rights in the company.

Unlike the implicit image conveyed by the idea of informal institutions, foreign investors do not operate their businesses under the shadow of law but beyond the shadow of law, by piggybacking on various regulatory regimes and areas of law. China’s overall rule of law development also explains investors’ choice of strategy. To attract FDI, China’s legal reforms began with contract and corporate laws as soon as the reforms began in 1979. While the former supports a contractual approach to constructing property substitutes, the latter offers foreign investors with another option based on corporate law. The following Parts illustrate how foreign investors have been able to devise the substitutive property institutions they most desire by conducting an arbitrage institutionally between contract, property and corporate law.

III. SECURITY OF PROPERTY RIGHTS

The Chinese government has promised common Chinese citizens and foreign investors the protection of property rights through both legal statutes and political announcements. Article 11 of PRC Constitution says that “[t]he State protects the lawful rights and interests of the non-public sectors of the economy such as the individual and private sectors of the economy.” Article 13 stipulates that “[c]itizens' lawful private property is inviolable . . . [t]he State, in accordance with the law, protects the rights of citizens to private property and to its inheritance.” It further states that “[t]he State may, in the public interest and in accordance with law, expropriate or requisition private property for its use and shall make compensation for the private property expropriated or requisitioned.” Some specific laws regarding foreign investment, such as the Law on the Protection of

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35 One can also apply a contractarian theory to understand the company law and define the corporation as a “nexus of contracts,” a set of agreements among the constituent parties whereby they organize their relations. See Teemu Ruskola, Conceptualizing Corporations and Kingship: Comparative Law and Development Theory in a Chinese Perspective, 52 STAN. L. REV. 1599, 1705-06 (2000) (discussing various theories of the corporation in the context of Chinese-style business organizations based on kinships and clans.). See also LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 514 (1985).
Taiwanese Investment, also reassert that “[t]he state will not nationalize and expropriate the investment and properties of Taiwanese investors.”

As foreign investors have been looking for security in their own ways, these legal guarantees have never soothed them because of poor enforcement and legal ambiguity throughout China’s rule of law transition. A major security concern arises from foreign investors’ pursuit of quick access to land. This was particularly prominent in early years when laws regarding foreign access to land were extremely ambiguous and foreign investors had to resort to various approaches to acquire land. One overarching strategy has been to create a unitary cooperative structure between foreign investors and locals who have access to land. This section discusses the function of this strategy (Part A), the role of contract approach (Part B) and corporate law approach (Part C) in implementing this strategy, and the rationale behind choices between the two approaches in context (Part D).

A. Unitary Cooperative Structure as an Overarching Strategy

“I have hired a retired party cadre as our company consultant to take care of these problems that can only be solved through guanxi, or connections. Why do I trust him? We share the same interests. He does not want this company down, otherwise he will lose a stable salary. A local official’s daughter also works in our factory. There is no other better way to secure our business than this.”

— A general manager of a leading manufacturing firm in automobile industry.

It is risky to make a land contract with a landowner who happens to be in an authoritarian state that does not really follow any law of eminent domain to expropriate the land. Some investors may nevertheless manage to make the most of this political structure. Prior to the promulgation of the Land Management Act (1988) and the Interim Regulations of the PRC Concerning the Assignment and Transfer of the Right to the Use of State-owned Land in Urban Areas (1990), any land lease and the transfer of use rights were unlawful even though foreign investors had signed contracts with local governments. After the enactment of these two laws, foreign investors needing access to state-owned urban land must sign a lease with city or county governments. With regard to rural land legally prohibited

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37 Interview with the general manager of one of Volvo’s major outsourcing companies in China, in Qingpu District, Shanghai (June 2006).
from being leased, foreign investors can lease it only after the district governments exercise eminent domain and transform it to urban land. However, the reality is that before and after the enactment of these laws, numerous foreign firms have signed land leases with local officials regardless of whether the lands were allowed to be leased.\(^{38}\) Apparently, such contracts are sufficient to secure investors’ rights to use their lands. The question remains: why?

In the face of opportunism, people could mitigate the risks and effects by altering the costs and benefits of breach, such as exchanging hostages or putting up collateral.\(^{39}\) The other option is to eliminate the condition of divergent interests that makes the opportunism possible in the first place—what this article generally refers to as “the unitary cooperative structure.”\(^{40}\) Risks exist only because the parties perceive their interests to be divergent. Absent such divergence, there would be no danger of opportunism on either side.

After the unitary cooperative structure is established, the interests of individual transactors become integrated and more identical, and therefore the dependence on formal contracts and other third-party mechanisms reduces. The exact form of the unitary cooperative structure varies. Following this mindset, for example, foreign investors have established numerous unions with local governments, state-owned enterprises (SOEs) and township- and village-owned enterprises (TVEs) in various forms: fake SOEs and TVEs, subcontracting manufacturing factories, equity joint venture companies, or other forms of organizations. Both the central and local governments tolerate and even encourage such unitary cooperative structure, mainly because foreign firms bring in large amounts of capital as well as job opportunities through these unions.

The remaining sections examine how exactly contract and corporate law approaches help create the property substitutes based on the unitary cooperative structure.\(^{41}\)

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\(^{38}\) See interview with the senior manager of a real estate consulting firm, in Changning District, Shanghai (June 2006); interview with the president of a real estate group, in Changning District, Shanghai (June 2006); interview with the market analyst of a real estate group, in Changning District, Shanghai (June 2006); interview with the vice president of the legal department of a land development firm, in Changning District, Shanghai (June 2006); interview with the governmental official and director of an industrial management committee, in Songjiang District, Shanghai (July 2010).


\(^{40}\) See id. at 22.

\(^{41}\) For the sake of simplicity, this article will use “union” to refer to the unitary cooperative structure hereafter.
B. Contractual Approach: The Case of the Subcontracting Manufacturing Factory

“The town has assigned a resident as the head of our factory. He is just a symbol of the town’s ownership and actually never shows up. But the township government does take care of some troublesome things we face. For instance, whenever the central government requires us to pay head tax since we do not pay income tax, the town helps us come up with an ‘optimal’ head count number as the tax base.”

— An owner of a subcontracting manufacturing factory

One type of early-developed unions between foreign investors and local governments is the subcontracting manufacturing factory (SMF). SMFs are purely based on contractual arrangements between foreign investors and the locals (usually the village committees, the owners of rural lands) because SMFs are neither a legal entity under the company law regime nor lawful owners of lands according to the property regulations. To gain access to lands, SMFs are usually formed falsely as TVEs. This way foreign investors can unlawfully lease land from local governments, then construct plants, import equipment and raw materials, and begin their export-oriented manufacturing production. Mayors or assigned local officials or residents are the nominal heads of SMFs although foreign investors actually operate SMFs. While their Chinese partners are nominal owners, foreign investors merely acquire the management rights of SMFs based on side contracts, the spirit of which actually denounces the corporate formation and its legality. Although SMFs run like de facto corporations, foreign investors’ interests in SMFs have no legal basis in the corporate laws

Note:
42 Interview with the owner of a subcontracting manufacturing factory, in Dongguan City, Guangdong Province (June 2006).
43 The origin of SMF can be traced back to late the 1970s. Research shows that it was invented by investors from Hong Kong. See Lu-Lin Cheng, The Invisible Elbow: Semiperiphery and the Restructuring of the International Footwear Market, 35 TAIWAN: A RADICAL QUARTERLY IN SOCIAL STUDIES 1, 15 (1999).
44 In addition to access to land, foreign firms may have other potential benefits if they “collectivize” their firms. In general, SOEs and TVEs, as agents of the state in the market, have advantages over foreign firms, including (1) low or even no cost for state-owned land and facilities; (2) better security of property and less opportunity for land confiscation; (3) low bank loan interest rates; (4) more political backing and business chances; (5) better ability to enforce contracts via non-judicial measures; (6) greater information to evaluate business risks; and (7) more governmental subsidies.
and are merely based on contractual arrangements about the use of facilities and the control of revenues. Some of these contractual agreements are incomplete and even not formally enforceable. Nonetheless, SMFs have been commonly used by numerous investors from Hong Kong, Taiwan, and Macau since the early 1980s. SMFs also help explain why the productivity of TVEs between 1979 and 1991 grew approximately three times higher than that of SOEs. In 2006, for instance, there were still more than six thousand Taiwanese SMFs in Guangdong province.

At first blush the SMF is by no means a secure form for investors to align with their Chinese partners. First, the SMF is not a legal person and cannot possess the rights that a legal entity enjoys, such as the right to sue in courts. The SMF can only be designated as a “factory” instead of any formal form of corporation. Second, making the situation even more tenuous, foreign investors do not own their factories because SMFs are officially owned by their Chinese partners in various forms of TVEs that have access to land and export permits. What foreign investors have in these unions are contractual rights with respect to access to land, ownership of the factory production, and de facto control and management rights of the SMFs. Clarke and Howson, in their examination of derivative action cases in China, also point out courts’ tendency to rely on pure formalities in permitting the derivative claim and that the ambiguity of corporate ownership and legal identity has led to difficulties in protecting shareholders by derivative actions meant for the formal corporate form.

Why would ethnically Chinese foreign investors opt for SMFs and how do they handle the risks and enforce their contractual agreements? To begin with, the nature of contractual rights, coupled with the unenforceability of these illegal contracts in question, have functionally created a form of limited liability to the amount of their investment in SMFs. As foreign investors are neither legal representatives of the entities nor official owners of the corporate assets, they bear lower legal risks in the face of third parties’ claims and hence better control their risks. If necessary, they can even exit the investment structure swiftly provided they are willing to endure the losses, which are limited to the corporate assets they have

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47 Weitzman & Xu, supra note 17, at 128-29. See also, Yasheng Huang, Debating China’s Economic Growth: The Beijing Consensus or the Washington Consensus, 24 (2) ACADEMY OF MANAGEMENT PERSPECTIVES 31, 34-35 (2010).
contributed. Here the contractual approach crosses over the corporate law approach, and creates the core of the corporate form for the sake of securing property rights.

