LAW AND POLITICAL ECONOMY IN CHINA

The Role of Law in Corporate Governance and Market Growth

Applying a novel theoretical approach, Tamar Groswald Ozery combines law and political economy to deconstruct the role of law in China's market development since 1978. The book examines how economic and administrative powers within China's Party-state system have been legally and politically configured throughout China's growth process. Using a vast range of primary sources, Ozery illuminates how the law acts as a mediating institution that translates and gives shape to the relations between politics and economics. Using the evolution of public firms and corporate governance as a case study, Ozery illustrates the complex relationships between law, politics, and economic development, and sheds new light on the possible varieties of growth-supporting governance institutions in firms. By studying China's distinct market experience through the lens of law and political economy, Ozery offers a significant contribution to development studies, comparative corporate governance, and interdisciplinary discussions about China as a growth model.

Tamar Groswald Ozery is an assistant professor at the Hebrew University of Jerusalem. Previously, she was a Grotius Fellow (Michigan Law), a Research & Teaching Fellow (Harvard Law), and the editor of the Harvard Law School Forum on Corporate Governance. Her published scholarly works focus on Chinese corporate governance, cross-border investments, and party-state market relations. She is a frequent commentator on China's legal system, political economy, and global economic integration, and has testified before the US-China Economic and Security Review Commission. Prior to academia, she spearheaded the China department of a leading Israeli law firm.

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In memory of my grandmother, Raya (Raisa) Barhovik Skutel (1915–2011), who had seen many types of regimes in her lifetime and survived them all.

Contents

Figures

Tables

Preface

August 2009, a young foreign lawyer steps out of the gates of the Shanghai Hongqiao International Airport. Although she has been a student of China and of Mandarin Chinese for several years, it is her first visit to China as an adult, not to mention an adult on duty. She is nervous.

For the past three months, the lawyer and her team have worked tirelessly on a share purchase agreement (SPA) for the acquisition of shares in a Joint Venture (JV) that went awry. She was sent by her client, an American developer and supplier of AgroTech equipment, to make sure that the finalized deal actually goes through and that the JV's CEO, who is also the owner of the domestic Chinese partner in the JV and the JV's sole distributor in China, steps down. Luckily, she is accompanied by a mediator, a native of her country who joined the trip to help in the share purchase negotiations. The two locate their prearranged taxi among the bustling crowd of drivers angling for passengers.

On their way to the hotel, the lawyer cannot take her eyes from the windows. For six years she has been studying China from afar, yet nothing prepared her for the spectacular modern highways and skyscrapers she is now seeing. The trip is more than just a work visit for her; she is relocating to Shanghai for the next few years. Eager to catch every sight and code in her memory the name of every road in the place she will now be calling home, she is mesmerized with admiration and excitement. The mediator, amused, spits out "don't let that fool you." The banter falls on deaf ears.

Late afternoon, the lawyer and the mediator are set to meet with the Chinese partner at the firm's offices. The lawyer is only there to collect signatures on some ancillary documents and make sure the company chops are moved to the mediator's possession. Days and nights of remote negotiations and many rounds of revisions from both sides preceded this visit and the SPA has already been finalized and approved by both parties. "The meeting should be quick and smooth," she is reassured by the mediator.

But the Chinese partner, the CEO, is stalling. In fact, he completely ghosted them. For the next two weeks meetings are postponed repeatedly, and finalizing the deal is halted for no apparent reason. After some time, the lawyer and the mediator decide to show up unannounced at the firm's offices in an attempt to understand the situation. Surprisingly, they find the space half empty with occasional employees wandering about and no management on site. Even more alarming, the floor sign that used to greet clients and visitors with the JV's company name is nowhere to be seen. Instead, a name of a local distributor, the Chinese partner in the JV, decorates the building.

A few days later, the JV's head administrator (also its legal representative) agrees to meet with the lawyer and shed some light on the matter. The head administrator is seasoned in dealing with foreign investors. She was nominated by the American partner as his representative on that ground. Hopefully, the lawyer thinks to herself, she will be candid and have the client's best interests in mind. Reading between the lines (as the head administrator was not very generous with details), it seems that the Chinese partner was insulted by the SPA final draft. Apparently, a contingency provision in the SPA deliverables section stated that prior to his departure, the CEO should fulfill his duty and collect account receivables that were due to the JV under his management. Attesting her personal observation, the head administrator opined that in this moment of exchanging the final draft "the CEO lost his trust in his partners," and "his main objective changed to regain his honor."

Puzzled in disbelief that she now encountered what she always thought was an urban tale about Chinese "saving face" culture, the lawyer was alarmed. "The SPA has been finalized, the purchase price is already highly above value, an escrow account is standing to receive the sums!," she cried. The seasoned mediator, however, quickly responded "this means that he is now asking for more money."

