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Open Sesame: The Myth of Alibaba's Extreme Corporate Governance and Control

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OPEN SESAME: THE MYTH OF ALIBABA'S EXTREME CORPORATE GOVERNANCE AND CONTROL

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ABSTRACT

In September 2014, Alibaba Group Holding Limited (Alibaba) successfully launched a $25 billion initial public offering (IPO), the largest IPO ever, on New York Stock Exchange. Alibaba's IPO success witnessed a wave among Chinese Internet companies to raise capital in U.S capital markets. A significant number of these companies have employed a novel, but poorly understood corporate ownership and control mechanism—the variable interest entity (VIE) structure and/or the disproportional control structure. The VIE structure was created in response to the Chinese restriction on foreign investments; however, it carries the risk of being declared illegal under Chinese law. The disproportional control structure, usually in the form of dual-class shares, helps founders or controlling shareholders maintain control post-IPO with less equity contribution. Around 30 percent of U.S.-listed Chinese companies adopted a dual-class share structure or similar mechanism to enhance insider control. This percentage is much higher than that of U.S. public companies, which is only about 6 percent.

This Article uses Alibaba as a case study to analyze the legal challenges posed by the VIE and disproportional control structures. Specifically, it dissects the structure of the VIE and sheds important light on inherent legal and governance risks associated with the VIE structure, along with potential policy solutions to protect investors and reduce information asymmetry. Similar to most U.S. high-tech companies that adopt dual-class share structures to maintain control by founders, Alibaba grants a partnership, consisting of its founders and executives, an exclusive right to nominate a majority of its directors. Furthermore, Alibaba implements various anti-takeover measures to strengthen insider control, many of which are considered detrimental to the interests of minority shareholders. Such excessive insider control presents a puzzle as to the success of the world's largest IPO and casts doubt on the long-debated issue of whether corporate governance truly matters. In this Article, we argue that the idiosyncratic value brought by a charismatic founder-executive—in this case, Alibaba's Jack Ma—together with voluntary commitments made by Ma himself in Alibaba's prospectus, help mitigate the potential abuse inherent in disproportional insider control structures. However, the success of such a structure hinges on the reputation and commitments of specific founders and may not function to the benefit of all investors in the long run.

INTRODUCTION

When Alibaba Group Holding Limited (Alibaba) listed its shares on the New York Stock Exchange (NYSE) in September 2014, it generated considerable market buzz.[1] In addition to garnering the largest initial public offering (IPO) of all time, China's largest e-retailer employed a novel and poorly understood corporate ownership and control mechanism—combining the variable interest entity (VIE) with a disproportional control structure.[2] VIEs involve a complex set of financial arrangements that enable foreign investors to circumvent the Chinese regulatory restrictions on foreign investment in Chinese Internet companies.[3] Buyers of stock in a VIE-structured company do not actually own the underlying business.[4] Rather, they own rights to the revenues of the operating company through a series of contracts between the operating company and an offshore shell company.[5] Of the two hundred Chinese companies listed on the NYSE and NASDAQ, ninety-five employ the VIE structure.[6] The VIE structure enables international investors to access a sector of the Chinese economy that would otherwise be off-limits to foreign ownership due to China's foreign investment restrictions.

In addition to the VIE ownership structure, Alibaba employs another unique disproportional corporate control mechanism—an insider partnership. This insider partnership, formally registered as Lakeside Partners L.P., but more commonly known as the Alibaba Partnership (the Alibaba Partnership or Partnership), consists of a group of founders and insider executives. Alibaba's Articles of Association grant the Alibaba Partnership exclusive rights to nominate a simple majority of Alibaba's board members, no matter how many shares the Alibaba Partnership holds.[7] While the Alibaba Partnership consists of top executives who run the Alibaba Group, the two key founders of Alibaba (i.e., Jack Ma and Joe Tsai) ultimately control the Partnership.[8] Such a control-enhancing mechanism deviates from the

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1. Laura Lorenzetti, *Who Needs Alibaba? IPO Market Chalks Up a Strong Quarter*, FORTUNE (Sept. 30, 2014, 2:06 PM), http://fortune.com/2014/09/30/who-needs-alibaba-ipo-market-chalks-up-a-strong-quarter/.

2. Liyan Chen, Ryan Mac & Brian Solomon, *Alibaba Claims Title for Largest Global IPO Ever with Its Extra Share Sales*, FORBES (Sept. 22, 2014, 11:51 AM), http://www.forbes.com/sites/ryanmac/2014/09/22/alibaba-claims-title-for-largest-global-ipo-ever-with-extra-share-sales/#c9afbaa7c26d.

3. DAVID ROBERTS & THOMAS HALL, VIE STRUCTURES IN CHINA: WHAT YOU NEED TO KNOW, O'MELVENY & MYERS LLP RESEARCH REPORT: TOPICS IN CHINESE LAW 1, 4 (2011) (on file with the *Brooklyn Journal of Corporate, Financial & Commercial Law*).

4. Kenneth Kan, *Alibaba and the Variable Interest Entity*, THE MKT. MOGUL (2014), http://themarketmogul.com/alibaba-and-the-variable-interest-entity/.

5. *Id.*

6. Matt Schiavenza, *VIEs: The Quirky Little Structure Helping in the IPO*, INT'L BUS. TIMES (Sept. 17, 2014, 8:34 AM), http://www.ibtimes.com/alibaba-ipo-vies-quirky-little-structure-helping-ipo-1690160.

7. *See* Alibaba Grp. Holding Ltd., Amended and Restated Articles of Association 20 (2013) [hereinafter Alibaba Articles of Association], https://www.sec.gov/Archives/edgar/data/1577552/000119312514333674/d709111dex32.htm.

8. *See, e.g.*, Heather Timmons, *Don't Let Alibaba's 27 Partners Fool You—The Company is Controlled by Five People*, QUARTZ (June 26, 2014), http://qz.com/226541/dont-let-alibabas-27-partners-fool-you-the-company-is-controlled-by-5-people/.

traditional "one share, one vote" principle of shareholders' voting rights and completely separates shareholders' equity stake from corporate control.[9] The Partnership's exclusive nominating power also has an effect similar to that of dual-class shares—the most common disproportional control measure adopted by U.S. public companies.[10] Like the Alibaba Partnership, dual-class shares allow founders to control a majority of the board election votes, while holding a relatively small portion of economic rights.[11] In addition to disproportional control over the board, Alibaba has adopted several anti-takeover measures to protect it from the risks of change in corporate control.[12]

In general, about 6 percent of U.S. public companies have dual- or multiple-class shares, "comprising around 8 percent of the market capitalization of all firms."[13] However, this number has increased drastically over the past decade, as U.S. technology companies and U.S.-listed Chinese firms have more widely adopted dual-class share structures. To be exact, 29 percent of U.S.-listed Chinese firms, which represent 70 percent of the market capitalization of all U.S.-listed Chinese firms, employ dual-class share structures.[14] The growing popularity of this ownership-control structure among U.S. public companies is worth serious research efforts to assess its impact on corporate governance and shareholder protection.

While VIE and disproportional control structures are employed by a substantial portion of U.S.-listed Chinese firms, they carry several important hidden risks regarding corporate governance and control. Given the present legal uncertainty surrounding the VIE structure, what would happen if VIEs become illegal under Chinese law? Furthermore, given that investors do not own shares in the actual Alibaba operating company due to Alibaba's VIE structure, what are the implications of this arrangement on Alibaba's corporate governance? How can Securities & Exchange Commission (SEC) rules—which were designed for a very different type of corporate ownership structure—be strengthened to deal with VIEs? What are the impacts of disproportional insider control and anti-takeover measures on corporate governance and investor protection? Given the complexities of both the VIE

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9. Simon C.Y. Wong, *Rethinking "One Share, One Vote"*, HARV. BUS. REV. (Jan. 29, 2013), https://hbr.org/2013/01/rethinking-one-share-one-vote.

10. *Dual-Class Share Structures: The Cost of Control*, THE ECONOMIST (July 21, 2011), http://www.economist.com/node/18988938.

11. Matt Orsagh, *Dual Class Shares: From Google to Alibaba, Is it a Troubling Trend for Investors?*, CFA INST.: MKT. INTEGRITY INSIGHTS (Apr. 1, 2014), https://blogs.cfainstitute.org/marketintegrity/2014/04/01/dual-class-shares-from-google-to-alibaba-is-it-a-troubling-trend-for-investors/.

12. Reynolds Holding, *Anti-Takeover Measures Often Hurt Investors*, N.Y. TIMES: DEALBOOK (Dec. 17, 2014), http://dealbook.nytimes.com/2014/12/17/anti-takeover-defense-measures-often-hurt-investors/?_r=0.

13. Paul A. Gompers, Joy Ishii & Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051, 1053 (2010).

14. H.K. STOCK EXCHS. & CLEARING LTD., CONCEPT PAPER: WEIGHTED VOTING RIGHTS 8 (2014), http://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp2014082.pdf.

and control-enhancing mechanisms, do U.S. investors have sufficient legal tools to protect themselves from possible expropriation by controllers?

Aside from the various governance concerns, this Article also intends to explore the positive aspects of the disproportional control structure in light of Alibaba's successful IPO. In theory, there are two competing hypotheses regarding the effect of the disproportional control structure on firm value. First, the "entrenchment hypothesis" focuses on the agency costs incurred by control-enhancing mechanisms and argues that this entrenched governance design is value destroying for shareholders. Second, the "long-term value creation hypothesis," argues that, by protecting managers from hostile takeovers, an insider-dominated governance structure helps managers pursue long-term investments and create long-term shareholder value. Based on an analysis of the characteristics of key founders and relevant commitments made by Alibaba's founders in the company's prospectus, this Article finds that key founders create significant value for investors when they choose not to accrue excessive private benefits arising from their disproportional control. Furthermore, this Article argues that these voluntary commitments, in conjunction with the founders' reputations and the high growth potential of the Chinese Internet industry, make Alibaba's IPO a great success, despite the risks associated with its VIE structure and the Alibaba Partnership's disproportional control.