Furthermore, foreign investors’ security in their property interests in SMFs relies on an interdependent relationship with the local economy, giving rise to long-term cooperation. For example, the fact that many local residents working for SMFs live off the salaries they provide reduces the risk that local officials and party cadres would confiscate the property of SMFs. Also, each party may hold information that is harmful to their partners (e.g., tax evasion records) after a period of business practice in a gray area, or even one completely unlawful. This scenario, similar to playing repeated games of chicken, provides investors and their partners with incentives to maintain unions. This approach involves exchanging hostages, metaphorically, or putting up collateral to prevent opportunism in a contractual relationship without strong state interference for enforcement. However, if the balance of power shifts, then the relationship may turn sour. As such, foreign investors rarely stop looking for suitable institutional arrangements or adjusting their behavior to adapt to any condition changes.

Under the decentralization policy that began in 1979, Beijing did not have too much say about local property arrangements and, therefore, chose to tolerate these fake collective enterprises. Lacking sufficient capacity to monitor land use and enforce rules, the central government also faced difficulty correcting unlawful land use that local governments and foreign investors commonly adopted. As such, it decided to encourage SMFs by providing tax exemptions on the import of machines and raw materials, and to require local governments to submit part of the resulting revenues to the central government.\textsuperscript{50} The government also considered SMFs a policy tool to help transform domestic firms into modern business organizations through

\textsuperscript{50} SMFs are not regulated by the normal regulatory regime regarding foreign enterprises. Also, because tax agencies have difficulty in collecting the accounting information of SMFs, SMFs are usually required to pay tax based on head counts. However, such head count taxes can be easily evaded through cooperation between local officials and foreign investors. As such, the central government started discouraging the establishment of SMFs by setting disincentives in the early 2000s. Since 2002, for instance, SMFs have been required to pay income tax. See Wei Jia, Chinese Foreign Investment Laws and Policies: Evolution and Transformation 21 (1994); De-cong Chang, The Analysis of Transforming Mainland’s Material Processing Plants into Personal-Fund Enterprise, Strait Business Monthly (2002), http://www.sefb.org/mhypage.exe?HYPAGE=03/03_content_01.asp&weekid=38&idx=12 (last visited July 15, 2014); Legalization of Materials Processing Factories: The Deadline is Approaching, PricewaterhouseCoopers (2011), http://www.pwc.tw/zh/challenges/invest-in-mainland-china/invest-in-mainland-china-20110715.jhtml (last visited July 15, 2014); The Chinese Tax Bureau is Likely to Strengthen the Audit on Transfer Price of Material Processing Factories, PricewaterhouseCoopers (2011), http://www.pwc.tw/zh/challenges/invest-in-mainland-china/invest-in-mainland-china-20111021.jhtml (last visited July 15, 2014).
the introduction of new technology and corporate governance. Nevertheless the central government does restrict that SMFs’ products cannot be sold into domestic market so that the monopoly of SOEs and TVEs in the domestic market would not be threatened. When asked what the judicial system and regulatory authorities should do with hundreds of thousands of fake TVEs and SMFs in the coastal area, the then-Vice President of the PRC Supreme People’s Court asserted that unless those firms bring their legal issues to the court, the state and courts will not intervene. In fact, SMFs are not a recognized legal entity, capable of suing or being sued and, in practice, the Chinese courts generally refuse to hear land dispute cases involving local authorities, the business partners of many SMFs.

The downside of this contractual approach to securing property rights in land includes the moral hazard inherent therein and the geographic limit of its effectiveness. First, SMFs create special dangers and moral hazard in the short term because, until the bond of intimacy have taken hold and grown strong, the relaxation of defenses by illegal or incomplete contractual agreements may increase the risk of exploitation instead of diminishing it. Second, the geographic limit of its effectiveness occurs because the physical and social distance between business partners matters to self-enforcement. Property arrangements based on incomplete and/or illegal contracts are only viable within a certain level of close-knit groups. In the context of our discussions the line is not drawn along family units but roughly by culture; members within a close-knit group often govern their continued relationship by relational contracts, ensuring contract enforcement by forming contracts

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51 For instance, in the 1980s and 1990s, Beijing city encouraged Taiwanese investors to acquire SOEs or develop alliances with SOEs by setting various incentives, such as providing lands for real estate development or other businesses. See Straits Exchange Foundation, Measures for Beijing City to Encourage Taiwanese Investment, 36 STRAIT BUSINESS MONTHLY 21 (1994).

52 SMFs are prohibited from selling their products in the domestic market without getting approval and paying additional taxes, otherwise foreign investors will be charged criminally as smugglers. See, e.g., Criminal Trial Precedent No. 268, in 35 REFERENCE TO CRIMINAL TRIAL (Sup. People’s Ct. ed., 2003).

53 Wan Exiang, Former Vice President of Supreme People’s Court, Address at Yale Law School (Nov. 30, 2006) (answering the author’s question).

54 This policy has been specified in several internal notices issued by the Supreme People’s Court, provincial courts, and the Ministry of Construction. For example, Beijing’s Supreme Court has issued the “Beijing Supreme Court No. 106 Document” to specify four types of land disputes that the district courts should refuse to hear.

55 See Kronman, supra note 39, at 23.


only with members of the network and refusing to deal with a partner in the future if he or she defaults.  

In a sharp contrast with ethnically Chinese foreign investors, non-ethnically Chinese foreign investors are often amazed at the adoption of SMFs and other substitute institutions that are not necessarily lawful. An interesting interview revealed the difference in mentality between non-ethnically Chinese investors and their local business partners. On negotiating for an American firm to acquire the assets of a Chinese manufacturer in Guangdong Province where numerous SMFs exist, a U.S. attorney recalled: “One stumbling block was the [seller’s] company’s location: the manufacturing operation was in an area zoned only for agricultural use. The seller attempted to assure the buyer that there was no need for concern . . . and had experienced no problems [renewing the lease] with the local authorities.” The buyer also found the Chinese company had not paid certain taxes; once again, the seller argued such practice was prevalent in the area: “[I]f a local official knocks on our door and demands payment, we will negotiate and reach a compromise on the amount owed.” When the buyer tried to get the seller to lower the price, “the seller refused, arguing that it had done nothing that other companies had not done.” In the end, the buyer decided to walk away from the negotiation, demonstrating a very different mentality from that of ethnically Chinese foreign investors.

C. Corporate Law Approach: The Case of the Equity Joint Venture Company

“A variety of local units came to ask for a variety of fees . . . They just walked in our office at short notice. They brought with them some Xerox copies of laws and rules that we didn’t understand at all . . . It’s no way to pay all the money they asked. You shouldn’t satisfy their appetite. What could I do? I called the people at Xi Ling [the partner of the equity joint-venture company] for help. Most of the time, they solved the problems quickly. We’ve been paying them a great deal of money. If they don’t take care of the troubles, what else do we need them for?”

58 See Simon Johnson et al., Courts and Relational Contracts, J. L. ECON. & ORG. 18 (2002); Ronald J. Gilson et al., Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine, 110 COLUM. L. R. 1377, 1392 (2010); Gilson & Milhaupt, supra note 57, at 236.
60 See id.
61 See id.
62 See id.
63 See id.
A manager of a Taiwanese firm based in Xizhu City, Guangdong Province\(^{64}\)

The early development of China’s corporate law system also enables foreign investors to secure property rights by piggybacking on the corporate law regime. Over time, the equity joint venture company (“JV company”) became another popular type of union for investors and local enterprises.\(^{65}\) The JV company is incorporated legally pursuant to the Chinese-Foreign Contractual Joint Ventures Law (1988), one of a few early legislative efforts catering to foreign investors. Two other special laws have set a legal framework for foreign firms as well: Chinese-Foreign Equity Joint Ventures Law (1979); and, Foreign-Capital Enterprises Law (1986). The Company Law (1993) also serves as a fundamental and complementary regulatory regime. By forming different relationships between various actors in any given corporate entity, each of these laws sets different cost-efficient conditions for foreign investors to mitigate transactional opportunism.

The benefit of incorporating a JV company is that foreign investors can rely on a formal internal governance system to manage their cooperation with their local partners. Risks and duties can be fairly distributed and governed by rules decided on in advance rather than *ad hoc* negotiations that could be time-consuming and uncertain. Additionally, revenues can be distributed through a shareholding structure.

The JV company form may offer foreign investors, depending on their targeted markets, an advantage over SMFs under certain conditions, which largely reflect the political economy of China’s bureaucratic system. The central government tolerated, but placed severe restrictions, on SMFs, the substitute based on contractual agreement, limiting SMFs to export-oriented business so they would not detract from SOEs’ monopolies in domestic markets.\(^{66}\) As a result, SMFs are not a desirable option for investors targeting the domestic market. Furthermore, financial bargaining between the central and local governments also led to the JV company form. The JV company is a legal, taxable entity subject to tax paid to the central government. This allows the central government an opportunity to share in local revenues that would otherwise be completely held by local governments if foreign firms are registered as SMFs. To illustrate, a foreign firm manager stated, “Even if you go to city hall and want to register as a


\(^{65}\) For example, by 1994, around 44 percent of all FDI projects involved JV companies, accounting for 57 percent of the total FDI inflows in Yantai, a coastal city in Shandong province. See Huang, *supra* note 5, at 219.

\(^{66}\) *See Criminal Trial Precedent No. 26, supra* note 52.
formal company to hold assets and property, officials will discourage you because the higher government can share in the pie if you do that.”

Here the bargaining between the central and local governments has determined the form of property substitutes.

Similar to the contractual approach, foreign investors are inclined to establish JV companies with SOEs and TVEs that have legal and secure access to land. The cooperation, however, is legally based on SOEs’ and TVEs’ contribution of their land use rights to JV companies as a portion of the invested capital, with foreign investors’ contribution of cash and the rest of the necessary resources. Other governmental agencies may join these unions in various ways. The local People’s Liberation Army (PLA), for instance, may send soldiers as security guards.