After some days, when the lawyer was able to get ahold of the Chinese partner's legal team, she was told that the delay was due to "bureaucratic hurdles" as the CEO had received word that the purchase agreement would not be approved by the local authorities. Supposedly the escrow mechanism "is not looked upon favorably" when a foreign party acquires the shares of a Chinese partner. Once negotiations resumed, the CEO's legal team pushed for what they argued was a customary solution: In case the authorities would not approve the transaction, the sums will be released from escrow into the local partner's account, but he will be kept as a "passive nominee shareholder." This mechanism, per the legal team, was a common one designed to enable the execution of the SPA: a contractual arrangement that will de-facto transform the JV into a wholly foreign owned firm, while maintaining its current registration status. The local "partner" will forgo his voting rights, dividend rights, and any other rights in the company.

The foreign lawyer vehemently opposed such a deal. Her consultations with local counsels confirmed her understanding. Since the CEO will still be registered as a shareholder in a JV, he will be entitled to shareholders' governance rights under the PRC Company law. An attempt to enforce the proposed contractual arrangement in the future will de-facto require a court to ignore the provisions of the law. The chances for such a contract to be enforced are slim to none. Yet the client was eager to close one way or another. As a publicly listed company, enduring a conflict with a sole distributor in China would not be accepted well by the shareholders.

After several long months of further negotiations, the SPA finally went through, and the transaction was consummated with the appropriate authority approvals. In this process, the purchase price of the local partner's shares increased 30 percent above what has been agreed upon, and not due to any value increase in the firm. In fact, during that period, the company ceased operations almost entirely. The JV was practically held hostage and lost much of its distribution channels and clients to local competitors.

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A serendipitous epilogue to the case came two years later. The foreign lawyer coincidently ran into the (former) head administrator of the JV and the full complexity of the episode was unveiled. Apparently, the CEO has befriended a local official in Shanghai and confided with him about selling his shares in the JV. The official (an administrator at either SAIC, local COFTEC, or SAFE), getting in the weeds of the negotiation process, told the CEO that the deliverables under the SPA requiring him to collect payments before his departure would embarrass the CEO with his local clients and sub-distributors. Instead, the official apparently offered, the transaction could be renegotiated on the basis of expected "bureaucratic hurdles" by the authorities. This would give the CEO more leverage to improve his departure terms and save face.

What the local official had gained from such friendly advice was left untold (and is likely unknown) to this day.

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Today, the (former) Chinese partner works with several suppliers. He has since expanded his distribution network and supplies AgroTech equipment to former JV clients and others across China.

The (former) American partner continues its global operations, including the wholesale distribution of its products in China. It had since established a special advisory board for the Asian market.

[**The story is based on the author's personal experience. Identifying details have been altered.**]

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T.G.O
Jerusalem, Israel
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About the Book

This book examines the evolution in the role of formal law through four decades of market reforms in China. It employs two layers of analysis: the market development macro layer and the corporate governance and capital market micro layer. The macro layer, Part II, establishes the analytical framework of the book. It shows how the law translates and secures political-economic power dynamics within the Party-state system. By examining the evolving functions of law through the different eras of market reform, the analysis shows how formal law supports the Party-state's efforts to strike a delicate balance between its own needs for macro control, the interests of various hierarchies within the Party-state, and those of market participants, thereby configuring China's unique socialist market economy. The micro layer, Part III in the book, implements the framework. It digs deep into the development of corporate governance and the Chinese capital market and considers how law and political economic determinants entwine in shaping the business environment in which public firms operate.

Drawing from a chronological study of an extensive archive of laws, regulations, policies and normative opinions issued by organs of the Chinese Party-state since economic reforms began in 1978 until the present, the book sheds a new comparative light on a long-standing debate about the role of law in economic development and about the possible varieties of growth-supporting governance mechanisms.

Through its interdisciplinary approach, connecting deep knowledge about China's political economy, law and development theories, and corporate governance practices, the book aspires to produce novel insights about the relationship between law, economic development, and politics in contemporary China.

**A note about the cover: The front face of the coin portrays the mythical ancient creature Xiezhi (獬豸), a symbol of traditional Chinese law that represents righteousness. Xiezhi is believed to possess a divine ability to sense and fight corruption.

Abbreviations

AMC	Asset Management Companies
BRI	Belt and Road Initiative
CAC	Cyberspace Administration of China
CBIRC	China Banking and Insurance Regulatory Commission
CBRC	China Banking Regulatory Commission
CCDI	Central Commission of Discipline Inspection
CCP	Chinese Communist Party
COFTEC	Commission of Foreign Trade and Economic Cooperation
CRES	Commission for Restructuring the Economic System
CSRC	China Securities Regulatory Commission
JV	Joint Venture
M&A	Mergers and Acquisitions
MOF	Ministry of Finance
MOFCOM	Ministry of Commerce
NDRC	National Development and Reform Commission
NIE	New Institutional Economics
NPC	National People's Congress
NPCsc	National People's Congress Standing Committee
PBoC	People's Bank of China
PRC	People's Republic of China
RMB	Renminbi (the Chinese currency, also known as Yuan)
SAIC	State Administration for Industry and Commerce
SAFE	State Administration of Foreign Exchange
SAMR	State Administration for Market Regulation
SASAC	State Asset Supervision and Administration Commission
SERC	State Economic Reform Commission
SME	Small Medium Enterprise
SOE	State-Owned Enterprise
SPC	Supreme People's Court
TVE	Township and Village Enterprise
WFOE	Wholly Foreign-Owned Enterprise
WTO	World Trade Organization