The Article proceeds as follows. Part I introduces the background of Alibaba's public listing on the NYSE. Part II examines the history and structure of the VIE, including its status under the laws of the People's Republic of China (China). This Part will also look at various types of risk that VIEs pose for investors. Part III investigates the structure and composition of the Partnership as well as anti-takeover provisions adopted by Alibaba and their impact on corporate governance. Drawing on existing corporate control literature and empirical evidence from the Alibaba IPO, Part IV provides possible explanations for the popularity of Alibaba's securities listing, despite serious concerns over its corporate governance. Part V offers policy recommendations to mitigate the risks associated with the VIE and disproportional control structures. The final Part concludes.

I. BACKGROUND

Alibaba's listing on the NYSE was not its first bite at the public listing apple. Alibaba previously sought to list on the Hong Kong Stock Exchange (SEHK) with a dual-class share structure.[15] However, the SEHK rebuffed Alibaba on the grounds that its dual-class share structure violated the SEHK's "one shareholder, one vote" rule.[16] As a compromise, during its negotiations

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15. Shei Wei & Angus Young, *Dual Share Plan in Context: Making Sense of Hong Kong's Decision Not to Embrace Alibaba's Listing*, 26 INT'L CO. & COM. L. REV. 4, 4 (2015).

16. *Id.*

with Hong Kong authorities, Alibaba proposed to form a "partnership" consisting of twenty of the company's leading executives—led by founder Jack Ma—that would nominate the majority of the company's directors.[17] The proposed structure was akin to those of U.S. technology companies, such as Facebook and Google, whose founders exercise considerable control.[18] An Alibaba spokeswoman touted the partnership structure as "open, innovative, responsible and [a] sustainable system for a company's fundamental needs."[19]

Nonetheless, Hong Kong authorities rejected the dual-class share structure proposed by Alibaba.[20] The loss of Alibaba cost the SEHK an estimated $200 million HKD, which could have added 2 to 3 percent to the exchange's 2013 revenues.[21] Upon having its partnership proposal rejected by Hong Kong regulators, Alibaba turned to the NYSE, which agreed to its partnership proposal.[22] The NYSE's approval of Alibaba's proposal allowed Alibaba to move forward with its plans and leave corporate control firmly in the hands of the Partnership.

Control-enhancing mechanisms include: (1) granting a certain person an exclusive right to nominate directors and (2) dual-class share structures. Under existing U.S. listing rules, shareholders have the power to appoint and dispose of directors.[23] Since 1986, however, the NYSE has allowed dual-class share structures, which grant certain classes of shares disproportional voting rights in relation to their economic rights.[24] Alibaba's partnership control structure resembles the dual-class share structure in that it both allows disproportional corporate control and deviates from the "one share, one vote" principle. The NYSE is open to such deviations as long as the company makes sufficient disclosures regarding its corporate structure.

On September 22, 2014, Alibaba filed a prospectus with the SEC pursuant to section 424(b)(4) of the Securities Exchange Act.[25] The

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17. *Id.*

18. *See, e.g.*, Matthew Yglesias, *All Hail, Emperor Zuckerberg*, SLATE (Feb. 3, 2012, 3:29 PM), http://www.slate.com/articles/business/moneybox/2012/02/facebook_s_ipo_how_mark_zuckerberg_plans_to_retain_dictatorial_control_his_company_.html; Walter Frick, *How Google Changed Management, 10 Years After its IPO*, HARV. BUS. REV. (Aug. 20, 2014), https://hbr.org/2014/08/how-google-has-changed-management-10-years-after-its-ipo/; *About Google: Company*, GOOGLE, http://www.google.com/about/company/ (last visited Feb. 16, 2016).

19. Charlotte So, *U.S. Bourses Accept Board Plan*, SOUTH CHINA MORNING POST (Oct. 21, 2013, 10:02 AM), http://www.scmp.com/business/companies/article/1336259/us-bourses-accept-board-plan-alibaba.

20. Wei & Young, *supra* note 15, at 5.

21. *Id.*

22. Telis Demos, Juro Osawa & Jacob Bunge, *Alibaba: NYSE, NASDAQ Approve Partnership Structure Proposal*, WALL ST. J. (Oct. 21, 2013, 7:28 PM), http://www.wsj.com/articles/SB10001424052702303672404579149981322056134.

23. Wei & Young, *supra* note 15, at 5.

24. Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775, 785 (2005).

25. Alibaba Grp. Holding Ltd., Final Prospectus (Form 424B4) (Sept. 22, 2014) [hereinafter Alibaba Prospectus].

prospectus details a relationship between Alibaba and the Partnership.[26] The Partnership consists of "certain management members of [Alibaba], Small and Micro Financial Services Company, and China Smart Logistics, [which have] . . . the exclusive right to nominate a simple majority of the board of directors [for the] company."[27] This structure is different from the dual-class shareholding structure employed by companies like Google, Inc. and Facebook, Inc., which issue two classes of shares, one of which gives founders extensive rights and privileges above regular common shareholders.[28] By contrast, under Alibaba's structure, the Partnership effectively controls the board of Alibaba, despite only owning a minority equity stake in the company.[29]

Alibaba was quick to point out that, while different from Silicon Valley tech companies, its choice of structure also differed from other Chinese Internet companies:

> Our holding company structure differs from some of our peers in that we hold our material assets and operations, except for ICP and other licenses for regulated activities, in our wholly foreign-owned enterprises and most of our revenue is generated directly by the wholly-foreign owned enterprises.[30]

Thus, Alibaba sought to minimize the use of the VIE structure to the greatest extent possible. Only around 12 percent of Alibaba's revenue is tied to the VIE structure.[31] In areas in which foreign ownership is permitted, Alibaba conducts business through its wholly foreign-owned enterprises (WFOEs).[32] Thus, Alibaba's choice of structure provides a unique combination: a blend of Silicon Valley-esque insider control with elements of the VIE structure typical of the Chinese Internet sector.

Alibaba's shares closed up 38 percent on September 19, 2014, its first day of trading on the NYSE,[33] raising $21.8 billion, equal to the total amount

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26. *Id.*

27. *Id.* at cover; *see also* Prudence Ho & Juro Osawa, *Alibaba Details Partnership Structure*, WALL ST. J.: MONEYBEAT (Jun. 19, 2014, 12:18 AM), http://blogs.wsj.com/moneybeat/2014/06/19/alibaba-details-partnership-structure/.

28. S*ee* Ho & Osawa, *supra* note 27.

29. Fang Ying et al., *Alibaba's Stock Structure: Love It or Hate It?*, CUHK CHINA BUS. KNOWLEDGE (Nov. 21, 2014), www.bschool.cuhk.edu.hk/faculty/cbk/post.aspx?id=38D5B05EBCF4.

30. Alibaba Grp. Holding Ltd., Registration Statement (Form F-1) 110 (May 6, 2014) [hereinafter Alibaba Registration Statement].

31. Leslie Picker & Zijing Wu, *How Tsai Went From Yale Lacrosse Fields to Alibaba Mega-Deals*, BLOOMBERG (Aug. 24, 2014, 6:00 PM), http://www.bloomberg.com/news/articles/2014-08-24/how-lacrosse-playing-yalie-tsai-became-alibaba-s-mega-dealmaker.

32. *See* Paul Gillis, *Alibaba Sets the VIE Gold Standard*, CHINA ACCT. BLOG (May 7, 2014, 10:26 AM), http://www.chinaaccountingblog.com/weblog/alibaba-sets-the-vie-gold.html.

33. William Alden, *Alibaba's Shares Up 38% on First Day of Trading*, N.Y. TIMES: DEALBOOK (Sept. 19, 2014, 6:32 AM), http://dealbook.nytimes.com/2014/09/19/live-blog-tracking-the-giant-alibaba-i-p-o/.

raised for all IPOs in the first half of 2015.[34] Despite the successful listing on the NYSE, the Alibaba IPO left numerous questions unanswered. For instance, what is the legality of the VIE structure under Chinese law? Given the ability of the Partnership to control the board of Alibaba, how can other shareholders—even those with large equity stakes—influence corporate governance? Will the structure impede responsive governance over the long run? Part II of this Article will analyze the VIE corporate structure.

II. VARIABLE INTEREST ENTITY: WHAT IS THERE TO *VIE* FOR?

A. WHAT IS A VARIABLE INTEREST ENTITY?

A VIE is a company that is consolidated into the financial statements of a listing company because it is "controlled through contracts, rather than ownership."[35] In other words, control of a company is based on contractual arrangements, rather than owning equity in the underlying company. In the case of a U.S-listed Chinese firm, a VIE refers to a company that is incorporated in China and owned by individuals who are Chinese citizens, typically its founders. The VIE, in turn, contracts with a U.S.-listed offshore entity. Because the VIE technically meets the requirements for operating legally in China (i.e., it is owned by Chinese citizens), it is permitted to conduct business in industries that prohibit foreign ownership in China.[36]

The VIE structure allows an investor to purchase shares in an offshore entity, typically a shell company domiciled in the Cayman Islands.[37] This is done through a series of contracts between the listed offshore entity and the VIE in China. As such, the enforceability of this arrangement is contingent upon the validity of the underlying contract.[38]

In 2000, the VIE structure emerged as a way to circumvent restrictions on non-Chinese ownership of companies in sensitive sectors, such as energy, the Internet, and telecommunications.[39] The term originates from the U.S. Financial Accounting Standards Board's (FASB) Interpretation No. 46,

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34. *Id.*

35. Paul Gillis, *Variable Interest Entities in China*, FORENSIC ASIA 1, 2 (Sept. 12, 2012), http://www.chinaaccountingblog.com/vie-2012septaccountingmatte.pdf.