**D. Choosing Between Contractual and Corporate Law Approaches**

The foreign investors’ choice between contractual (i.e., SMFs) and corporate law (i.e., JVs) approaches for securing their property rights is largely based on a cost and benefit analysis. One primary benefit of the corporate law approach is the formal internal governance system available under the corporate law regime. Foreign investors can apply such corporate governance regime to their property relationships and manage the cooperation between locals and themselves. Unlike SMFs based on contracts that cannot be enforced formally, the corporate law approach provides a legal way to access to land, and hence, better security and certainty. Without a functional judiciary to enforce various contracts, foreign investors may reduce legal risks by transforming numerous deals into internal business decisions of a JV company.

One important advantage to the corporate law approach is the ability of foreign investors to position themselves between the foreign and domestic

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67 Interview with the deputy director of the administration department of a high-tech manufacturing company in Dongguan City, Guangdong Province (July 2006).

68 For a general discussion, see PITMAN B. POTTER, FOREIGN BUSINESS LAW IN CHINA: PAST PROGRESS AND FUTURE CHALLENGES 22-29 (1995).

69 Such involvement may or may not reflect the foreign investors’ preference. Nonetheless, it is usually part of the deal reached between the investors and their local partners and the investors have to accept such involvement.

70 Although working like ordinary employees, these soldiers are not on the payroll like their coworkers in the companies; instead, their salaries are taken by the PLA units, while they in return get lower but standard wages from the PLA. See Wu, supra note 64, at 333.

71 Other business consideration may be taken in account too. For instance, the location of the land to be acquired, the tie with the local officials, the primary market of the firms’ businesses, or costs and risks to maintain the union.

corporate regimes through institutional arbitrage. Forming JV companies in foreign jurisdictions (e.g., Hong Kong and Singapore) where a better-designed and enforced regulatory regime is available has been widely adopted. Such international corporate structure is also associated with the security of revenues, which are subject to China’s capital control policies and may not be wired abroad freely or swiftly. This is especially troublesome for revenues generated through informal property arrangements. As such, transnational corporate structure becomes a major solution to address concerns about the security of revenues. For example, JV companies may be incorporated overseas, with domestic subsidiaries merely as their contracted manufacturers holding limited assets and just enough cash to pay local employees and purchase raw materials from their overseas parent companies. The revenues are to be paid to overseas JVs and retained overseas, thereby making the balance sheet of domestic subsidiaries show low or even no income. This way the capital control is circumvented.

Nevertheless, foreign investors need to weigh the benefits against potential disadvantages. First, because the legal tie between partners of JV companies is closer than that of SMFs, foreign investors must be more cautious about choosing their partners in JV companies. Specifically, because majority rule is its norm, whenever any disagreement occurs, corporate law works against foreign investors that are not majority shareholders. Before the minority shareholder protection (e.g., derivative actions) sufficiently develops in China, foreign investors run the risk of the moral hazard inherent in JVs, as evidenced by numerous court cases involving fraudulent change of shareholder registration records by JV partners.73 As a result, most foreign investors prefer to cooperate with SOEs rather than TVEs, because the former may have not only stronger market positions and political backing but also relatively well-documented information and better corporate governance. In this way it reduces the risk of transaction opportunism.

Furthermore, the location of unions may also reflect investors’ consideration and preference, especially in terms of access and the security of their properties. For instance, foreign investors may decide to set their JV

companies in Beijing rather than other cities because they are in union with central party cadres as well as those SOEs that have better connections to the central government. In contrast, SMFs based on informal contractual arrangements primarily exist in southern China, away from the central monitoring.

Second, foreign investors must take into account the operating costs of JV companies. The costs may be higher than those of SMFs because the JV companies’ de facto rent for land is equivalent to the shares held by Chinese partners, usually fifty percent. It would be more expensive to pay rent on land according to the fixed ratio of revenues than to pay a fixed amount. Not surprisingly, there is always a dual contractual arrangement within JV companies: one contract for official documentation, the other for internal revenue distribution. However, this creates a moral hazard similar to that of the informal contract approach and also poses the risk of exploitation, especially before a long-term interdependent relationship has taken hold.74

In comparison, the local governments’ choice between contractual or corporate law approaches depends largely on the political economy within the bureaucratic system. If local governments are able to gain more revenue through SMFs than through JV companies, local officials will favor SMFs, which are fully under their control through contractual arrangements at the local level. On the other hand, the central government is likely to extract higher revenues by incentivizing the formation of JV companies rather than SMFs because JVs are taxable by the higher authorities.

Consequently, foreign investors face a dilemma: the legalization of property implies better security, yet increased monitoring and control by the state over their property and revenues creates a danger of exploitation by the central government. This explains why the central government is generally supportive of the legal approach to holding property through corporate forms. After the 1979 Chinese-Foreign Equity Joint Venture Law of the

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74 Due to inherent moral hazard, many reports have revealed a great deal of cases in which local partners confiscated their foreign counterparts’ properties. As a result, since 2000 most foreign investors have switched to a better form of corporate entity, the wholly-owned foreign enterprise (WOFE), made available by the 1986 Law on Foreign-Invested Enterprises, most recently amended in 2000. A WOFE has greater freedom and independence and can better protect its intellectual properties, compared to a joint venture. In 2002, approved WOFEs accounted for 65 percent of foreign companies. Many investment and legal consultants, as well as the U.S. Department of Commerce, suggest that foreign investors incorporate as WOFEs rather than JV companies unless foreign investors greatly need assistance that can only be acquired through the JV relationship. See, e.g., Straits Exchange Foundation, 16 STRAIT BUSINESS MONTHLY 26 (1993); Straits Exchange Foundation, 74 STRAIT BUSINESS MONTHLY 33 (1998); JINGLIAN WU, ECONOMIC REFORMS IN CONTEMPORARY CHINA 288-89 (2004); UNITED STATES OF AMERICA DEP’T OF COMMERCE, DOING BUSINESS IN CHINA: 2011 COUNTRY COMMERCIAL GUIDE FOR U.S. COMPANIES 8 (2011), http://www.buyusainfo.net/docs/x_8054544.pdf (last visited July 15, 2014).
PRC, the central government provided a greater variety of corporate forms in the subsequent years.\textsuperscript{75} In particular, Beijing incentivized the adoption of the corporate law approach by lowering the administrative costs of using land use rights as capital for JV companies.\textsuperscript{76} Some high-ranking party officials have claimed that the practice of “using land as capital” is one of the two most important institutional inventions during China’s economic transition.\textsuperscript{77}

Once they decide on the approach to apply, foreign investors’ biggest challenge in the short term is how to manage the risks resulting from the unions created under either approach. The relaxation of defenses by the forming unions may increase the risks of exploitation rather than diminishing them.\textsuperscript{78} For instance, in the case of SMFs, local officials involved in SMFs may block foreign investors’ business by opportunistically processing bureaucratic matters on behalf of foreign investors. The value of land or other contributions as JV capital may also be arbitrarily decided by local officials and enterprises due to the absence of neutral land appraisers.\textsuperscript{79}

In the long term, contrastingly, the foreign investors need to deal with the dilemma between a stable union and the hostage effect. This is particularly the case when foreign investors’ partners are local governments.


\textsuperscript{76} For example, Beijing encouraged the establishment of JV companies through the enactment of the Regulations for the Implementation of the Chinese-Foreign Equity Joint Venture Law in 1983 and with subsequent amendments in 1987. In 1997, the NPC further enacted the PRC Partnership Enterprise Law, which provides a more flexible type of corporate union for foreign investors to align with domestic legal entities that are encouraged to use land use rights as capital. This law has been further amended in August 2006 to generally grant foreign investors greater flexibility in structuring ventures in China. The Company Law has been modified in 2006 and does not require Chinese firms to have at least two shareholders. This former two-shareholder requirement increased foreign firms’ risk when they wanted to set a domestic subsidiary that would be viewed as a domestic firm. Foreign firms often introduced a nominee shareholder to comply with this requirement, which increased costs and risk. See Regulations for the Implementation of the Law on Sino-Foreign Equity Joint Ventures (promulgated by the St. Council, Sep. 20, 1983, effective Sep. 20, 1983), available at http://english.mofcom.gov.cn/article/lawsdata/chineselaw/200301/20030100064563.shtml (China); Law of the People’s Republic of China on Partnership Enterprises (promulgated by the Standing Comm. Nat’l People’s Cong., Feb. 23, 1997, effective Feb. 23, 1997), available at http://www.npc.gov.cn/englishmpc/Law/2007-12/11/content_1383548.htm.

\textsuperscript{77} Straits Exchange Foundation, 27 STRAIT BUSINESS MONTHLY 19 (1994). The other vital institutional invention is the Household Responsibility System that allowed peasants to keep their production and hence created a great productive incentive.

\textsuperscript{78} See Kronman, supra note 39, at 23.

\textsuperscript{79} Tai-yun Wang, The Land Appraisalment of Joint Venture Negotiation Between Firms Across the Strait, 151 STRAIT BUSINESS MONTHLY 44, 45 (2004); You-Ren Yang, The Studies of Taiwanese IT Companies’ Trans-border Production Network and Local Development in China: A Comparison between Suzhou and Dongguan 1-22 (2005) (Ph.D. dissertation, National Taiwan University) (on file with the author).
When investors align themselves closely with the authorities, they are likely to form strong unions. This also means that local officials can collect possibly incriminating information that increases their bargaining power, especially when officials pursue one-shot gains rather than long-term cooperation. As a result, foreign investors suffer from the hostage effect because their investments in lands are immobile.  

In short, in addition to the viability of respective institutional arrangements, the success of either SMFs or JV companies depends on the bargaining power between parties in the union. As a senior manager of a middle-size firm stated:

That firm, a large international computer manufacturing company, has been well known for its guts to stand against the local government. A few years ago, after having a serious dispute with local officials, the firm just let all of its employees have one day off. After the downtown was crowded by 30,000 laborers for only one day, the local government compromised. Of course, we dare not to do that.

This statement illustrates that the bigger the firm is, the more it can alleviate the risk of this hostage effect. For local governments, the cost of losing the union relationship is roughly equivalent to that of losing foreign investment. Such a structure, however, will become unstable if bargaining power between the parties involved significantly changes. For this reason, this article further analyzes in Part VI whether institutional substitutes can serve as a long-term development strategy.

