

# 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**

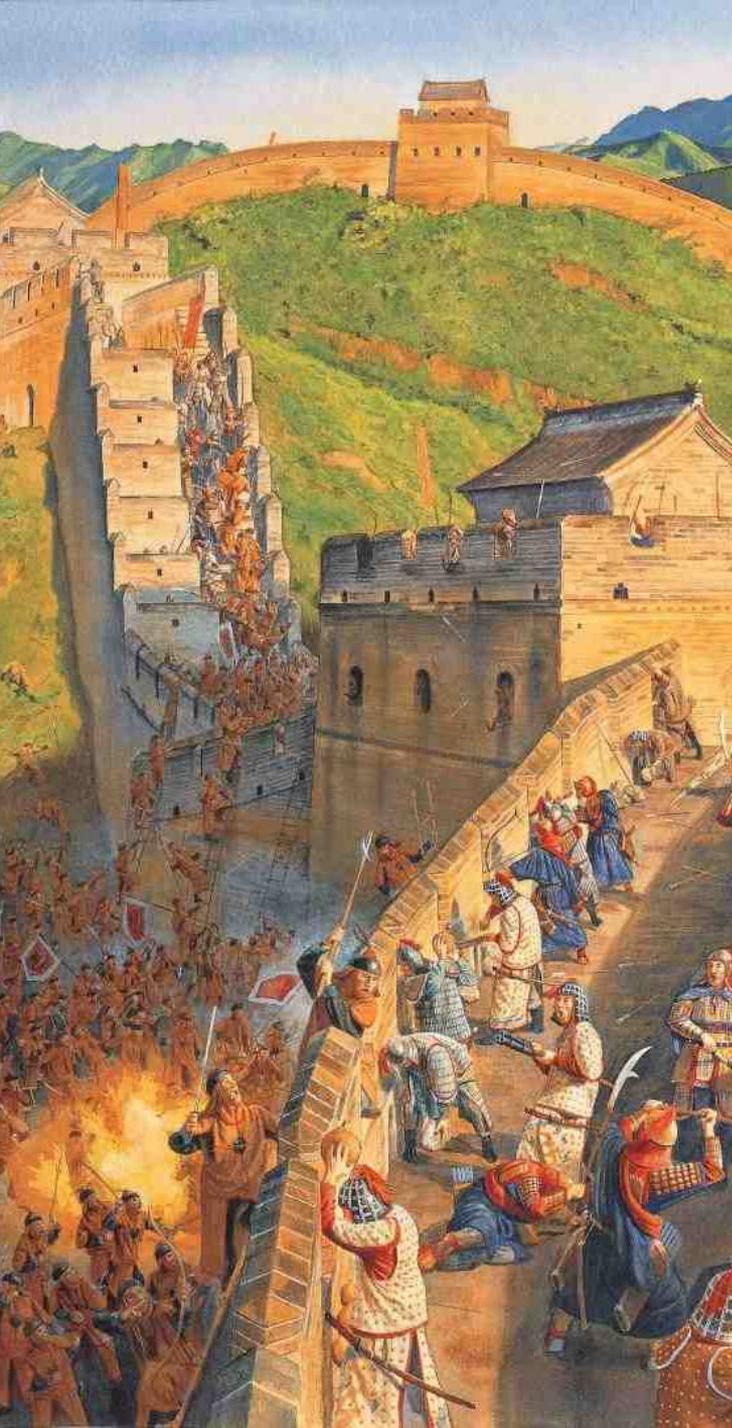
# What about Alibaba and Jack Ma?



**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

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- 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**

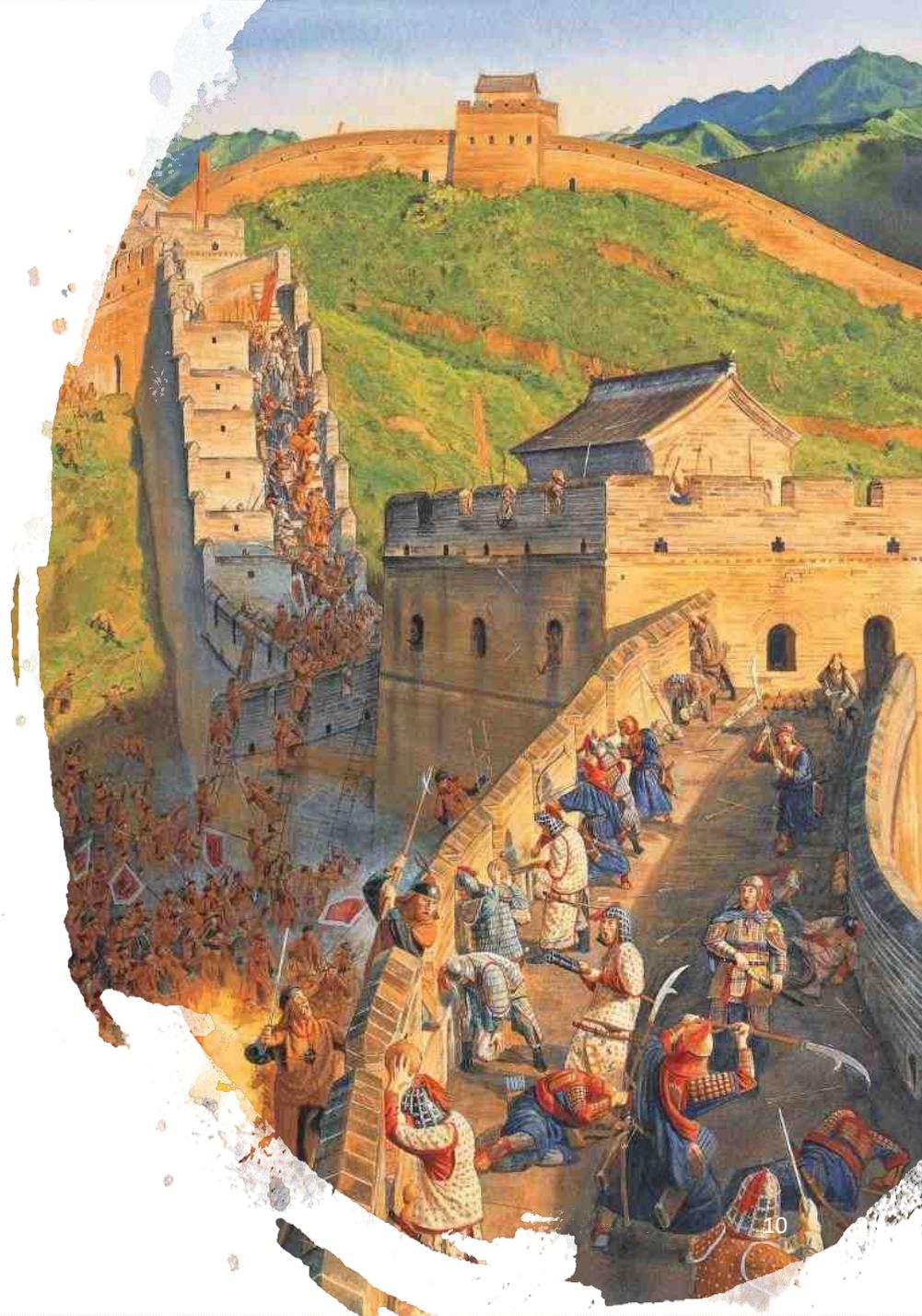
- subject to same restrictions on depositions/discovery
- mutual assistance treaty, EMMoU, so far useless

# 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!