36. *Id.*

37. *See Understanding the VIE structure: Necessary Elements for Success and the Legal Risks Involved,* CADWALADER, WICKERSHAM & TAFT 1, 2 (Aug. 10, 2011), http://cadwalader.com/uploads/cfmemos/a6415b15f2ab1795be964c203f513215.pdf; Paul Gillis, *Explaining VIE Structures*, CHINA ACCT. BLOG (Mar. 20, 2011, 4:00 AM), http://www.chinaaccountingblog.com/weblog/explaining-vie-structures.html.

38. *See* Paul Gillis & Michelle Rene Lowry, *Son of Enron: Investors Weigh the Risks of Chinese Variable Interest Entities*, J. APPLIED CORP. FIN., Summer 2014, at 61, 66.

39. Serena Y. Shi, *Dragon's House of Cards: Perils of Investing in Variable Interest Entities Domiciled in the People's Republic of China and Listed in the United States*, 37 FORDHAM INT'L L.J. 1256, 1267–68 (2014).

Consolidation of Variable Interest Entities.[40] The interpretation was later revised in 2003 and is now known as FIN46(R), which stipulates the criterion for consolidating a VIE in financial statements.[41] All foreign investment in China, including the purchase of equities on China-based exchanges, is subject to a government approval process that implicitly discourages foreign investment.[42] The VIE structure provides a "creative compliance" mechanism; the foreign-owned offshore entity is not required to undergo the approval process.[43] While the VIE cannot operate in the restricted sector itself, it can give foreign investors access to the revenues of the underlying company that does.

In practice, an offshore listing company will incorporate a WFOE in China that holds material assets and conducts material operations for the listing company. The listing company generates revenues directly through its ownership over the WFOEs, which directly captures the profits of the VIEs through a series of contracts between the WFOEs and the VIEs (Figure 1).[44] Within this series of contracts, a loan agreement is included that capitalizes the VIE and sets forth its governing mechanisms.[45] There may also be an equity pledge, whereby the Chinese owner will offer collateral for the loan agreement. VIEs and their Chinese owners will also sign a power of attorney agreement, which grants the WFOEs the right to vote at shareholder meetings.[46] Finally, VIEs typically include a technical services agreement, which gives the WFOE the rights to the residual profits of the VIE, which are exchanged for services such as website maintenance, sales service, training, and administrative support.[47]

Alibaba's Chinese VIEs employ many of the classic elements of the VIE structure. Investors in Alibaba's shares, for instance, do not technically own shares in the Alibaba VIEs themselves, but rather have contractual rights to revenues of the VIEs. Jack Ma and Simon Xie are VIE equity holders for most of Alibaba's Chinese VIEs.[48] Jack Ma and Simon Xie authorized any person designated by the WFOEs to exercise shareholders' rights of the VIEs,

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40. *See* FIN. ACCT. STANDARDS BD., FASB INTERPRETATION NO. 46, CONSOLIDATION OF VARIABLE INTEREST ENTITIES: AN INTERPRETATION OF ARB NO. 51 (2003), http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1175801627792&acceptedDisclaimer=true.

41. *Id.*; *see also* Guo Li, *Chinese Style VIEs: Continuing to Sneak Under Smog?*, 47 CORNELL INT'L L.J. 569, 572 (2014).

42. *See* Gillis & Lowry, *supra* note 38, at 61.

43. *See* Richard Pearson, *Looking at Chinese VIEs*, FORBES (Oct. 18, 2012, 1:39 AM), http://www.forbes.com/sites/richardpearson/2012/10/18/looking-at-chinese-vies/#45ebb408793a.

44. *See* Gillis & Lowry, *supra* note 38, at 62.

45. *Id.*

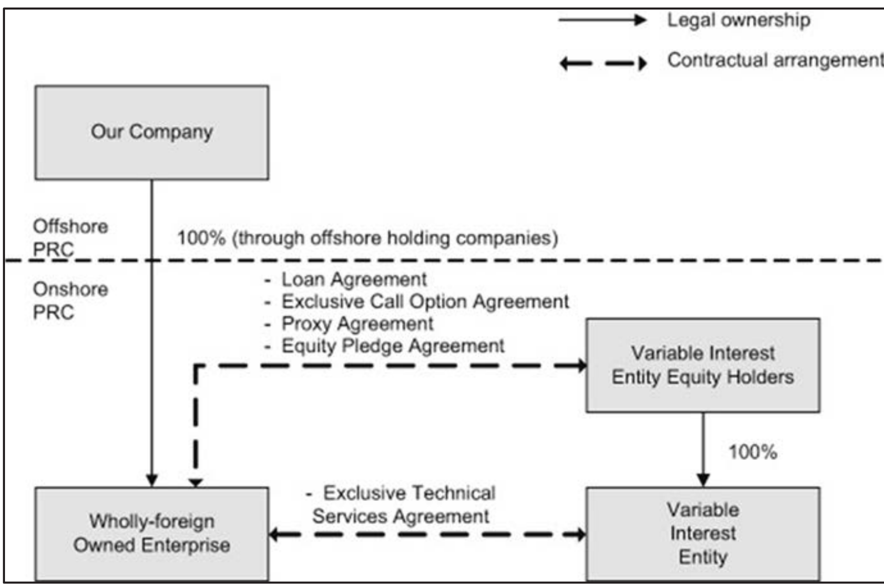
46. *See* Hai-Ching Yang, *An Update on China's Variable Interest Entities: Navigating Regulations and Mitigating Risks for 2013*, K&L GATES LEGAL INSIGHT 1, 1 (Mar. 8, 2013), http://www.klgates.com/an-update-on-chinas-variable-interest-entities—navigating-regulations-and-mitigating-risks-for-2013-03-08-2013/.

47. *See* Gillis, *supra* note 37.

48. *See* Alibaba Prospectus, *supra* note 25, at 11, 88.

including the right to attend and vote at the shareholders' meeting and appoint directors.[49] As with the typical VIE structure, Alibaba's structure provides for a technical services agreement between the WFOEs and the VIEs, a loan agreement, an equity pledge, a proxy agreement, and an exclusive call option agreement.[50]

Figure 1: Alibaba's Simplified VIE Structure[51]



B. INHERENT RISKS IN THE VIE STRUCTURE

Investing in any one of the 108 Chinese-domiciled VIEs listed on U.S. exchanges is not without risk.[52] Due to VIEs' questionable legal status, there may be incentives for the Chinese owner of a VIE to renege on a VIE contract; thus exposing U.S. investors to greater corporate governance risks.[53] For example, in 2010, Giga Media Limited (Giga Media), an Asian online gaming and services company incorporated in Singapore, operated its gaming business through three Chinese VIEs, which held the requisite licenses for operation and was entirely owned by Chinese nationals.[54] Giga Media fell into a dispute over the replacement of Wang Ji, the then-CEO of

49. *See id.* at 91.
50. *Id.* at 90–91.
51. *Id.* at 90.
52. *See* Gillis, *supra* note 35, at 2 (explaining that as of September 2012, 108 out of 225 (48%) of U.S.-listed Chinese firms adopted the VIE structure).
53. Dan Harris, *Crouching Tiger, Hidden Fraud. Clear Speaking on VIEs*, CHINA L. BLOG (July 16, 2011), http://www.chinalawblog.com/2011/07/crouching_tiger_hidden_fraud_clear_speaking_on_vies.html; Li, *supra* note 41, at 584–91.
54. Li, *supra* note 41, at 585.

its WFOE and Chinese VIE owner, who held both contractual and legal ownership of the Chinese VIEs.[55] As a result, much of the financial and licensing documentation regarding the Chinese VIEs suddenly went missing. Because Giga Media, as the listing company, did not have legal ownership over the Chinese VIEs, but simply relied upon the contractual relationships between its WFOE and the Chinese VIE owners (including Wang Ji), Giga Media was unable to consolidate the profits from the VIEs in that year and ultimately was required to deconsolidate its WFOE's financial results.[56]

Another famous example of the corporate governance risk inherent in VIEs is the Alipay controversy between Alibaba and Yahoo!. In 2010, Alibaba decided to spin-off AliPay, an online payment business developed with Alibaba resources, to a Chinese company Zhejiang Alibaba E-Commerce Co., which is owned and controlled by founder and Chairman Jack Ma.[57] Under Alibaba's existing VIE arrangement, there was no obligation for the VIE company to notify foreign or minority investors of these decisions.[58] Because there was no obligation to notify minority shareholders, Yahoo!—which owned roughly 15.4 percent of Alibaba at the time—missed an investment opportunity that it otherwise would have been able to pursue.[59] Such disparate interests between VIE-empowered shareholders (e.g., the Chinese owners who control VIEs) and minority foreign shareholders pose great corporate governance risks for U.S. investors of Alibaba and other companies that employ VIEs.

The heart of the issue lies in the risks of VIE agreements being declared illegal under section (3) or (5) of Article 52 of PRC Contract Law.[60] There have been two arbitration cases by the Shanghai Sub-commission of the China International Economic and Trade Arbitration Commission and one judicial decision by the People's Supreme Court rendering the subject VIE agreement or similar contractual arrangement void.[61] Even though the

55. *See id.*

56. *See id.*

57. KEVIN ROSIER, U.S.-CHINA ECON. & SECURITY REV. COMM'N, THE RISKS OF CHINA'S INTERNET COMPANIES ON U.S. STOCK EXCHANGES 6–7 (2014), http://origin.www.uscc.gov/sites/default/files/Research/The%20Risks%20of%20China%E2%80%99s%20Internet%20Companies%20on%20U.S.%20Stock%20Exchanges%20-%20with%20Addendum.pdf.