IV. ALIENABILITY OF PROPERTY RIGHTS IN LAND

Another major function that an ideal property regime provides is alienability of property rights. If the property owner is banned from transferring the property when necessary, investments in the property would be limited because the owner is not able to redeem the residual value of any investment by selling the property to a third party. Not only do such restrictions disincentivize the property user from improving and making

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80 For instance, when foreign investors have to rely on their local partners to deal with the numerous governmental surcharges, the record of this evasion can be used by local partners or officials who are in disputes with investors at a later time. Foreign firms may also be threatened not to exit a specific local jurisdictions, which may cause loss of tax revenues.

81 Interview with the deputy director of the administration department of a high-tech manufacturing company, supra note 67.
efficient use of the property, but they also deprive the property owners of the freedom that they may need to sell the property. In order to examine the substitutes about alienability, the following sections look at the ways the non-transferrable land can be effectively transferred (Part A) and examine in context the contractual approach (Part B) and the corporate law approach (Part C) to alienability.

A. How to Transfer the Non-Transferable

Restrictions on land transfer are the default and immutable rules under socialist collective land tenure. The government, however, has relaxed such restrictions as the reforms moved forward. In 1990, the State Council announced rules regarding the sales of urban land use rights. In 1998, both the Land Administration Law and the Constitution were amended to allow the use rights for both state-owned and collective-owned lands to be transferred according to law. Nevertheless, prevailing restrictions on alienability still exist. From time to time, ad hoc restrictions have also been announced as a result of policy and even political or ideological considerations, such as those aiming to curb overheating property markets by limiting alienability.82

How can foreign investors transfer their property interests in land, especially those acquired through informal channels and held by substitutive property institutions? Foreign investors also generally apply either contractual or corporate law approaches to fulfill their demand for alienability. The contractual approach primarily deals with the transaction costs caused by restrictions on alienability; in particular, how to absorb the costs caused by such restrictions over the course of dealings. As such, the contractual approach is passive compared to the corporate law approach. Contrastingly, the corporate law approach aims to proactively find a way to bypass the limits of alienability through the law of business organization. The bottom line is that both approaches intertwine with property rules, thereby demonstrating again the interaction and interdependence between the rules of property, contracts, and business organizations when establishing substitutes for property institutions.

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82 For example, land use rights could be withdrawn if land developers do not start the land development projects two years after they acquired the use rights. Although the enforcement of these regulations is questionable, such restrictions exist and change frequently, creating uncertainty and legal risks.
B. Contractual Approach: Institutionalizing Short-Term Horizon

“After we signed the land lease with the local government, the chief party secretary, mayor, and deputy mayor hired about 3,500 workers to construct our manufacturing plant. Deputy mayor Yeh actually was the general manager of a local development company. It took only 6 months to finish our plant that is 100,000 square meter big! It was unbelievable if you did not participate in the process.”

— A senior manager of a computer monitor manufacturing company, ranked as 4th in the world

From a foreign investor’s point of view, a one-party Leninist regime that tightly controls the allocation of land use rights may reduce the transaction cost tremendously during the investment process. While businessmen in transitional Russia claimed that the hardest part in acquiring land property and securing contracts was finding the right person (local officials, rights-holders, or the mafia) to negotiate with or to bribe, foreign investors in China do not face this problem and can easily find the right persons with whom to make a deal: party secretaries or cadres at the local level. Party cadres, with power of eminent domain, even approach foreign investors first to advertise collective land still used by peasants or other local residents. Therefore, the possibility of bargaining failure due to an excessive number of parties being involved is low.

Party cadres heavily discount the value of land that they control due to the party’s internal rotation and promotion system based primarily on economic performance indicators. The current value of land is much

86 See interview with the general manager of a real estate and construction-consulting firm, in Kunshan City, Jiangsu Province (June 2011); interview with the manager of a recycling service company, in Kunshan City, Jiangsu Province (June 2011); interview with the vice president of a recreational resort, in Songjiang District, Shanghai (May 2006).
87 In general, if the number of participants is large, the efficient adaptation of property rights arrangements to new circumstances is more difficult because the consensus is harder to achieve. See GARY D. LIEBACAP, CONTRACTING FOR PROPERTY RIGHTS 6-7 (1989).
88 CCP’s cadre responsibility system has been effective since 1988. The principal criteria of evaluation are formulated in very general terms, including work achievement, political integrity, competence, diligence, and achievements, with an emphasis on actual work achievements. Work achievement usually accounts for 60 to 70 percent of the evaluation. See PIERRE LANDRY, DECENTRALIZED AUTHORITARIANISM IN CHINA: THE COMMUNIST PARTY’S CONTROL OF LOCAL ELITES IN THE POST-MAO ERA (2008); Maria Edin, State Capacity and Local Agent Control in China: CCP Cadre Management from a Township Perspective, 173 THE CHINA QUARTERLY 35, 36-37 (2003).
higher to them than it will be in the future because they lose power over the land after leaving their current post.\(^8^9\) Thus, they have both fiscal and political incentives to cooperate with foreign investors pursuing economic gains through land property rights arrangements. Ultimately, strategic bargaining is attenuated and agreements are easily formed.

Long-term cooperation, however, may relieve foreign investors of concerns about security but not those about transferability because land transfers suspend such union and cooperation. Local governments, for example, may pressure investors not to exit the local market, or conversely may require them to assign the lease to designated firms that have offered a higher price for their lands and promised higher revenue contributions. As a result, foreign investors often end up with sales made at a huge discount due either to time or to political pressure.\(^9^0\) Therefore, under the contractual approach, rather than thinking of the transfer \textit{per se}, foreign investors focus on the means to absorb the costs and risks caused by restrictions on alienability.

Foreign investors manage such risks largely by changing their business behaviors. To begin with, foreign investors may shorten their payback periods in the face of long-term risks. Land developers, for instance, try to finish construction within six months of acquiring the land and construction permits and try to finish the transactions as quickly as possible.\(^9^1\) Land developers may prefer to construct mansions rather than condominiums for the general public because the former involves fewer transactions, albeit a better profit may be earned through condominium projects because they have much more units to sell.\(^9^2\)

\(^8^9\) Studies also show that, in some cases, highly successful rural industrialization may make promotion less attractive to village leaders, who are less integrated into the state system and receive no fixed salary from the state, as their counterparts in the higher township level do. With their more independent status and resulting greater discretionary control over TVEs, they can gain more through the status quo than through pursuing promotion from the lowest bottom of the party/state system. Nevertheless, their motivation is based on greater opportunities of rent seeking, which makes them indifferent from those who pursue promotion by abusing collective land. See Susan Whiting, The Micro-Foundations of Institutional Change in Reform China: Property Rights and Revenue Extraction in the Rural Industrial Sector, at 275-76 (1995) (Ph.D. dissertation, University of Michigan); Scott Rozelle, Decision-Making in China's Rural Economy: The Linkages between Village Leaders and Farm Households, 137 CHINA QUARTERLY 115 (1994).


\(^9^1\) Interview with the vice president of a land development firm in Shanghai, in Songjiang District, Shanghai (June 2006); interview with a former PRC governmental official, in New Haven, Connecticut, United States (December 2006); interview with the general manager of a manufacturing company, in Taipei, Taiwan (July 2010).

\(^9^2\) See interviews cited supra note 91.
Furthermore, investors tend to exploit land to achieve a quicker return. Manufacturing firms, for instance, try to facilitate the investment payback by acquiring as much land as possible. By doing so, they can construct basic but massive factories and start to manufacture products as soon as possible. Although a variety of payback periods may exist, many firms set them for two to three years; five years at most. Achieving their goals, the firms do not worry that the government may take their land back. In-house legal counsel for high-tech companies with high margins have revealed that land is not even viewed as an asset but as part of their business cost on their balance sheets. This is because they assume they will not be holding the rights to their land for long when they calculate the cost-benefits of their investment plans.

Ironically, some investors consider the seizure of land by the state, usually controversial, to be the last resort for dealing with the inalienability. To illustrate, the founder of a manufacturing firm stated:

I plan to retire soon, but my son is working as a software programmer in the US and has no interest in taking over our business in China. If I manage to persuade the government to exercise the power of eminent domain and take my lands by providing compensation, that will be my best exit strategy.

Given the prominent short-term mentality and short payback period, it is not uncommon for both the investors and the local government to welcome the exercise of eminent domain, which is functionally similar to the buyback option in a contractual context.

C. Corporate Law Approach: The Case of the Project Company

“I went to the local office of the land bureau to ask how to buy a parcel of land that we had been trying to buy from a division of the military. An official asked if I had registered a ‘project company.’ I had no idea about what the ‘project company’ was and wondered why I had to have one to buy land.”

— A land investor taking about his first land buying experience in China

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93 See interview with the in-house lawyer of an international computer manufacturing company, in Taipei, Taiwan (May 2008); interview with the deputy director of the administration department of a leading high-tech manufacturing company, in Dongguan City, Guangdong Province (July 2006).

94 Interview with the president of a Taiwanese Merchant Association, in Taipei, Taiwan (February 2014).

95 Interview with a Taiwanese real estate investor, in Shanghai (May 2006).
In theory, one who intends to participate in the land development industry in China should incorporate a real estate development company, the official type of corporation adopted for land development. A complicated governance structure for real estate development companies has been established by the central government. In practice, however, land investors, foreign investors included, have commonly applied the corporate law approach to execute land transactions for the sake of alienability—that is, the project company.

The rationale for using the project company reflects a natural lawyering instinct: if land cannot be transferred, then transfer the shares of the company that owns the land. A project company merely owns a single parcel of land and exists until its land development project is completed, because it is created solely for the development of already-acquired land and subsequent land transfer. In contrast, a real estate development company, like any normal company, can develop multiple projects and continue as long as the law permits.

