

China and the Rise of Law-Proof Insiders

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Overview of Presentation

- Role of *enforceable* corporate & securities laws in protecting investors in CS firms
- Alibaba as Mainland-based/Cayman-dom./U.S.-listed CS firm
- Effect of insiders, records, assets being located in Mainland
- Effect, on margin, of Alibaba's Cayman domicile
 - Corporate law
 - Securities law
- Effect, on margin, of Alibaba's HK listing
- Implications for sec. reg.

Role of *enforceable* laws in CS firms

- **Investors in controlling-shareholder (CS) firms face risk of massive tunneling**
 - midstream: self-dealing (etc.)
 - final-period: low-price freeze-out
- **Law can reduce tunneling risk**
 - corporate (substantive legal protection)
 - securities (disclosure, needed for enforcing corporate law)
- **But law must be *enforceable*, so can deter via:**
 - imprisonment
 - financial liability
 - litigation costs, including damage to reputation
- **If laws unenforceable, insiders are “*law-proof*,” undermining deterrence**

What about Alibaba and Jack Ma?

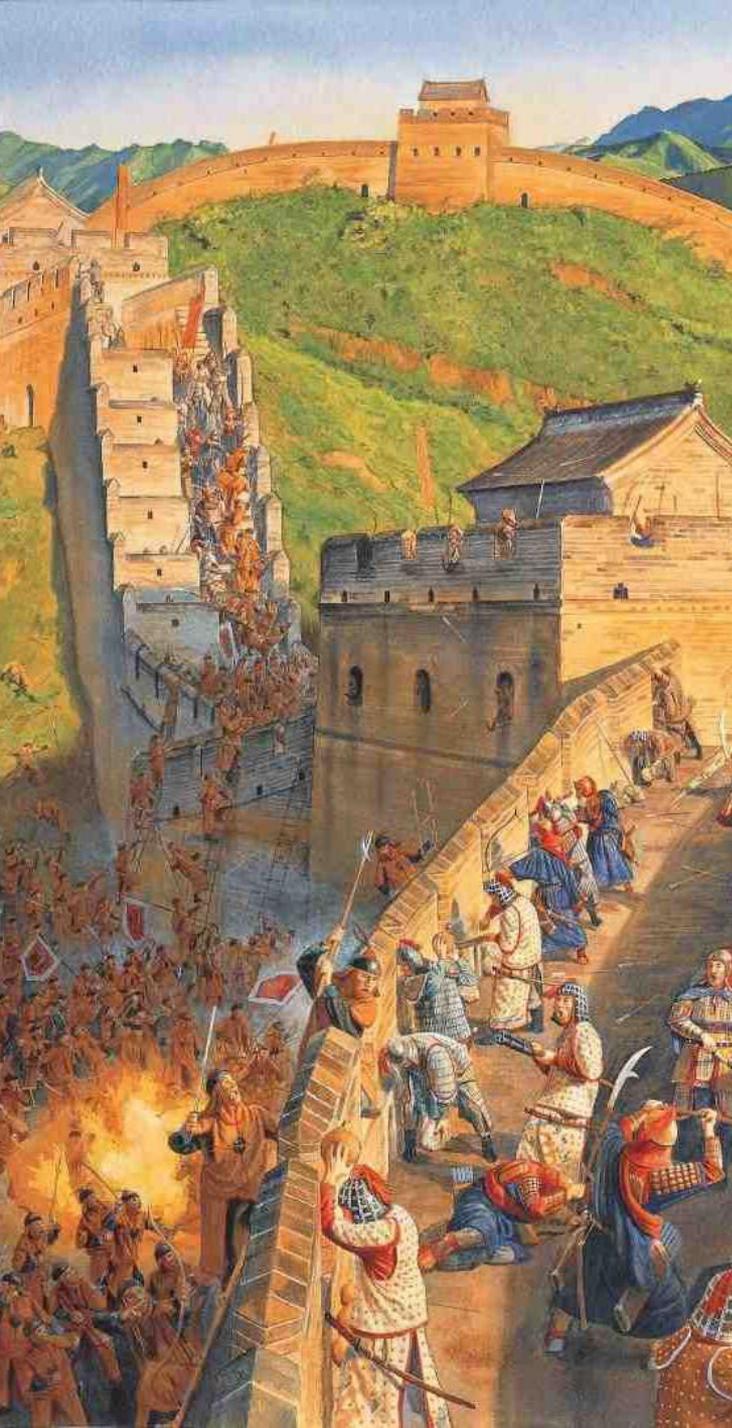


Alibaba Group

阿里巴巴集团

Mainland-based Cayman-domiciled CS firm listed only outside Mainland (in US, HK)