58. *Id.*

59. *Id.*; Allan Sloan, *Yahoo's Complex Alibaba Spin-off Deal on Wall Street Will Save Billions in Taxes*, WASH. POST (Jan. 28, 2015), http://www.washingtonpost.com/business/economy/yahoos-complex-alibaba-spin-off-deal-on-wall-street-will-save-billions-in-taxes/2015/01/28/8e9de498-a732-11e4-a06b-9df2002b86a0_story.html (noting Yahoo!'s ownership interest in Alibaba).

60. "A contract is invalid under any of the following circumstances . . . (3) there is an attempt to conceal illegal goals under the disguise of legitimate forms; or . . . (5) mandatory provisions of laws and administrative regulations are violated." Zhonghua Renmin Gongheguo Hetongfa (中华人民共和国合同法) [Contract Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 15, 1999, effective Oct. 1, 1999), art. 52(3),(5) (1999), http://www.npc.gov.cn/englishnpc/Law/2007-12/11/content_1383564.htm [hereinafter Contract Law of China].

61. Li, *supra* note 41, at 592–95.

arbitration cases are not binding on later judicial decisions and the judicial decision by the People's Supreme Court did not directly deal with the validity of VIE agreements, but rather only with similar contractual arrangements, the negative attitude towards the validity of similar agreements held by the highest judicial institution in China clouds the future of VIE structures.[62]

To address the uncertainty with regard to the validity of widely adopted VIE agreements, the Chinese government intends to regulate VIE agreements in the 2015 Draft Foreign Investment Law. On January 19, 2015, the State Council of the People's Republic of China (equivalent to the U.S. Cabinet) released draft legislation, entitled the Foreign Investment Law of the People's Republic of China (Draft Foreign Investment Law),[63] designed to overhaul China's foreign investment regime. In Article 15(6), the Draft Foreign Investment Law defines "foreign investment" to include controlling or obtaining equity of domestic firms through contract or trust.[64] In Article 18, the Draft Foreign Investment Law further defines "control," whereby the law would treat a Chinese operating entity as if it were "controlled" by a foreign entity, if the foreign entity can wield decisive influence on the management, finance, human resource, or technology of the Chinese operating entity through contract or trust. By the operation of these two definitions, the Draft Foreign Investment Law regards the VIE structure as a form of foreign investment; thus such structure would theoretically contravene the foreign investment restrictions and be deemed illegal under this new Draft Foreign Investment Law initiative.[65]

These proposed changes to Chinese foreign investment legislation will leave existing VIEs—such as Alibaba—in a precarious state. The Draft Foreign Investment Law essentially acknowledges that existing VIEs that are in the restricted industries would fall into the definition of "foreign investment" and thus are not legal under Chinese law.[66] Article III.3 of the Explanatory Note of the Draft Foreign Investment Law provides a solution

62. *Id.* at 595; *see also* Shi, *supra* note 39, 1294–95.

63. Zhong Hua Ren Min Gong He Guo Wai Guo Tou Zi Fa (Cao An Zheng Qiu Yi Jian Gao) (中华人民共和国外国投资法 (草案征求意见稿)) [Draft Foreign Investment Law of the People's Republic of China (Draft for Public Comment)] (promulgated by the Ministry of Com., Jan. 19, 2015), http://english.mofcom.gov.cn/article/newsrelease/policyreleasing/201501/20150100875221.shtml (follow "Attachment") (last visited Feb. 16, 2016) [hereinafter Draft Foreign Investment Law].

64. *Id.* art. 15; *see also* Hon. Mario Mancuso & Michael Gershberg, *China Releases Draft Foreign Investment Law*, FRIED FRANK INT'L TRADE & INV. ALERT (Feb. 9, 2015), http://www.friedfrank.com/siteFiles%2FPublications%2FFinalv2-%20020915%20-%20FF%20International%20Trade%20and%20Investment%20Alert%20-%20China%20Releases%20Draft%20Foreign%20Investment%20Law.pdf.

65. Draft Foreign Investment Law, *supra* note 63, art. 18.

66. *Id.* arts. 15(6), 18; *see also* Qiang Li et al., *China's New Foreign Investment Law*, O'MELVENY & MYERS, LLP (Jan. 22, 2015), https://www.omm.com/resources/alerts-and-publications/publications/chinas-new-foreign-inv/.

of sorts, although its implementation is uncertain.[67] VIEs operating in restricted sectors will need to obtain permits and exemptions to comply with new restrictions in order to continue their operations.[68] Without the necessary permits or exemptions, the VIE will be required to cease operations or face a penalty.[69]

Article 149 of the Draft Foreign Investment Law proposes levying heavy penalties on contractual schemes designed to circumvent Chinese foreign investment restrictions.[70] It is uncertain whether authorities would apply this retroactively. The Ministry of Commerce (MOFCOM) will solicit comments from the public on the regulation of companies employing the VIE structure.[71] This might provide large companies employing the VIE structure, such as Alibaba, a solution whereby they either receive an exemption from the restrictions, or are considered effectively Chinese-controlled entities.

Due to the legal uncertainty exacerbated by the newly proposed Draft Foreign Investment Law, Chinese companies are now seeking to avoid the VIE structure. Recently, some U.S.-listed Chinese firms, including Qihoo, Grand Game, Perfect World, and Jiayuan, have announced plans to privatize and relist in China because of the higher price-to-earnings ratios for companies listed on Chinese exchanges. However, to avoid legal risks, those firms in the foreign investment restricted industries will need to deconstruct their VIE structures, which will be costly and time-consuming.[72] Moreover, the Chinese Ministry of Industry and Information Technology has announced plans to release restrictions on foreign investment in the Internet sector.[73] In

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67. *See* Draft Foreign Investment Law, *supra* note 63, art. III.3 (follow "Notes to the Foreign Investment Law of the People's Republic of China").

68. *See* Steve Dickinson, *China VIEs are Dead. Done. Over. Stick a Fork in Them*, CHINA L. BLOG (Jan. 22, 2015), http://www.chinalawblog.com/2015/01/china-vies-are-dead-done-over-stick-a-fork-in-them.html.

69. *Id.*

70. Draft Foreign Investment Law, *supra* note 63, art. 149; *see also* Donald Clarke, *Comments on China's Draft Foreign Investment Law*, CHINESE LAW PROF. BLOG (Jan. 23, 2015), http://lawprofessors.typepad.com/china_law_prof_blog/2015/01/comments-on-chinas-draft-foreign-investment-law.html.

71. *See A Key Milestone on Administrative Regime for Foreign Investments – China's Foreign Investment Law (Discussion Draft)*, PWC: CHINA TAX & BUS. ADVISORY 1, 2 (Feb. 2015), http://www.pwccn.com/webmedia/doc/635592458070994794_chinatax_news_feb2015_5.pdf.

72. Liu Yonggang (刘永刚), Zhong Gai Gu Xiang Hui Gui A Gu Xu Zhe Teng: Cai Jie VIE Jie Gou Cheng Ben Gao Shi Jian Bu Ke Kong (中概股想回归 A 股需折腾：拆解 VIE 结构成本高时间不可控) [Return to A Shares for Agonizing Want: The High Costs of Dismantling the VIE Structure], CHINA ECON. WEEKLY (May 25, 2015), http://www.ceweekly.cn/2015/0525/112622.shtml. Jiang Jinze (江金泽), Zhong Bang Zhong Gai Gu Hui Gui: Qi Hu Xuan Bu Shou Dao Si You Hua Yao Yue (重磅中概股回归：奇虎宣布收到私有化要约) [Blue-Chip Chinese Firms Returning Home: Qihoo Announced the Receipt of a Privatization Offer], WALL ST. CHINA (June 17, 2015), http://wallstreetcn.com/node/219486.

73. Guan Yu Fang Kai Zai Xian Shu Ju Chu Li Yu Jiao Yi Chu Li Ye Wu (Jing Ying Lei Dian Zi Shang Wu) Wai Zi Gu Bi Xian Zhi De Tong Gao (关于放开在线数据处理与交易处理业务 (经营类电子商务) 外资股比限制的通告) [Announcements Regarding Release Online Transaction Processing and Data Processing Services (Business Class E-commerce) Foreign Equity

that case, it is possible that the companies can keep their VIE structure while listing on Chinese stock exchanges.[74]

III. THE DISPROPORTIONAL CONTROL STRUCTURE AND ANTI-TAKEOVER PROTECTIONS

Corporate control-enhancing mechanisms are control structures or contractual arrangements that enable certain shareholders or persons to exercise disproportionate control rights in relation to their economic rights in the corporations. The most commonly seen structures include multiple-class shares, pyramids, cross-holdings, and voting agreements.[75] In the United States, typically there are two ways to achieve disproportional control: either creating dual-class shares, or granting a certain class or classes of shares an enhanced or exclusive right to elect a certain number or percentage of board members.[76] A study on S&P 1500 companies found that seventy-nine companies (5 percent) feature dual-class share structures and/or enhanced or exclusive board election rights.[77] Such unequal voting rights arrangements have become even more popular since 2010. Of the 170 U.S. companies that conducted IPOs from January 1, 2010 to March 28, 2012, twenty (12 percent) of them employed a multi-class capital structure and/or enhanced or exclusive board election rights.[78] Unlike most other U.S.-listed Chinese firms, Alibaba did not choose to adopt a dual-class share structure, but instead created the Partnership and granted exclusive board nomination rights to the Partnership.

In this Part, we will unveil the secretive Partnership and the Partnership Committee and explore the role of the key founders in this novel governance structure. In addition to reserving the nomination rights to the Partnership, Alibaba also adopted several anti-takeover measures to defeat possible challenges to the management and control rights of its key founders. We will introduce these measures and analyze their effect on governance and

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Restrictions], MINISTRY OF INDUSTRY & INFO. TECH. OF CHINA (Jun. 19, 2015), http://www.miit.gov.cn/n11293472/n11293832/n11293907/n11368223/16645347.html.