Transferring land through share transactions is done to circumvent various restrictions imposed on land alienability. For example, owners are not allowed to transfer lands unless they have completed at least 25% of their land development plans. Also, if lands have been obtained through illegal means, investors may have a hard time transferring the lands in question, such as those rural lands that have been illegally transferred for non-agricultural use. In reality, however, such restrictions on alienability have been bypassed and illegal transfer of land is prominent across China. A 2010 official investigation indicated that such illegally transferred lands composed 57.49% of the total number of buildings in Shenzhen, the major commercial hub in the north of Hong Kong. Isn’t the illegal transfer

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96 In addition to the regular procedure of company incorporation, a substantial review of the qualifications of applicants as real estate developers is required. See Nei-Wen Chang, The Operation of Real Estate Business in Mainland China 103-05 (2003).

97 The project company is incorporated in the form of a limited liability company under the Company Law.

98 Transferring shares is defined as either share transfer within the project company, or share swap between the project company and a purchasing company in the case of merger and acquisition. Players will choose different types of share transfer in different contexts. In general, share transfer within the project company is easy and efficient. If the buyer has had a company or plans to register another company eligible for more governmental subsidies, such as tax exemptions provided for certain types of foreign companies, share swap may be preferred.


100 Qiao, supra note 4, at 11.
through shares of project companies risky? “Not at all, and everyone does this” is probably the standard answer one will get from locals.\footnote{Qiao applies the game theory to explain why Shenzhen government has rationally chose not to enforce its outdated land laws and why not such poor enforcement has affected the credibility of the Shenzhen government. Id. at 22-24.}

In fact, local governments have also supported the corporate law approach and even required the adoption of the project company, as shown in the interview excerpt in the beginning of this section. Local officials have encouraged the adoption of the project company by not applying property income tax to the \textit{de facto} transfer of land that usually creates enormous returns. The primary reason lies in the low regulatory costs when local lands are regulated through project companies. Unlike the normal real estate company, one project company represents one parcel of land, and hence the boundaries of property rights are clear even if the land is subsequently transferred to a third party through the company’s share transfer. Based on clearly defined property units, local governments can govern and extract rents (e.g., by taxation) efficiently.

Transferring land through shares in fact depicts a process of securitization of property rights. One negative consequence of securitization is fragmentation of rights that would make land use inefficient. The next section explains this dynamic securitization process in detail and analyzes how the corporate law approach addresses such concerns.

\subsection{Informal Securitization of Property Rights}

The nature of the project company, as an intermediate form of land ownership, is an informal securitization of the property rights in land.\footnote{The project company is similar to the condominium associations and housing cooperatives that allocate housing units to their members and shareholders in the sense that the transfer of property rights is conducted in the form of a share transfer. A housing cooperative is usually a corporation that owns real estate such as one or more residential buildings. Each shareholder in the legal entity is granted the right to occupy one housing unit, which is similar to a lease.} The essence of securitization is to convert illiquid assets into liquid assets, thereby transferring securities to serve certain purposes such as obtaining financing.\footnote{By definition, asset securitization is the structured process whereby interests in loans and other receivables are packaged, underwritten, and sold in the form of “asset-backed” securities into an open market. \textit{See} Lowell L. Bryan, \textit{Introduction, in The Asset Securitization Handbook} 3-5 (Philip L. Zweig ed., 1989); \textit{see generally} OFFICE OF THE COMPTROLLER OF THE CURRENCY, \textit{Asset Securitization Comptroller's Handbook} (1997).} Similarly, the purpose of the project company is to convert
land ownership into company shares in order to obtain the alienability of land under a rigid state-owned land tenure regime.\textsuperscript{104}

Identical to the establishment of a project company, the first phase of a regular securitization process is to establish a company as the special purpose vehicle (SPV) that solely holds the properties to securitize. While the SPV is structured to avoid potential legal risks such as those posed by bankruptcy law,\textsuperscript{105} the project company runs as a vehicle for bypassing restrictions and risks posed by the regulations of China’s land regime.

The project company, however, differs from a regular securitization in the second half of the process because of the distinctive objectives of respective vehicles. While the SPV goes through a legally complex process to sell investors its securities in an open market, the project company simply sells investors its shares through close-knit networks. The owners of the SPV aim to obtain low-cost and long-term financing through an open market selling;\textsuperscript{106} the owners of the project company aim to reap their land investment quickly through a whole sale of shares.

Furthermore, the project company has even lower transaction costs compared to the SPV. A normal securitization in a mature market usually incurs high compliance costs due to sophisticated tax and accounting rules and the like; how to reduce these costs for the SPV, a one-shot corporate structure, is a major task.\textsuperscript{107} In contrast, the transaction costs for establishing and maintaining a project company are not a concern given the support of local governments, an easy registration process, and simple corporate governance.

2. Anticommons and Project Companies

Prior to the 1979 open door policy, China’s land system could be defined as a common property regime where no one had exclusive rights of use. After 1979, however, when decentralization was carried out, anticommons were created when the central government decentralized property rights without clearly defining the owners of land use rights. As a result, different levels of local governments and multiple owners (such as SOEs, TVEs, PLA, and various work units (\textit{danwei})) may hold rights of

\textsuperscript{104} The securitization is usually associated with land because land is valuable and the rent is easily collected. The securitization of mortgage-backed loans is a case in point. In fact, the origin of securitization is related to land, which is valuable but immovable and illiquid. See Friedman, \textit{supra} note 35, at 246-47.


\textsuperscript{106} See Schwarcz, \textit{supra} note 105, at 135.

\textsuperscript{107} See \textit{id.} at 138-41.
exclusion to the same piece of land.\textsuperscript{108} The consequence of anticommons is usually underuse of properties due to multiple parties holding exclusionary rights, as seen during the economic transition in Russia.\textsuperscript{109}

In theory, informal securitization separating land property rights into multiple property rights fragments would jeopardize the potential problems of anticommons because more owners would exist after the securitization. Bargaining failure for efficient land use would also occur if too many rights holders were involved, with resources then becoming prone to waste.\textsuperscript{110} This is what property rights literature labels as the “tragedy of anticommons.”\textsuperscript{111}

In reality, however, the use of the corporate law regime as a substitute for property transfer does not lead to the problems of fragmentation and underuse of land because the project company actually only fragments land temporarily. To reap the benefits of rent-seeking, shareowners have a great incentive to exit the project company by selling their shares wholesale. The value of the shares of project companies lies not solely in the value of lands, but also in the transferability of land with which owners can redeem that value. In practice, subsequent buyers will require sellers to ensure that the shares/lands are easy to transfer afterwards. Therefore, sellers have to aggregate the outstanding shares, and, in most cases, sell all shares to one single buyer. This internal governance mechanism guarantees that the fragments of ownership will be recombined before they are transferred to the next buyer.

The project company nonetheless contributes to the high frequency of land transfers and the soaring property prices in China. It creates a fast channel for land speculators, who usually acquire lands from the government at a cost lower than the market price, to cash out the value of lands by simply transferring them without any development. Other side effects include problems of corruption and land grabs. One study shows that lands are commonly transferred four to five times before actual development starts.\textsuperscript{112} Each subsequent transferee has to cover the rising costs by raising the price for the next deal. In suburban areas, underuse still happens, but not

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{109} See Heller, \textit{supra} note 84, at 643-44.
\item \textsuperscript{110} To prevent these problems, multiple mechanisms can be adopted, including: preventing and abolishing fragments; indirectly imposing costs on ownership such as property tax and registration fees that deter fragmentation; and informally, through non-legal institutions and social norms that replace formal boundary rules. See Michael A. Heller, \textit{The Boundaries of Private Property}, 108 YALE L. J. 1166, 1166, 1169, 1173 (1999).
\item \textsuperscript{111} Heller, \textit{supra} note 84.
\item \textsuperscript{112} See QING-LIAN HE, CHINA’S DESCENT INTO A QUAGMIRE 43–44 (2003).
\end{itemize}
\end{footnotesize}
because of anticommons; it results from rent-seeking and overdevelopment causing what the locals call “ghost towns.”

D. Choosing Between Contractual and Corporate Law Approaches

The contractual approach primarily deals with the transaction costs caused by restrictions on alienability, while the corporate law approach takes advantage of the law of business organizations to circumvent various restrictions. The former is more reactive than the latter, which is proactive but also more complicated.

The choice between the two approaches depends largely on the nature of one’s business and the arrangements of the lands before foreign investors acquire them. If foreign investors do not count on land transfer as their source of revenue, it is easier and less risky to stay put rather than incorporate a company to hold lands in order to sell them illegally through share transfer at a later date. In this case, the contractual approach may be preferred. Accordingly, the investors may adjust their business behaviors to manage the risks and costs caused by the restrictions on alienability, such as shortening the investment payback period or even engaging in an exploitative manner towards land use. In contrast, if the predecessors initially acquired the lands in question through shareholding, foreign investors will likely just follow suit by adopting the corporate law approach. This is not uncommon because numerous governmental agencies have also used the project company as a vehicle to transfer land under their control through share swap among them (e.g., an eastern province can exchange their lands with a western province through such swaps). When such lands are to be transferred in the secondary market, share transfer is the default method to transfer the lands.

The corporate law approach is particularly beneficial for the formation of a union involving multiple parties. The first reason is that the project company is easy to join and exit by transfer of shares. Second, by piggybacking on a corporate regime, partners can also allocate revenues in proportion to respective shareholding. This is a simple way to govern their

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114 See interview with the vice president of the legal department of a land development firm, in Changning District, Shanghai (June 2006); interview with the president of a real estate group, in Changning District, Shanghai (June 2006); interview with a real estate investor, in Shanghai (May 2006); interview with the outside legal counsel of a real estate company, in Huangpu District, Shanghai (June 2009).
internal relationship, which is all about revenue sharing. Third, the company can bypass a land registration process under a normal property transfer procedure, which usually requires governmental approvals. This is not ideal for illegal or non-registrable titles or for partners that are legally entitled to own the lands in question (such as corrupt officials or unqualified foreign owners). Lastly, restrictions on alienability can be circumvented.