Great Legal Wall of China

- Whether Alibaba domiciled in Cayman or Delaware, location of **insiders, assets, information** in Mainland makes insiders largely law-proof for U.S. investors/regulators
- **Why?**
 - No extradition
 - No enforcement
 - Hard to get information

No Path to Punishment

- **No extradition**
 - **Mainland:**
 - no US treaty
 - no known extraditions
 - **HK**
 - treaty now suspended
 - even before, Mainland pressured HK not to extradite to US
- **No enforcement of U.S. judgments in Mainland**
 - **Investors:** no enforcement treaty for private judgments
 - 1 PRC court has enforced American's judgment against PRC national, but unusual
 - **Feds:** mutual criminal assistance treaty, which includes asset seizure, has (to our knowledge) been useless

Hard to Get Information

- **U.S. investors**
 - slow or no service of process
 - no depositions in Mainland (even by phone)
 - documents hard to get
 - State Secrets Protection Law (very broad)
 - Archives Law
 - Public Accountancy Statute
 - Article 177 of Securities Laws
- **Feds**
 - subject to same restrictions on depositions/discovery
 - mutual criminal assistance treaty, EMMoU not very helpful (to our knowledge)

Reverse Merger Frauds

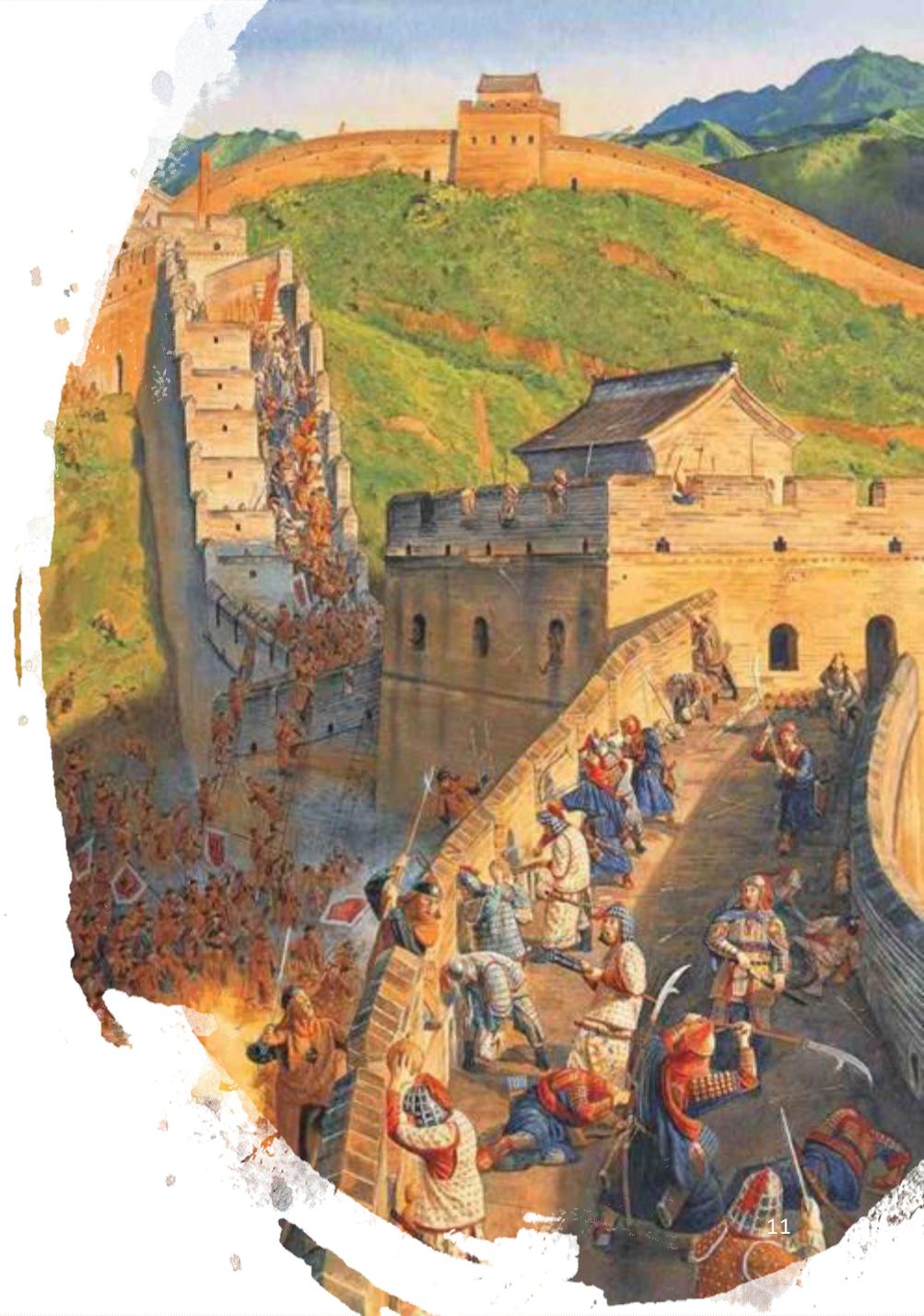
- **Great Legal Wall not merely “theoretical”**
- **China Reverse-Merger (CRM) frauds (2010-14)**
 - 100s of Mainland firms conducted reverse mergers
 - merged into registered shell co’s domiciled in Del or Nev
 - cash raised from US investors went to Mainland
 - dozens were frauds
 - when fraud revealed, prices of all CRM firms fell
 - US investors/feds could not reach fraudsters
 - Investors: judgments in US, but no enforcement
 - Feds: tried to get documents, failed
 - Non-fraud firms taken private at cheap prices
 - Often relisted in Hong Kong or Mainland