74. Shanghai The9 Education Technology Co., Ltd. became the first company with a VIE structure to receive approval to list on the National Equities Exchange and Quotations (NEEQ). The business does not belong to the industries that are restricted or prohibited from foreign investments. *See China Practice Global Vision: Legal Updates*, HAN KUN LAW OFFICES (2016), http://www.hankunlaw.com/downloadfile/newsAndInsights/da97b890df980765bab578b92b08de01.pdf.

75. *See* Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471, 498–505 (1999); Mara Faccio & Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. FIN. ECON. 365, 366 (2002); Stijn Claessens, Simeon Djankov & Larry H.P. Lang, *The Separation of Ownership and Control in East Asian Corporations*, 58 J. FIN. ECON. 81, 93 (2000).

76. IRRC INST., CONTROLLED COMPANIES IN THE STANDARD & POOR'S 1500: A TEN YEAR PERFORMANCE AND RISK REVIEW 1, 4 (2012) [hereinafter CONTROLLED COMPANIES], http://irrcinstitute.org/pdf/FINAL-Controlled-Company-ISS-Report.pdf.

77. *Id.* at 3.

78. *Id.* at 15.

shareholder protection. Finally, drawing on economic theories of corporate control, we intend to provide theoretical explanations for the stunning success of the Alibaba IPO in light of governance concerns over excessive insider control and the associated risks of shareholder expropriation.

A. The Alibaba Partnership

1. The Evolution

Alibaba's insider partnership model is an innovative corporate governance structure that is new to investors and regulators. However, those well acquainted with the origins of Alibaba know that the founders have "acted in the spirit of partnership" when they founded Alibaba in 1999.[79] On February 20, 1999, the eighteen founders of Alibaba gathered in Jack Ma's "Lakeside Gardens" apartment near Xi Hu (West Lake) in Hangzhou.[80] The founding capital of Alibaba was only $500,000 CNY ($76,687 USD).[81] Although Jack Ma could have personally contributed the full amount himself, thereby becoming the sole shareholder of the new company, he instead asked that each of the eighteen founders contribute a portion of the start-up funds because he wanted the founding team to act in the spirit of partnership.[82] People even called the partners the "Eighteen Disciples of the Buddha."[83]

During the first ten years of the company's existence, the eighteen founders laid out the key foundation for the future growth of Alibaba. However, after the first decade of the company's existence, Alibaba needed new talent to ensure continuing growth and prepare itself for its IPO. Therefore, Jack Ma decided to formalize the Partnership to allow the admission of new members, while at the same time preserving the culture shaped by the founders.[84] In September 2009, all of the original founders wrote letters to Jack Ma formally resigning from their positions as "founder[s]."[85] The group resignation marked the coming of the partnership stage of Alibaba.[86]

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79. Alibaba Prospectus, *supra* note 25, at 229.

80. Wang Jingyu, Ma Yun Yi Jing Cheng Wei Zhong Guo Shou Fu Le, Dang Nian De Shi Ba Luo Han Ne? (马云已经成为中国首富了，当年的十八罗汉呢?) [Jack Ma Has Become the Wealthiest Person in China, But Where Are "Eighteen Disciples of the Buddha"?], 36 KR (Sept. 21, 2014, 1:50 PM), http://www.36kr.com/p/215495.html.

81. According to the exchange rate on March 29, 2016, 1 USD = 6.5078 CNY. *See* Bloomberg Bus., http://www.bloomberg.com/quote/USDCNY:CUR (last visited March 29, 2016).

82. Wei Xin (魏昕) and Shi Hai E (石海娥), Ma Yun Di Guo Zhen Mian Mu (馬雲帝國真面目) [The Truth About Jack Ma's Empire] 94, 105 (2014).

83. Jingyu, *supra* note 80.

84. Alibaba Prospectus, *supra* note 25, at 229.

85. A Li Ba Ba Zhou Nian Qing Dian Ma Yun Yan Jiang Quan Wen Shi Lu (阿里巴巴 10 周年庆典马云演讲全文实录) [Jack Ma's Speech on the 10th Anniversary Ceremony of Alibaba], TECH 163 (Sept. 11, 2009, 12:28 AM), http://tech.163.com/09/0911/00/5IT0UL13000915BF.html.

86. *Id.*

In July 2010, Alibaba formalized the Partnership as Lakeside Partners L.P.—a Cayman Islands exempted limited partnership named after the Lakeside Gardens residential community where Jack Ma and other founders started Alibaba in 1999.[87] At the time Alibaba held its IPO in September 2014, Alibaba disclosed in its prospectus that the Alibaba Partnership consisted of thirty partners.[88] Among the thirty partners, twenty-four were Alibaba managers, five were managers from Zhejiang Ant Small and Micro Financial Services Group Co., Ltd., and one was from China Smart Logistics.[89] In terms of the seniority of partners, seven were founders, eleven were grass-root managers who joined Alibaba before 2004, and the remaining twelve partners were professional managers who joined Alibaba Group after 2005.[90] This vast composition of members attests to the purpose of the Partnership, which is to accommodate new talent and enhance Alibaba's performance, innovation, and sustainability.[91] The company also points out that, "[u]nlike dual-class ownership structures that employ a high-vote class of shares to concentrate control in a few founders, our [partnership] approach is designed to embody the vision of a large group of management partners."[92] Even though Alibaba claimed that its approach is different from dual-class shares and that all partners have equal voting power, in reality the ultimate control rights still lie in the hands of a few, just as in the dual-class share structure. This is because Alibaba created another internal organization, which is higher in the hierarchy than the Partnership—the Partnership Committee. The Partnership Committee and the five members therein have ultimate control over the nomination of partners comprising the Partnership, as well as the nomination of directors of Alibaba.

2. The Partnership Committee—A Dictatorship

Within Alibaba's corporate structure, there is a Partnership Committee superior to the Alibaba Partnership, which controls the nomination of partners and Partnership Committee members.[93] That is to say, the ultimate management right of Alibaba rests in the hands of five committee members—Jack Ma, Joe Tsai, Jonathan Zhaoxi Lu, Lucy Peng, and Ming Zeng.[94] Jack Ma, Joe Tsai, and Lucy Peng were founding members in 1999.[95] Jonathan Zhaoxi Lu joined Alibaba in 2000 and succeeded Jack Ma as chief executive

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87. Alibaba Prospectus, *supra* note 25, at 229; Alibaba Articles of Association, *supra* note 7, art. 1.

88. Alibaba Prospectus, *supra* note 25, at 229.

89. *Id.*

90. *See id.* at 232.

91. *Id.* at 229.

92. *Corporate Governance: Alibaba Partnership*, ALIBABA GRP., http://www.alibabagroup.com/en/ir/governance_9 (last visited Feb. 17, 2016) [hereinafter *Alibaba Corporate Governance*].

93. Alibaba Prospectus, *supra* note 25, at 230–31.

94. *Id.* at 230.

95. *Id.* at 232.

officer in May 2013.[96] Ming Zeng joined Alibaba in 2006 and serves as the senior vice president for corporate strategy.[97] The Partnership Committee even reserves the right to nominate the committee members for itself.[98] The Partnership Committee members serve a term of three years and may serve multiple terms, with elections held once every three years.[99] The Partnership Committee nominates eight partners as candidates, and each partner of the Alibaba Partnership votes for five nominees. The five nominees who receive the most votes are elected to the Partnership Committee.[100] Since the Partnership Committee reserves the right to nominate its own members, the current five members have control over their own future, along with any future members nominated to the Partnership Committee.

The Partnership Committee also controls the nomination of new partners to the Partnership. Although every partner can propose candidates, the Partnership Committee determines the final list of candidates proposed to the entire Partnership for election.[101] Although election of new partners requires the approval of at least 75 percent of all partners, a candidate would not make it to the election without the support of the five Partnership Committee members.[102] In other words, those five Partnership Committee members effectively control the composition of the Partnership. However, the power of the Partnership Committee is not without limit. Any partner can be removed from the Partnership, including those in the Partnership Committee, upon the vote of a simple majority of all partners for cause.[103] In theory, if certain members of the Partnership Committee violate the partnership agreement, including failure to actively promote the corporate mission, vision and values, committing fraud, gross misconduct or gross negligence, the Alibaba Partnership can remove those Partnership Committee members from the Partnership.[104] This could potentially serve as a check on the immense power of the Partnership Committee. However, in practice, the partners are unlikely to use their removal power against other Partnership Committee members because the Committee has the right to nominate partners.

According to the prospectus, the Partnership Committee has the right to nominate director nominees to be voted on by all the partners.[105] Those

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96. *Id.* at 236.
97. *Id.* at 232.
98. *See id.* ("Prior to each election, the partnership committee will nominate a number of partners equal to the number of partnership committee members that will serve in the next partnership committee term plus three additional nominees.").
99. *See id.*
100. *See id.*
101. *Id.* at 229. ("The partnership committee reviews the nominations and determines whether the nomination of a candidate will be proposed to the entire partnership for election.").
102. *Id.*
103. *Id.* at 233.
104. *Id.*
105. *Id.* at 230.

nominees who receive the vote of a simple majority of the partners are selected as the Partnership director nominees.[106] Eventually, these nominees will be subject to a vote by the shareholders.[107] If any nominee does not receive a majority of votes from the shareholders at the general meeting, the Alibaba Partnership has the right to appoint a different person to serve as an interim director until the next annual general meeting.[108] At present, Alibaba's board consists of eleven members,[109] four of whom are Alibaba Partnership nominees—Jack Ma, Joe Tsai, Jonathan Zhaoxi Lu, and Daniel Yong Zhang.[110] Among them, three are members of the Partnership Committee, namely Jack Ma, Joe Tsai, and Jonathan Zhaoxi Lu, further demonstrating the five Partnership Committee member's immense control over the the Partnership's director nominees.[111]

This unique partnership-governance structure centralizes management control of Alibaba in the five Partnership Committee members. As mentioned, one of the checks-and-balances mechanisms that may be employed is the removal of partners by a simple majority vote of all partners. However, there is little chance that such removal rights will be exercised in practice. Not just because the partners can only be removed for cause, but also because, in addition to the nomination rights for new partners, the Partnership Committee also controls the allocation of the annual cash bonus pool for all partners.[112] Furthermore, partners retire from the Partnership when they cease employment with the Alibaba business group.[113] Since all partners are executives of the company, the board has the right to remove incompetent executives.[114] Given that the Partnership Committee controls the board, the Partnership Committee can remove any partner by ending his/her employment relationship with the company.[115] In light of this removal power, it is unlikely that any partner would vote to remove the Partnership Committee members, as it might jeopardize their own employment. As such,

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106. *Id.*

107. Alibaba Articles of Association, *supra* note 7, art. 90 ("Director nominees shall be elected by an Ordinary Resolution of Shareholders at each annual general meeting of the Company to fill the seats of those Directors whose terms expire at such annual general meeting.").

