China and the Rise of Law-Proof Insiders

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China-Based Firms Listed in US

• Taxonomy
  – (1) **SOES**: gov-controlled; domiciled and usually listed in China (thus subject to Chinese corporate & securities laws, US securities law)
  
  – (2) **Reverse-merger firms**: non-listed Chinese firms merged with U.S. shell, start trading. No IPO. Domicile and only listing in US (thus subject **only** to US corporate and securities laws).
  
  – (3) **Tech-companies** (e.g., Alibaba). IPO in US. Domicile in Cayman Islands (thus, at IPO, subject **only** to US securities law and Cayman corporate law). If subsequent listing in HK, also to HK securities law.
Role of enforceable laws in CS firms

• Investors in controlling-shareholder (CS) firms face risk of massive “tunneling” (diversion of value)
  – midstream: cheap asset sales to CS (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 CS/insiders via:
  – imprisonment
  – financial liability
  – litigation costs, including damage to reputation

• If laws unenforceable: CS/insiders “law-proof” -- no deterrence
What about Alibaba and Jack Ma?
Mainland-based Cayman-domiciled CS firm listed only outside Mainland (in US, HK)

Alibaba Group 阿里巴巴集团

Alibaba OpCo & Assets

CS & most officers and directors
Great Legal Wall of China

• Regardless of where Alibaba domiciled (Cayman, 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
  – Feds: mutual criminal assistance treaty, which includes asset seizure, has 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

- **Feds**
  - subject to same restrictions on depos/discovery
  - mutual assistance treaty, EMMoU, so far useless
Reverse Merger Frauds

• Great Legal Wall not merely “theoretical”

• Reverse-Merger frauds (2010-14)
  – 100s of Mainland firms merged into registered shell companies domiciled in Del or Nev
    – cash raised from US investors went to Mainland
  • dozens were frauds

  – when fraud revealed, prices of all China RM firms fell
  • US investors/feds could not reach fraudsters
    – investors: judgments in US, but no enforcement
    – feds: tried to get documents, failed; no fines paid
  • Non-fraud firms taken private at cheap prices
    – Often relisted in Hong Kong or Mainland
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 we have not yet seen massive tunneling

• Possible constraints
  – desire to preserve reputation in US
  – desire to travel to US (or countries that extradite to US)
  – fear of CCP
  – desire not to harm non-PRC (and thus reachable) nationals at Alibaba

• But these constraints are not reliable
Implications for HFCAA

- **Holding Foreign Companies Accountable Act (HFCAA)** enacted in 2020 will delist China-based firms whose audits are not PCAOB-inspected after 3 years.

- Will probably lead to delisting...

- But even if PCAOB can inspect audits, China-based insiders will still be law-proof.
  - They can divert assets at any time, with or without fraud.
  - Not clear PCAOB inspections will make a big difference in reducing fraud.
Thank you!