Nevertheless, the downside of applying the corporate law approach for land transfer is twofold. First, similar to its moral hazard problem in the context of JVs, the corporate law approach may subject foreign investors to potential abuse by majority shareholders. The default majority rule of the company law may work against subsequent shareholders/investors who are not majority shareholders. Many disputes are caused by the ambiguity of shareholder status due to various side arrangements. Second, various parties cannot benefit from property law, which provides default rules to allocate the risks of property transactions among the seller, buyer, and third party. Under the corporate law approach, risks may result from the lack of accurate information about the company’s financial status, potential liability, unwritten contractual obligation, undisclosed share pledges, mortgage or guarantee. Buyers can only acquire necessary information through personal networks. To illustrate, an experienced businessman advising a new investor considering the purchase of a PLA-owned project company stated, “Give me the name of the owner and that company. I can ask my friend in the Public Security Bureau to investigate his reputation and financial status.”

In contrast, the formal property registration system provides a better disclosure and notice mechanism, thereby vesting land purchasers with property rights that are in principle enforceable against third parties.

It is interesting to note the attitude of district governments toward land transfers through project companies: governments are very supportive of such transactions due to fiscal considerations. As each project company registered within its jurisdiction represents one clear taxable target, the local government can collect rents from development projects with lower enforcement costs. A county government, for instance, will not allow a project company registered in another county to conduct land development within its jurisdiction because the county cannot tax that project company. Rather, the county would require the developer to register a project company within its jurisdiction. In contrast, a real estate company can manage inter-regional land business and thus is subject to various regulations set by the

115 See discussion supra Part III.D.
116 See supra note 73 and accompanying text.
117 Interview with the vice president of a recreational resort in Shanghai, supra note 86.
central government. As a result, the form of real estate companies not only limits the company’s business flexibility but also constrains the local government’s monopoly of tax revenues generated therein.

Although both contractual and corporate law approaches can facilitate the land transfers and manage the transaction costs caused by restrictions on alienability, they are far from the perfect options that property law normally provides. Benefits and burdens in land may not be fully disclosed due to the absence of registration, and competing interests cannot be efficiently prioritized according to normal property rules. The alternative approaches to transferring land also require supplementation by the practice of kinship networks and hence remain subject to geographic limits. Investors who are out the loop, for example, would face uncontrollable risks and may hesitate to engage in land transfers arranged by the corporate law approach.

V. PROPERTY RIGHTS DISPUTE RESOLUTION

“After I started practicing law here, I was surprised by the important role of contracts in Shanghai’s business world. Contrary to my understanding of Chinese culture, people do not seem to trust each other and therefore rely heavily on written contracts. If you don’t write down your counterparty’s promise, do not expect him to carry it out.”

— A Taiwanese Attorney in Shanghai

The increase in the use of contracts may help reduce disputes, provided parties are willing to comply with the agreements. On the other hand, it also indicates an increase in distrust between business actors that may lead to failures in contract enforcement, especially in cases of incomplete contracts. In a 2006 survey about Taiwanese businessmen’s everyday obstacles, 40.7% of the interviewees point to the “counterparty’s


119 Interview with a Taiwanese attorney based in Shanghai, in Changning District, Shanghai (June 2006).

120 See interview with the general manager of an American firm, in Caohejing Hi-tech Park, Shanghai (June 2013); interview with the managing partner of a law firm that has a presence in Beijing and Shanghai, in Taipei, Taiwan (June 2013). See also JAMES MCGREGOR, ONE BILLION CUSTOMERS: LESSONS FROM THE FRONT LINES OF DOING BUSINESS IN CHINA 274-75 (2005) (providing a similar observation about the increasing distrust between people in China’s business world); Stanley Lubman, Looking for Law in China, 20 COLUM. J. OF ASIAN L. 1, 80-81 (2006) (contending that a value crisis has occurred in China where older traditions have been eroded and the Communist ideology itself has increasingly lost its coherence).
unwillingness to carry out contractual obligations” as a major problem.\textsuperscript{121} Such is also the case with land disputes, which account for one of their major investments.\textsuperscript{122}

When disputes arise, court has never been a top option. Instead, mediation and arbitration are the two preferred approaches. This preference results from a number of well-recognized problems with Chinese courts, including corruption, local protectionism, and lack of judicial independence.\textsuperscript{123} Shareholder protection mechanisms (e.g., derivative lawsuits), vital for addressing the moral hazard problem inherent in the corporate law approach, have been successfully implemented but remain insufficient to resolve disputes.\textsuperscript{124} Sometimes, however, judicial proceedings play an unconventional role in the union between foreign investors and their local partners. For instance, foreign investors and local officials may use courts to fulfill various bureaucratic requirements for formality, such as for writing off debts or providing compensation for which a court decision is needed. “In fact, we sued local government divisions because local officials working there asked us to sue for the sake of formality,” said an investor with experience suing governments.\textsuperscript{125} Similarly, SOEs usually file their cases in court merely to collect verdicts in order to write off their non-performing loans.\textsuperscript{126}

Foreign investors widely use private extrajudicial mediation through various networks rather than judicial mediation or the people’s mediation committee system. The foregoing 2006 survey indicates that 53.8% of interviewees viewed such mediation as the most effective way to resolve disputes.\textsuperscript{127} Furthermore, 27% of interviewees further revealed that they

\textsuperscript{122} Id.
\textsuperscript{124} Clarke & Howson, supra note 49.
\textsuperscript{125} See interviews cited supra note 38.
\textsuperscript{127} CNFI, supra note 122. This finding also echoes with the outcome of similar surveys regarding dispute resolutions adopted by firms in China during the same period. In a study of firms in Shanghai and Nanjing, 92.8 percent of firms typically relied on direct negotiation to resolve disputes. In a World Bank survey, 87.1 percent of firms used negotiation in the final resolution of disputes with at least one client, while 93.2 percent used negotiation with at least one supplier. Donald Clarke et al., Law, Institutions, and Property Rights in China, 129 ASIA PROGRAM SPECIAL REPORT 42, 46 (July 2005).\end{flushleft}
used Taiwanese Merchants Associations (TMAs) as mediators to resolve disputes.\textsuperscript{128} As a matter of fact, this article argues that TMAs are organizations that have institutionalized both the contract and corporate law approaches for establishing substitutive property institutions. This Part first focuses on the risks underlying the relevant disputes and then on the role of TMAs in dispute resolution.

\textbf{A. Managing the Disputes That Cannot Be Won}

The best way of resolving disputes is to prevent the opportunism and conflicts of interest that breed and fuel the disputes. Both the contractual and corporate law approaches generally engage this method of preventing underlying conflicts. However, without protection by property law, disputes arise not only from the failure to enforce incomplete contracts, but also from the limitations of contractual rights in the face of third parties with competing claims. Investors must apply diverse approaches to enforcing various agreements and preventing disputes.

Foreign investors heavily rely on the second-party mechanism to prevent and solve disputes. Reputation mechanism plays a crucial role. If the promisor breaks the relationship by pursuing a one-shot increase in profit, the promisee can punish him by making him lose future business opportunities.\textsuperscript{129} In a study of firms in Shanghai and Nanjing, 74.2\% of the surveyed firms said that other businesses would hear about any disputes that arose between the firm and one of its suppliers.\textsuperscript{130} This may jeopardize the future business opportunity of the defaulting party. A senior manager of a recycling service company also revealed the practice of reputation mechanism:

\begin{quote}
We don’t do business with strangers, only with clients recommended by our friends. We trust them as long as they are introduced by friends. We communicate candidly. For instance, some let us know who their concurrent partners were, or which party secretary had also introduced them to other service providers whom they were not supposed to reject. They
\end{quote}

\textsuperscript{128} CNFI, supra note 122.


\textsuperscript{130} Clarke et al., supra note 127, at 46. See also Donald Clarke et al., The Role of Law in China’s Economic Development, in CHINA’S GREAT ECONOMIC TRANSFORMATION (Loren Brandt & Thomas G. Rawski eds., 2008).
could switch to us if we help them get away from those people.131

To engage in the similar second-party mechanism, the corporate law approach depends on direct participants in the firm (e.g., shareholders and managers) rather than indirect participants (e.g., accountants, judges and lawyers) to self-enforce its governance regime.132 For example, shareholders in a JV company that recognize the merit of long-term cooperation will bring reciprocity of trust and honesty into the exchange process. If foreign investors with key managerial expertise exit before the end of the payback period, local partners will likely lose their initial investment. Additionally, the resulting increase in unemployment, which could cause social unease, will also concern local officials.133

This reputation mechanism for self-enforcement applies to the cooperation between foreign investors and local officials too. It is not uncommon for a local official to refuse to comply with a contract between his predecessor and foreign investors, sometimes for legitimate reasons such as the illegality of such contracts. If such contract repudiation happens, the reputation of related local officials or information about the business environment in that region as a whole spread quickly, especially through trade associations discussed later in this section.

The object of contracts also matters for the enforcement: the more irreplaceable it is, the more likely the enforcement can be maintained.134 One key objective of unions between local officials and foreign investors is regulatory power (e.g., secure access to land and alienability guaranteed by the authority) that is exchanged for tax revenues. In underdeveloped regions, this exchange is unlikely to be replaceable, whereas it becomes more replaceable in an urban area where late-arriving investors may incentivize the locals to deliberately breach contracts by promising them higher revenue contribution. In such an event, the contacts in question become vulnerable under increasing pressure to be replaced.

131 Interview with the manager of an electronics recycling company, in Dongguan City, Guangdong Province (June 2006).
133 It is not unusual that a single foreign company contributes more than half of the annual tax revenue that a town or county government collects. Chih-Jou J. Chen, The Role of Taiwanese Businessmen in The Cross-Strait Political and Economic Interaction 58-59 (Research Report of Mainland Affairs Council of Taiwan (ROC), 2001).
Moreover, business behaviors may be adjusted according to perceived risks. For example, Taiwanese investors are more willing to give trade credit to their fellow investors and increase credit after long-term cooperation, but they give little or even no credit line to their local trade partners. Some firms also prefer cash transactions when doing business with local firms so they can have a shorter payback period and a better exit strategy. Such practices indicate that norms beneficial for a group’s insiders may have different effects on outsiders of this group, and therefore the methods for resolving disputes may vary accordingly.