108. Alibaba Prospectus, *supra* note 25, at 230.

109. *See Alibaba Corporate Governance*, *supra* note 92.

110. Alibaba Grp. Holding Ltd., Registration Statement (Form 20-F) 131 (Jun. 25, 2015) [hereinafter 2015 Registration Statement].

111. Alibaba Prospectus, *supra* note 25, at 230.

112. *Id.* at 233.

113. *Id.*

114. Alibaba Articles of Association, *supra* note 7, art. 103 ("Subject to these Articles, the Directors may from time to time appoint any Person, whether or not a Director, to hold such office in the Company as the Directors may think necessary for the administration of the Company, including but not limited to, the office of president, chief executive officer, chief financial officer, chief operating officer, chief risk officer, chief technology officer, one or more vice-presidents, treasurer, assistant treasurer, manager or controller . . . . Any Person so appointed by the Directors may be removed by the Directors.").

115. *See id.*

the power of partners to remove the members of the Partnership Committee from the position of partners is unlikely to be an effective checks-and-balances mechanism against the extreme control of the Partnership Committee. In sum, the Partnership Committee resembles a dictatorship over the Alibaba empire.

B. INSIDER CONTROL AND ANTI-TAKEOVER MEASURES

1. Exclusive Nomination Rights and Super-Majority Provision

According to Article 90 of the Alibaba Articles of Association, the Partnership has the right to nominate up to a simple majority of directors on the board, which means the Partnership controls over half of the candidates for directors.[116] The granting of exclusive nomination rights to a specific class of shareholders or controlling shareholders is a common control mechanism in U.S. controlled companies and has a similar anti-takeover effect to the dual-class share structure.[117] To ensure the Partnership's nomination right will endure, Alibaba also adopts another anti-takeover provision—the super-majority provision. The Articles of Association provides that any change to the Partnership's nomination rights would require the voting approval of 95 percent of all shareholders at the shareholders meeting.[118] This is an incredibly high threshold for shareholders to achieve.

The uniqueness of Alibaba's exclusive nomination rights provision is that the nomination right does not belong to certain shareholders, as in other U.S. controlled companies; instead, the right is granted to a group of founders and professional managers, who constitute the Partnership. The composition of this group of founders and professional managers will change over time subject to the decision of the five-member Partnership Committee. Interestingly, the qualification for partner-status does not depend in anyway on the shareholding of partners.[119] In theory, it is possible that one day no partners will own any shares in Alibaba, yet they may still control the board.

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116. Alibaba Articles of Association, *supra* note 7, art. 90 ("or so long as the Partnership Condition is satisfied, the Partnership shall have the right to nominate up to such number of persons who shall stand for election as Directors as may be required to ensure that Directors nominated or appointed by the Partnership shall constitute a simple majority of the total number of Directors on the Board, with as equal a number of such nominated Directors assigned to each group of Directors as possible.").

117. CONTROLLED COMPANIES, *supra* note 76, at 4–6.

118. Alibaba Articles of Association, *supra* note 7, art. 1 ("Special Resolution . . . being a resolution: (a) passed by a majority of not less than three-fourths (or, in respect of any resolution relating to a Special Partnership Matter, or in any way having the effect of affecting a Special Partnership Matter, including, without limitation, any amendment to the provisions of the Memorandum or Articles which relate to a Special Partnership Matter, by 95% . . .)."); Alibaba Prospectus, *supra* note 25, at 231.

119. There is a requirement for share retention for all the partners, but there is no minimum shareholding requirement for partners. *See* Alibaba Prospectus, *supra* note 25, at 234.

This creates an even larger discrepancy between cash-flow rights and control rights than in a dual-class share structure.

In fact, upon its IPO, all thirty partners held approximately 349,859,983 ordinary shares of Alibaba, which accounted for only 15.55 percent of all outstanding shares.[120] The key founders, Jack Ma and Joseph Tsai, owned 8.8 percent and 3.6 percent respectively, totaling 12.5 percent of Alibaba's shares.[121] With only 12.5 percent of cash-flow rights, Jack Ma and Joseph Tsai, through their control over the Partnership Committee and in turn the Alibaba Partnership, led the nomination of a simple majority of board members. Such a control structure resembles the type of ownership structure called a "controlling minority structure," where a shareholder controls a company while holding only a fraction of shares.[122] Firms with controlling minority structures suffer from far greater agency costs than those with dispersed-ownership structures or controlled-ownership structures.[123] This is because firms with controlling minority structures suffer from both agency problems associated with the other two previously mentioned ownership structures, namely: (1) divergence-of-interests agency problems, and (2) entrenchment agency problems.[124] Divergence-of-interests agency problems arise when the controlling shareholders' interests are not aligned with those of noncontrolling shareholders because the controlling shareholders do not internalize the value effects of their decisions due to low cash-flow rights.[125] In this respect, Alibaba suffers from the same divergence-of-interests agency costs found in a dispersed-ownership structure because partners of the Alibaba Partnership hold disproportionally higher control rights than cash-flow rights. Additionally, Alibaba suffers from the entrenchment agency problem, which is associated with a controlled-ownership structure. Alibaba's partnership control structure insulates the firm from the threat of mergers and acquisitions and monitoring from the market for corporate control because outside shareholders can never control a majority of the board, even if they obtain a majority of shareholdings. The controllers of the firm (i.e., the Alibaba Partnership or, particularly, Jack Ma and Joseph Tsai) are entrenched and are thus freer to extract private benefits of control than are managers in dispersed-ownership structure firms. The dual agency problems of Alibaba's control structure provide the controllers with not only

120. As of June 30, 2014, there were 2,250,073,061 ordinary shares issued and outstanding. *See id.* at 272.

121. *Id.* at 250.

122. Lucian A. Bebchuk, Reinier Kraakman & George Triantis, *Stock Pyramids, Cross-Ownership and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, *in* CONCENTRATED CORPORATE OWNERSHIP 295, 295–96 (Randall K. Morck ed., 2000).

123. *Id.* at 301–06.

124. *See id.* at 301–10; Randall Morck, Daniel Wolfenzon & Bernard Yeung, *Corporate Governance, Economic Entrenchment, and Growth*, 43 J. ECON. LITERATURE 655, 676–79 (2005).

125. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 67–70 (1991).

the incentive, but also the power, to extract private benefits at the expense of noncontrolling shareholders.[126]

2. Voting Agreement with Principle Outside Shareholders

In addition to granting the Alibaba Partnership exclusive control over half of the board seats, Alibaba, Jack Ma, and Joe Tsai also entered into voting agreements with Alibaba's principle outside shareholders, Softbank and Yahoo!, to ensure effective control over shareholders meetings (the voting coalition).[127] Upon forming the voting coalition, the stated parties came to three major agreements: (1) granting Softbank the right to nominate one director, provided that Softbank maintains a holding of more than 15 percent of Alibaba common shares; (2) forming a voting coalition to support director candidates nominated by the Alibaba Partnership and Softbank (Softbank nominees are also subject to the condition that Softbank holds more than 15 percent of Alibaba shares); and (3) limiting the voting power of Softbank and Yahoo! to a certain percentage or level by granting voting power to Jack Ma and Joe Tsai by proxy.[128] At the time of Alibaba's IPO, Jack Ma owned 8.8 percent, Joe Tsai owned 3.6 percent, Softbank owned 34.1 percent, and Yahoo! owned 22.4 percent[129]—totaling 68.9 percent of Alibaba's shares. Even after one year, the parties still owned 57.8 percent of Alibaba's outstanding shares.[130] Because Alibaba adopted a majority vote standard for the election of directors,[131] and with the voting coalition (i.e., Jack Ma, Joe Tsai, Softbank, and Yahoo!) owning over half of the votes, the Partnership director nominees are essentially guaranteed election.

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126. Bebchuk, Kraakman & Triantis, *supra* note 122, at 301–06.

127. Alibaba Prospectus, *supra* note 25, at 255.

128. *Id.* at 255–56. ("SoftBank will agree (i) to vote its shares in favor of the election of the Alibaba Partnership's director nominees at each annual general shareholders meeting until SoftBank's shareholding declines below 15% of our outstanding shares and (ii) to grant the voting power of any portion of its shareholdings exceeding 30% of our issued and outstanding ordinary shares to Jack and Joe by proxy; Jack and Joe will vote their shares and any other shares over which they hold voting rights in favor of the election of the SoftBank director nominee at each annual general shareholders meeting in which the SoftBank nominee stands for election until SoftBank's shareholding declines below 15% of our outstanding ordinary shares; Yahoo will agree (i) to vote its shares in favor of the election of all of the Alibaba Partnership's director nominees and the SoftBank director nominee, if so standing for election, at each annual general shareholders meeting until SoftBank's shareholding declines below 15% of our outstanding shares and (ii) to grant the voting power over any shares it owns, up to 121.5 million of our ordinary shares, to Jack and Joe by proxy . . . .").