Cayman Domicile: Further Insulation

- **Effect on corporate-law protection**
 - Cayman domicile creates procedural barriers to enforcement
 - Bring suit in Cayman?
 - derivative claims face high hurdles
 - no contingent fee, and loser-pay
 - **[no suit on behalf of public investors ever brought in Cayman]**
 - Bring lawsuit in US?
 - derivative claims face high hurdles
 - for direct claims, Alibaba has loser-pay provision in articles of association
 - **powerful forum non conveniens & personal jurisdiction defenses**
- **Effect on securities-law protection**
 - Cayman domicile qualifies firm as foreign private issuer (FPI)
 - Much less disclosure
 - SEC's focuses less enforcement on FPIs

HK Listing: Does Not Help US Sh's

- In, HK no private suits due to loser-pay and no contingent fees. Regulators carry enforcement burden.
- **HK, like US (and Cayman), is on far side of Great Legal Wall of China**
 - no extradition from Mainland
 - no enforcement of judgments in Mainland
 - limited information sharing



What prevents Alibaba insiders from massive tunneling?

- **Alibaba's Mainland-based insiders are law-proof**
 - but perhaps might not engage in massive tunneling
- **Possible constraints**
 - ethical beliefs
 - desire to preserve reputation in US
 - desire to travel to US or other countries that extradite to US
 - fear of CCP
 - desire not to harm non-PRC (and thus reachable) nationals at Alibaba

Implications for Securities Regulation Generally

- **U.S. sec. reg. biased toward Chinese entrepreneurs**
 - Disclosure
 - Chinese can choose FPI or standard regime
 - Americans cannot
 - Enforcement
 - Chinese can lower enforcement risk by staying in China
 - Americans cannot opt out even in small ways (i.e., by reducing at IPO investors ability to sue, capping damages)
- **Need to level playing field**
 - If investors can't price protection at IPO and thereafter (premise of mandatory sec. reg.), **level up**
 - require same disclosure for all firms
 - bar law—proof insiders
 - If investors can price, **level down** – full private ordering at IPO

Thank you!