After all, it is impossible to eliminate the risk of disputes entirely, and investors’ mindsets and biases also enhance their willingness to bear risks, particularly in China. To begin with, a long-lasting economic upturn has given rise to a lower expectation of risk, and this optimistic bias results in systematic overconfidence in risk judgments. Additionally, a short-term mentality makes investors less worried about risk unless the risk is in the foreseeable future. It is common for foreign investors in China not to worry about the security of properties resting on a time-limited or legally problematic land lease rather than a legally-binding permanent property title. This mentality in turn gives rise to a status quo bias that tends to desensitize investors to risk. Over time, foreign investors come to feel relatively secure about their unlawful land use after realizing that many other investors share the same illegal status and learning of the government’s difficulties in carrying out stringent law enforcement. As a result, further institutional arrangements are needed to deal with these residual risks, and hence the trade associations are used by foreign investors as a means of collective action in response to such risks.

137 Even worse, the author was often told that some career employees may only focus on the risk that may materialize within their short stays in China.
138 This is also related to a mentality of availability heuristics. People base their prediction of the frequency of an event or the degree of risk on how easily an example can be brought to mind. When foreign investors learn about numerous other investors that share similar status with them and have not been confronted with serious problems, they tend to ignore risk. Many of my interviewees have mentioned that they used to be concerned with the time limit of their land use rights and some illegal land arrangements with towns and villages, but not anymore. See Behavioral Law and Economics 4, 9 (Cass Sunstein ed., 2000).
B. Trade Associations

“If they [local party cadres] cannot help to solve my problems beyond their jurisdiction, they would introduce me to their friends that have jurisdiction over the issues. This is extremely important for us, given the huge market in China.”

— A senior manager of a Taiwanese firm based in Shanghai

One shared feature of substitutive legal institutions is the limited geographic or social scope in which they can be effective. For example, foreign investors based in Shanghai may have difficulty finding new trustworthy partners in Beijing to create a union. Residual risks that neither contractual nor corporate law approaches are able to fully cope with would fail a self-enforcing mechanism. In response, a more collective and organized approach is needed as a supplementary mechanism—the trade association.

The trade association has roots in Chinese business society, and now plays the further role of unifying foreign investors and local regulators’ interests to the extent that dispute resolutions can be facilitated. Foreign investors, ethnically Chinese or not, have various options for trade associations, such as the Association of Enterprises with Foreign Investment (AEFI), a nationwide network sponsored by the government. This Part B focuses on the TMAs catering to the Taiwanese foreign investors across China.

The role of TMAs is to institutionalize contractual and corporate law approaches by engaging in collective means to optimize outcomes. TMAs help transcend geographic limitations and improve foreign investors’ bargaining powers. Both the foreign investors and the governments also use TMAs as a platform to legalize and institutionalize their collaboration.

1. Preventing Disputes by Transcending Geographic and Social Network Limitations

Given strong local protectionism and dense local networks, individual foreign investors have difficulty breaking into a new regional market. To
cope with the limited scope in which substitutes can be effective, TMAs make themselves a broad networking and information exchange mechanism. Mainly established in the mid-1990s, TMAs are loosely unified associations in major industrial cities across China. As such, TMAs turn out to be a crucial mechanism for Taiwanese investors to transcend geographic limitations.

TMAs greatly supplement both contractual and corporate law approaches and prevent disputes because information about remote markets and local partners’ reputations can be efficiently circulated among foreign investors. In forming informal property relationships with local partners, for example, most investors are concerned with the issue of hold-up. If one or two shareholders refuse to transfer their shares of the project company holding the land, the tragedy of anticommons will occur due to the exercise of widely dispersed veto power. Land transfer by the corporate law approach will fail if such a hold-up happens, because potential buyers are unlikely willing to purchase incomplete property rights in the form of shares. Consequently, hold-up impedes the efficient use of land. As such, finding a reliable transaction party in new markets, potentially through TMAs, is crucial for successful business expansion.

2. Resolving Disputes by Facilitating Mediations and Collective Bargaining

TMAs also play the role of a mediation institution outside the official mediation system, and recent surveys show that the majority of Taiwanese firms across regions and industries have ranked TMAs as their top choice for resolving disputes. Most importantly, different TMAs share networks with each other, thereby facilitating mediation by bringing in resources relevant to the mediation process and penetrating local protectionism.

TMAs themselves could also be a stakeholder in mediation because efficiently preventing or resolving disputes increases their value as a trade association. For instance, TMAs frequently organize group visits to other regional markets that their members are not familiar with in order to help transcend the limitations of geographic scope. To reduce risk of negotiating with local developers individually, TMAs may, on behalf of their members, negotiate collectively with local governments or special economic zones

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142 YUAN-HSIANG CHEN ET AL., STUDIES OF DISPUTE RESOLUTIONS BY TAIWANESE INVESTORS IN CHINA 137-141 (National Taipei University Asian Studies Center ed., 2011).
about the price of land. In such cases, TMAs have a strong incentive to help resolve subsequent disputes, thus maintaining their own reputation as an institution worth joining.

3. Privatizing Regulatory Powers and Institutionalizing Substitutive Institutions

Like other substitutive property institutions, TMAs receive support from the Chinese government, which relies on workable substitutes to compensate for its current institutional deficits. This has helped TMAs formalize and institutionalize the contractual and corporate law approaches to creating property substitutes.

First of all, local governments have privatized their authority to TMAs and delegated to trade associations the authority to officially issue governmental notices in the form of so-called “red-letterhead documents.” This practice facilitates business-related administrative procedures and resolves disputes with governmental agencies. This form of governmental notice is often used by local officials for issuing instructions about specific cases, executive guidelines for policy implementation, or more general rules and ordinances. Local governments sometimes even use such notice to nullify existing land leases in order to re-allocate land. A folk saying

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143 For instance, to reduce the risk of buying land individually, Shanghai Taiwan Merchant Association gathered more than 200 merchants to a new developing area named Nan-tong, where the price of land is less than one-quarter of the Shanghai suburbs. They negotiated with local officials in a collective way. See Dao-Cheng Lee, Reducing the Cost of Buying Land for the Members of Taiwan Merchant Association, INDUSTRY AND BUSINESS TIMES, May 5, 2006, at A7; Collective Action is the Power, INDUSTRY AND BUSINESS TIMES, Mar. 25, 2006, at A7.


145 These administrative notices indeed have great influence on matters beyond the bureaucracy since they can be used to set the principles for policy decisions. See Qinfen Wen, The Scope and Definition of “Law” in the Concept of Rule of Law: A Normative Perspective and A Pragmatic Perspective, 9 SOC. SCI. IN NANJING 62, 66 (2001) (in Chinese); Qinye Shi, A Review on the Authority and Effectiveness of Red-letterhead Documents, 4 SECRETARY’S COMPANION 5, 5-6 (2006) [in Chinese]; How Could Red-letterhead Documents Intervene and Change Land Leases? XINGHUA VIEWPOINT, Jan 31, 2007,
illustrates the power of such administrative notice: “Black letterhead (formal laws and statues) are inferior to the red letterhead; however, the red letterhead is inferior to white letterhead (officials’ private instructions on a piece of paper).”\(^{146}\) Although non-governmental organizations, TMAs have nevertheless been granted authority with respect to matters that do not have a direct effect on the general public.\(^{147}\) Consequently, members of TMAs can reach local governmental agencies directly and efficiently, while non-members or ordinary people can only air their grievances through external, formal channels.

Moreover, local officials have participated in TMAs’ management directly and thus converted TMAs from non-governmental organizations to government-linked organizations or government-operated non-governmental organizations (GONGOs). It has become standard practice for local governments to assign a senior official to serve as the executive secretary general of a TMA. Other positions such as advisors and honorific presidents are likewise served by a variety of local officials, including senior officials or heads of the Labor Bureau, the Post and Telecom Bureau, the Armed Police Bureau, the Public Security Bureau, the Customs Office, the Economic and Trade Commission, or the Taiwan Affairs Office at the local level.\(^{148}\) This way, local officials and foreign investors can formalize their networks in a way similar to the corporate law approach. To illustrate how TMAs facilitate and institutionalize personal relationships, one businessman stated, “To be frank with you, how can my employees sue me and win the case in local courts? The head of the Labor Bureau is my friend. I go to the parties. I hang out with local officials. Then my problems can be solved on the spot.”\(^{149}\)

In short, the functions of trade associations are twofold. On the one hand, they are designed to give the state control over organized interests in
society. By empowering a single organization to represent the sectorial interests of individuals and firms, the state aggregates foreign investors into a sole association. This is beneficial for the state’s ability to manage, monitor, and allocate land property rights to foreign investors. On the other hand, the trade associations were themselves responses to the failure of the simple reputation mechanism, representing a further institutional arrangement. It is advantageous for the government to breach its commitments and abuse the property rights of some investors once lands become scarce and land prices are soaring. Foreign investors must act collectively to further institutionalize their informal arrangements because commitment obtained through informal arrangements is a private good rather than a public one.

VI. ANALYZING INSTITUTIONAL SUBSTITUTES AS A DEVELOPMENT STRATEGY

This article suggests that foreign investors have been able to develop multiple types of substitutes for property institutions depending on market and institutional conditions in respective regions or industries. In regards to this process, China is by no means unique. In the context of Asian developing countries, the comparative law literature has documented how the government becomes one of many interest groups and adopts a responsive regulatory approach by using state power to sensitize decision-making to industry needs rather than imposing substantive objectives. Vietnam and Indonesia are the other two cases on point. In fact, in most developing countries, as Frank Upham argues, informal and alternative property rights institutions appear to be more relevant to economic growth.