129. *Id.* at 250.

130. As of June 23, 2015, Jack Ma owned 7.6%, Joe Tsai owned 3.1%, Softbank owned 31.8 percent, and Yahoo! owned 15.3%, totaling 57.8%. *See* 2015 Registration Statement, *supra* note 110.

131. Alibaba Prospectus, *supra* note 25, at 275 ("Our articles provide that persons standing for election as directors at a duly constituted general meeting with requisite quorum shall be elected by an ordinary resolution of our shareholders, which requires the affirmative vote of a simple majority of the votes cast on the resolution by the shareholders entitled to vote who are present in person or by proxy at the meeting.").

3. Appointment Rights of Directors

Even if the voting rights held by the voting coalition fall under 50 percent, Alibaba's Articles of Association provide another layer of protection. In the event a nominee fails to gain approval at the shareholders meeting, the Articles of Association grant the nominating party the right to arbitrarily appoint a different person to the board to be a director until the next annual shareholders' meeting, without further vote or approval by the shareholders or the board.[132] Apparently, such governance design addresses the possibility that major shareholders might sell their shares in the future, causing the voting coalition to collapse. As the appointment rights currently stand, the Alibaba Partnership is essentially assured that every nominee they select will be on the board, whether they are elected or appointed. Such appointment rights destroy the mechanism of voting and shareholder democracy. Insiders not only control the first stage of nomination, but also the second stage of shareholder votes. The only difference between winning and losing the shareholder vote lies in the tenure of the directors. If the nominees pass shareholder votes, then the tenure is three years.[133] If not, the tenure is one year.[134] Even if a Partnership nominee does not pass the shareholders' vote, the Alibaba Partnership can still appoint another nominee as an interim director for one year and nominate a candidate (except for the original nominee) for a vote at the next shareholders' meeting.[135] Thus, such governance design paralyzes the voting mechanism and provides insiders uncontestable control over both the board of directors and the shareholders' meeting.

4. Staggered Boards

In addition to exclusive nomination rights and voting agreements, Alibaba also employs another powerful anti-takeover measure—the staggered board. Studies have shown that staggered boards negatively correlate with firm value and thus destroy value for shareholders.[136] In a

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132. *Id.* at 276.
133. Alibaba Articles of Association, *supra* note 7, art. 88.
134. *Id.* art. 91.
135. *Id.*
136. Paul A. Gompers et al. created a governance index, which includes twenty-four governance measures that weaken shareholder rights, and proved that firms with weaker shareholder protection have lower firm value. *See* Paul A. Gompers, Joy L. Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 112 (2003). Among the twenty-four governance measures, Lucian A. Bebchuk, Alma Cohen, and Allen Ferrell selected six measures that entrench the board and created an entrenchment index. Lucian A. Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance?*, 22 REV. FIN. STUDS. 783, 784 (2009). The six measures include staggered boards, limits to shareholder bylaw amendments, poison pills, golden parachutes, and supermajority requirements for mergers and charter amendments. *See id.* at 783–85. Bebchuk et al. proved that these six measures are correlated with negative firm value, while the other eighteen measures are not. *See id.* In particular, Bebchuk, Cohen, and Wang focus on the effect of staggered boards and find that staggered boards are associated with statistically significant

staggered board structure, directors are classified into groups—typically three groups—where the tenure of each group expires in different years. As a result, at each annual shareholders' meeting, only one-third of the directors will be replaced, making it harder for outsiders to gain control over the board. The board is thus better protected against hostile takeovers and is entrenched in power.

Alibaba's Articles of Association stipulate that there are a total of nine directors who are divided into three groups, designated as Group I, Group II, and Group III.[137] Group I directors—consisting of Joe Tsai, Jonathan Lu, and Michael Evans—serve until the first annual general meeting of shareholders after the IPO. Group II directors—consisting of Daniel Zhang, Chee Hwa Tung, and Jerry Yang—serve until the second annual shareholders' meeting. Group III directors—consisting of Jack Ma, Masayoshi Son, and Walter Kwauk—serve until the third annual shareholders' meeting.[138] Joe Tsai, Johnathan Lu, Daniel Zhang, and Jack Ma are the nominees of the Alibaba Partnership, while Masayoshi Son is the nominee of Softbank.[139] The remaining four directors are independent directors; however, Jerry Yang is the co-founder and former CEO of Yahoo!.[140]

Alibaba's governance structure not only ensures the Partnership's control over a majority of the board seats, but also requires that the number of Partnership director nominees should spread as evenly as possible in each group of directors.[141] With director nominees of the Partnership occupying at least one seat in each group, together with the appointment rights of the Partnership in the event that the nominee fails the shareholder vote, outsiders can only alter at most two director seats in any given year. Because the Partnership will always control a majority of the board under the Articles of Association, it would take outsiders at least two consecutive years to control only a minority of board seats. Therefore, such a governance structure effectively shields Alibaba's incumbents from the market for corporate control and thus exposes investors to great entrenchment and agency costs.[142]

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reduction in firm value. *See* Lucian A. Bebchuk, Alma Cohen & Charles C.Y. Wang, *Staggered Boards and the Wealth of Shareholders: Evidence from Two Natural Experiments* (Harv. John M. Olin Ctr. for Law, Econ. & Bus., Discussion Paper No. 697, 2011), http://www.law.harvard.edu/programs/olin_center/papers/pdf/Bebchuk_et%20al_697.pdf; *see also* Lucian Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409 (2005).

137. Alibaba Articles of Association, *supra* note 7, art. 88.

138. Alibaba Prospectus, *supra* note 25, at 275.

139. *Id.*

140. *Id.* at 235. However, Michael Evans was appointed as President of Alibaba on August 4, 2015, making him a management director instead of an independent director. Gillian Wong, *Alibaba Group Names Michael Evans as President*, WALL ST. J. (Aug. 4, 2015, 2:01 PM), http://www.wsj.com/articles/alibaba-group-names-michael-evans-as-president-1438682344.

141. Alibaba Prospectus, *supra* note 25, at 276.

142. Bebchuk, Kraakman & Triantis, *supra* note 122, at 301–06.

IV. AN ECONOMIC ANALYSIS OF ALIBABA'S EXTREME GOVERNANCE STRUCTURE

Alibaba's governance structure grants disproportional control to the founders as compared to the shareholdings owned by them. As illustrated in the previous Subpart, such governance structure might lead to greater entrenchment and agency costs. The question then arises as to why the founders of Alibaba designed such a governance structure in the first place? In theory, a firm would design an efficient governance structure in an IPO to attract investors to subscribe IPO shares with a reasonable price. Given the fact that investors oversubscribed to Alibaba's IPO shares,[143] why were investors willing to invest? Are there benefits of such a disproportional control structure that would outweigh the associated agency costs? Existing financial contracting and corporate control literature provide two hypotheses regarding the effect of disproportional corporate control on shareholders' value. First, the "entrenchment hypothesis" argues that the disproportional control structure is value destroying because investors bear significant agency costs from both board entrenchment, and from divergence of interests between controlling and noncontrolling shareholders.[144] Contrary to the entrenchment hypothesis, the "long-term value creation hypothesis" posits that a disproportional control structure helps managers fight short-termism, and encourages managers to pursue long-term investments and increase long-term shareholder value.[145]

Many policy makers have adopted the latter "long-term value creation" view in justifying an enhanced control structure.[146] For example, France passed the Florange Act in March 2014 to make it a default rule that shareholders who hold shares for more than two years will be granted double voting rights, unless two-thirds of investors dissent.[147] The new law rewarded shareholders who hold shares for more than two years with double voting

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143. Liyan Chen, Ryan Mac & Brian Solomon, *Alibaba Claims Title for Largest Global IPO Ever with Extra Share Sales*, FORBES (Sept. 22, 2014, 11:51 AM), http://www.forbes.com/sites/ryanmac/2014/09/22/alibaba-claims-title-for-largest-global-ipo-ever-with-extra-share-sales/.

144. Bebchuk, Kraakman & Triantis, *supra* note 122, at 301–06; Gompers, Ishii & Metrick, *supra* note 13. For a summary of empirical studies on the effect of disproportional control structure on firm value, see Renee Adams & Daniel Ferreira, *One Share-One Vote: The Empirical Evidence*, 12 REV. FIN. 51, 62–65 (2008).

145. LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC 63–73 (1st ed. 2012); William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653 (2010); Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006).

146. Klaus J. Hopt, *Corporate Governance in Europe: A Critical Review of the European Commission's Initiatives on Corporate Law and Corporate Governance* 26 (Eur. Corp. Governance Inst., Working Paper No. 296, 2015), http://ssrn.com/abstract=2644156 or http://dx.doi.org/10.2139/ssrn.2644156.

147. *Shareholder Rights in Europe: Short-term or Short-changed?*, THE ECONOMIST (May 2, 2015, 3:13 PM), http://www.economist.com/news/business/21650149-enhanced-rights-loyal-investors-are-increasingly-touted-way-make-companies-think.

rights to encourage long-term investments.[148] Italy followed France and removed its prohibition on multiple voting rights in 2014.[149] In 2015, the Committee on Legal Affairs (JURI) of the European Parliament proposed an amendment proposal to the Shareholders' Rights Directive of 2007 that would reward long-term shareholders with extra voting rights or dividends.[150] This approach was especially welcomed by state and family businesses. Critics have commented that French reforms were led by a socialist government in order to control state-owned enterprises with less capital, and as a protectionist guard against foreign investors.[151] Most institutional investors do not find double voting rights welcoming and strongly oppose the reform.[152]

Current empirical evidence on the effect of disproportional control measures is rather mixed. There are different views amongst scholars as to the impact of disproportional insider control.[153] This Article argues that there are two forces at play: the first is the value created by concentrated control, and the second is the value-decreasing effect of the agency costs resulting from disproportional control. A rational investor would purchase shares in a

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148. Marco Ventoruzzo, *The Disappearing Taboo of Multiple Voting Shares: Regulatory Responses to the Migration of Chrysler-Fiat* 1, 8 (Eur. Corp. Governance Inst., Working Paper No. 288, 2015).