150 See DICKSON, supra note 140, at 25.
151 Historically, this approach is not unique to China. The merchant guilds in Medieval Europe also held certain regulatory powers and coordinated merchants’ responses to a ruler’s conduct. See AVNER GREIF, INSTITUTIONS AND THE PATH TO THE MODERN ECONOMY: LESSONS FROM MEDIEVAL TRADE 91-93 (2006).
152 See id.
153 See id. Greif also points out a similar trend that happened to merchants in the medieval era. When trade had expanded, the ruler began abusing and discriminating existing merchants’ rights because the expansion reduced the value of the future tax payment of each individual merchant.
than formal ones. In this regard, law and economics theorists have examined the informal norms by which property relationships can be sorted out and arranged without using law. Michael Trebilcock and Mariana Prado, two leading law and development theorists, have also proposed the idea of “institutional bypass” to describe how various institutions have been established to overcome social-cultural-historical obstacles to reforms.

This article focuses on both norms and institutions and applies the notion of “institutional substitute” as a means to better capture the dynamism of property rights in China. In light of the forms and complexity of various substitutes uncovered by the fieldwork of this article, the notions of “formal/informal” or “property/non-property” institutions do not seem to be able to characterize the dynamic operations of these substitutive institutions. Similarly, “institutional bypass” may not be a good metaphor here because institutional substitutes are annexed to multiple segments of the legal system; they do not bypass but are embedded in each other. As this article demonstrates, property substitutes have been made possible by a mix of formal and informal institutional settings based not only on property law, but also on contract and corporate law. However, while land (precisely speaking, state leases) is formally owned by the project company pursuant to property law, the transferability of property interests in land is made possible informally through the Company Law, which is a formal statute.

Nonetheless, the forms of the substitute and the patterns of these hedging practices are heavily context-dependent. For instance, the nature of the foreign investors’ businesses may affect their institutional preference. Small companies with short payback periods (e.g., clothing manufacturing firms) may prefer the contractual approach in order to access land quickly, whereas companies aiming to profit from future transfers of land (e.g., real estate developers) may apply the corporate law approach so that they can easily transact land in the form of shares. Other factors matter too, such as the business scale, the remoteness of target markets and the law enforcement climate in various regions. Given the variations in institutional settings, these substitutes are further supplemented by social norms, changes in business behaviors, and collective actions through trade associations. As a result, demands for the security of property rights, alienability, and effective


157 See ELICKSON, supra note 129.

dispute resolutions have been fulfilled well enough to sustain the current record levels of FDI.

That said, the institutional substitute remains questionable as to whether it serves as a sustainable development strategy. The underlying structure of substitutes and the regulatory framework that makes these substitutes possible deserves further evaluation in terms of long-term sustainability. The mechanisms of various substitutes demonstrate how institutional speculators can take advantage of the configurations of multiple regulatory regimes or different segments of the legal system, piggybacking on the one with lower transaction costs and/or lax regulatory standards (e.g., contract or corporate laws) in order to create substitutes for the other characteristic of higher risks or costs (e.g., insufficient property regime). In this way, market players can compensate for existing institutional deficits by leveraging comparative institutional advantages within multiple regulatory regimes, thereby fulfilling their institutional demands. In this sense, substitutes are not only the functional equivalent of the property system. Rather, they have turned the property system into, metaphorically, a customized quilt that consists of various functional equivalents tailored from other segments of the legal system. Settlers in the American colonies devised quilting as a way to sew together small scraps of fabric by hand, creating warm bedding with multiple layers in a relatively quick and cheap manner; likewise, market actors in the early stage of economic development also establish institutional substitutes swiftly by a patchwork of different segments of law with layers of configurations catering to various functions.

Like financial arbitrage and hedging, using substitutes as a law and economic development strategy is by no means risk-free. Rather, it may go well most of the time, but could become highly unstable when the tides turn. Incrementally, risks associated with institutional weaknesses in one area (e.g., insufficient property rights) can flow into less-regulated markets or the domain of less-stringent institutions that operations of substitutes rely upon. For example, when landowners apply the corporate law approach to transfer their land interests in land in the form of shares, property law will not govern such de facto property transactions. Competing property interests not disclosed in the transaction, such as banks’ mortgage interests, may subsequently give rise to disputes and impede efficient use of the land. As a result, risks of ambiguous property rights eventually flow into contract, banking, or corporate law regimes upon which property substitutes rely. In other words, institutional substitutes simply distribute the risks to a wider pool. It makes transactions possible in the short term, but may eventually lead to deficiencies in other parts of the legal system.
In the long term, the government has to streamline these interdependent legal relationships for the sake of efficiency and legal justice. Success depends on whether the government can reduce the switching cost. With respect to less interlocked arrangements, the government may incentivize a switch by legalizing the existing property arrangements. For example, local governments have tried to legalize land titles obtained through SMFs as long as they pay evaded taxes and levies. However, the switching cost is much higher in institutional settings that have interlocked with each other. Think about this hypothetically: a piece of land had been illegally transferred by project companies five times in the course of five years before a foreign buyer finally bought it and built an office building. The construction was financed by a number of bank loans secured by the land and building in question. Given the number of parties involved and various legal relationships created, how can the illegality be dealt with while striking a balance between efficiency and fairness? This issue has aroused legal debates between practitioners as well as policymakers. What if this is not just one case, but one out of 1,000 similar cases in a region? For some pragmatic officials, the best solution is not to fix it as long as it does not fall apart.

In short, it remains debatable whether institutional substitutes can be used as a sustainable development strategy. There are three underlying problems. First, risks cannot be dissolved by institutional substitutes and can only be distributed to a less-regulated market or governance regime that does not cater to regulating the subject matter in question. As previously discussed, substitutes for making the property alienable simply transfer the risks caused by incomplete property rights to the banking system, where the lands in question are often put up as collateral. Second, substitutes would be vulnerable to any changes in market conditions that can destabilize the balance of power between participants. For example, the soaring price of land may change landlords’ cost-benefit equation, tempting them to default on the contractual agreements that have constructed existing substitutes. In fact, this dynamic has accounted for reportedly increased land disputes between local government and ethnically Chinese foreign investors.159 Last, substitutes may impede structural reforms by interlocking defective institutions, thus increasing the switch costs down the road. Cronyism and

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vested interests may distort policymaking and law enforcement, and they may fail even the most dedicated reformists. Such increasing difficulty in implementing reforms has been manifested in various pressing issues in China today, including rampant corruption and land grabs. If not contained, these problems will seriously undermine the sustainability of institutional substitutes.

VII. CONCLUSION

Since the 1990s, a body of scholarship mainly authored by economists and sociologists has suggested competing theories to explain China’s unorthodox economic achievements in spite of its resilient state-owned land system. Most scholars pointed to an informal or hidden privatization through a pragmatic and deliberate ambiguity of property rights in land. However, exactly what legal institutions have facilitated this hidden privatization remains largely unexplored in previous literature. This article’s main contribution is uncovering the dynamic and diverse institutional settings underlying this phenomenon by engaging with interdisciplinary property rights theories to unveil various substitute forms, their institutional configurations, and the mechanisms that the operations rely upon.

In fact, the findings also resonate with the idea of legal pluralism that comparative law theorists have long emphasized. Institutional substitutes shed light on the interaction between state and non-state actors, formal and informal regulations, and the processes by which laws and norms are transplanted from the ‘center’ to the ‘periphery’ and localized in a global context. Comparative law scholars often use the analogy of mixing oil and water when discussing encounters between Western and Eastern legal systems. Some use this analogy to suggest the resistance and inevitable divergence between the two systems in the process of legal transplant, while others focus on the aspect of harmonization that may lead to a certain level of convergence down the road. In contrast, the findings of this article suggest that the story of China’s property substitutes is one of alchemy: producing oil from water, or the other way around. If the legal institutions in question are not satisfactory to market participants, what happens when

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161 Gillespie, supra note 154, at 209.
the strong market force (namely, FDI) comes into contact with the indigenous legal tradition and institutions? Among property, contract, and corporate law in China, it seems that each form may be tailored into the functional equivalent of other form under suitable conditions, creating localized solutions for institutional deficits.

In addition to conventional property law, this article has identified two more approaches that could manufacture property rights through institutional substitutes—contractual and corporate law approaches. The choice of suitable approach depends on various factors, including local institutional settings, law enforcement culture, the scale and nature of the businesses, the way in which market players perceive and calculate risks, and regional market conditions. As each property substitute consists of formal and informal, as well as property and non-property laws, it makes the bifurcated notion of “formal/informal” and “property/non-property” insufficient to capture this dynamic trajectory of property rights.

Nonetheless, these institutional substitutes do not seem to represent a sustainable development strategy in either legal or economic terms. For foreign investors, institutional substitutes probably serve well for the purpose of hedging against risks of insufficient property institutions in the short term. In the long term, however, changes in economic conditions and market status could destabilize the overarching structure of the substitutes by increasing tangible and intangible costs for maintaining such substitutes, or, even worse, could fail existing substitutes. Along with market development, increasingly complex business transactions need to be facilitated by more sophisticated legal institutions. American, European, and other non-ethnically Chinese investors, who have diversified China’s FDI sources and probably share neither cultural ties nor similar views about the role of law with locals, may not be able to replicate the substitutes created by overseas Chinese investors. Institutional substitutes simply distribute, rather than dissolve, risks to other areas of law that various substitutes rely upon, making defective institutions interlock with each other. Consequently, the switching costs of moving from substitutive to formal institutions may increase accordingly towards an irreversible point. In short, stages of economic development matter and the policies required to initiate a transition may be qualitatively different from those required to sustain the transition.

China’s experiences have shed light on the evolution of legal institutions and demonstrated diverse trajectories therein. Developing through substitutes, among other factors, has helped China lift more than 500 million people out of poverty—a remarkable record in human history.
However, it has limitations, some of which are economically debilitating. Karl Marx captured the path of his fellow socialists’ switch from communism to capitalism when he said, “Men make their own history . . . not under self-selected circumstances, but under circumstances existing already.”162 Drawn from past traditions and applying borrowed laws and various substitutes, we shall witness how the evolution of institutions in China and her fellow developing countries brings to light other dimensions of the legal system in the years to come.

162 KARL MARX, THE EIGHTEENTH BRUMAIRE OF LOUIS BONAPARTE (1852).