149. *Id*. at 13.

150. *See Report of the Committee of Legal Affairs*, at 33, COM (2014) 213 (May 12 , 2015), http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2f%2fEP%2f%2fNONSGML%2bREPORT%2bA8-2015-0158%2b0%2bDOC%2bPDF%2bV0%2f%2fEN; Jeroen Delvoie & Carl Clottens, *Accountability and Short-Termism: Some Notes On Loyalty Shares*, 9 L. & FIN. MKTS. REV. 19, 23 (2015). On July 8, 2015, the European Parliament rejected the proposal to reward long-term shareholders. *See Revision of the Shareholders Rights Directive: It's a Long Way Home*, LEXOLOGY (July 14, 2015), http://www.lexology.com/library/detail.aspx?g=10cdafcd-9dea-43fc-9016-a96ae6952489.

151. Steve Johnson, *'Protectionist' French Law Alarms Investors*, FIN. TIMES (Feb. 22, 2015), http://www.ft.com/intl/cms/s/0/5f390b20-b839-11e4-b6a5-00144feab7de.html#axzz3jbsUik88.

152. *Id.*

153. Some scholars find disproportional control structure to be value-destroying for shareholders. *See* Stijn Claessens, Simeon Djankov, Joseph P. H. Fan & Larry H. P. Lang, *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. FIN. 2741 (2002) (finding that firm value increases with the largest shareholders' cash-flow rights and decreases when there is a discrepancy between voting rights and cash-flow rights); Karl V. Lins, *Equity Ownership and Firm Value in Emerging Markets*, 38 J. FIN. & QUANTITATIVE ANALYSIS 159, 170–72 (2003) (finding that firm value is lower when insiders' voting rights exceed cash-flow rights); Gompers, Ishii & Metrick, *supra* note 13 (finding that firm value increases with insiders' cash-flow rights and decreases with insiders' voting rights); Bebchuk, Kraakman & Triantis, *supra* note 122 (arguing that the agency costs associated with the controlling-minority structure are greater than those associated with either dispersed-ownership structure or controlled structure); Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, 124 YALE L.J. 1554 (2015) (arguing that maximizing long-term shareholder value may well destroy more value than maximizing short-term shareholder value). Others find disproportional control increases long-term shareholder value, *see* Lynne L. Dallas & Jordan M. Barry, *Long-Term Shareholders and Time-Phased Voting*, 40 DEL. J. CORP. L. 541 (2015) (finding firms that grant more voting rights to long-term shareholders outperform the market as a whole); Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560 (2016) (arguing that shareholders would benefit from disproportional entrepreneurial control due to the idiosyncratic vision of entrepreneurs).

company with disproportional control only when the benefits of control outweigh the agency costs of disproportional control. These two forces are competing and will change over time, even within a single company. This partly explains why one sees mixed results from empirical studies. The effect of disproportional control is dynamic, rather than static. This means different companies at different times may experience various levels of agency costs and benefits resulting from disproportional control. Therefore, the net effect of disproportional control will change over time.

The application of the above concepts can help explain the myth of Alibaba's extreme insider control governance. As illustrated in the following paragraphs, Jack Ma and the founding team at Alibaba have proven that they can create great value for investors, while committing themselves to not accruing excessive private benefits of control. By making voluntary commitments in the prospectus, the founders put a cap on the level of private benefits they could extract, thereby alleviating investors' concern over the potential expropriation risks of their wealth associated with Alibaba's governance structure. We argue that even though the founders disproportionally control the firm, Alibaba successfully persuades its investors that they can still gain value from such governance design because other factors are present, including capped agency costs, the founding team's experience increasing firm value for the investors based on their past reputation, and the high growth potential for the Chinese Internet industry.

A. VALUE CREATION BY THE FOUNDER

Any controlling shareholder who enjoys disproportionate control over a firm can be tempted by uncontestable voting powers and is likely to abuse such power to benefit him or herself. However, if the controlling shareholder has a long-term vision for the company and is uniquely future-oriented, shareholders may be better off granting the controlling shareholder absolute control to pursue an opportunity that only they could envision. Without absolute control, other shareholders or directors may not approve of the controlling shareholder's business decisions, as there is an information asymmetry problem—other shareholders or directors may not see, or may miss, the opportunity.[154] With absolute control, the controlling shareholder is able to realize their pursuit of idiosyncratic value and eventually increase the firm's value, which is thereby shared pro rata by all shareholders.[155] By granting the controlling shareholder disproportionate control, other shareholders are better off, as the value created by the controlling shareholder outweighs the agency costs of expropriating private benefits of control.

A successful entrepreneur usually carries great enthusiasm for the business he or she founds, and is more willing to devote enormous amounts

154. Goshen & Hamdani, *supra* note 153, at 579–81.
155. *Id.* at 572–74.

of time to pursuing his or her business goal.[156] Empirical studies have documented that founder participation matters.[157] Studies have shown that family ownership creates value only when the founder actively participates in the business.[158] In the past, families usually adopted control-enhancing mechanisms to exert control over their businesses when seeking outside finance.[159] In family firms with dual-class share structures, the benefits of control outweigh the costs of disproportionate control only when the founder actively participates in management.[160] If the descendants are in charge, the net effect of disproportionate control tends to be negative.[161] This means that the benefits the founders bring are large enough to offset the costs of disproportionate control. As a result, these empirical studies support our argument that Alibaba's investors expect that they would benefit from the participation of Alibaba's founders by granting them disproportionate control over the firm.[162] Jack Ma, being the spiritual leader and most reputable founder of Alibaba, sits on the apex of the control chain by holding the position of Partnership Committee member and continuity partner.[163]

Jack Ma has sought to mold Alibaba in his own image. Ma is a former English teacher who overcame enormous obstacles to build Alibaba into the world's largest online retailer.[164] He has done so, however, in a quite iconoclastic way. Ma, who claims not to understand technology, first used the Internet in 1995, and sought to build an online marketplace to link buyers and sellers.[165] He has identified six core values for his company—customers first, teamwork, embrace change, integrity, passion, and commitment—and

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156. *See, e.g.*, Noam Wasserman, *The Founder's Dilemma*, HARV. BUS. REV., Feb. 2008, at 102.

157. Belen Villalonga & Raphael Amit, *How Do Family Ownership, Control and Management Affect Firm Value?*, 80 J. FIN. ECON. 385, 402–03 (2006) (finding founder-CEOs or founder-chairman with a hired CEO creates the most value in family firms, as compared with descendant-CEOs); Dušan Isakov & Jean-Philippe Weisskopf, *Are Founding Families Special Blockholders? – An Investigation of Controlling Shareholder Influence on Firm Performance*, 41 J. BANKING & FIN. 1, 11–13 (2014) (finding that accounting performance is higher in Swiss family firms where the founder actively participates).

158. Villalonga & Amit, *supra* note 157, at 402–06.

159. Harry DeAngelo & Linda DeAngelo, *Managerial Ownership of Voting Rights*, 14 J. FIN. ECON. 33, 34 (1985); Ben Amoako-Adu & Brian F. Smith, *Dual-Class Firms: Capitalization, Ownership Structure and Recapitalization Back into Single Class*, 25 J. BANKING & FIN. 1083, 1096 (2001).

160. Villalonga & Amit, *supra* note 157, at 406–08; Isakov & Weisskopf, *supra* note 157, at 11–13.

161. Villalonga & Amit, *supra* note 157, at 402–03.

162. *Id.* at 406–08.

163. As a continuity partner, there is no retirement age for Jack Ma. He can only be removed for cause by majority vote of all partners of the Alibaba Partnership. Alibaba Prospectus, *supra* note 25, at 233.

164. *See* Steve Tobak, *How Alibaba's Jack Ma Became the Richest Man in China*, ENTREPRENEUR (Sept. 23, 2014), http://www.entrepreneur.com/article/237692.

165. *See* Michael Zakkour, *How Jack Ma's 'Crazy' Management Style Built a Technology Empire*, ENTREPRENEUR (Sept. 29, 2014), http://www.entrepreneur.com/article/237881.

closely tied the company's values to his own.[166] He has also sought to link his work with Alibaba with broader changes in China.[167]

Ma is often compared to Steve Jobs for his ability to anticipate and satisfy market trends.[168] For instance, Ma saw the huge potential for the Internet to change commerce in China at a time when only one percent of the country's population was online.[169] He also foresaw the potential for an online escrow—Alipay—to eliminate people's hesitance to conduct transactions online.[170] Ma now "has plans to disrupt China's commercial banking and insurance sectors."[171] Given Ma's entrepreneurial vision, his close association with Alibaba's values and actions, and his future commitments, Alibaba investors can reasonably expect that the value Ma will be able to create with stable control over Alibaba would be greater than the costs of expropriation if he were to extract private benefits for himself.

B. CREDIBLE COMMITMENTS BY THE FOUNDER

While founders bring idiosyncratic value to the firm, rational investors would not agree to invest if the risks of expropriation by the founders were unforeseeable. The investment decision of a rational investor is a trade-off between granting control and seeking protection from agency costs. If the founders want more control, then the investors will ask for more protection against potential expropriation. If the founders are not able to make commitments to limit the level of expropriation, rational investors may refuse to invest and the funding project will likely fail. This is called the commitment problem.[172] The fiduciary rules that constrain conflicts of interest and related party transactions are the key institutional constraint on expropriation of private benefits of control.[173] However, the effectiveness of fiduciary rules and judicial review depend on a firm's place of incorporation

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166. Paul Jankowski, *What the Core Values of Alibaba Can Teach Us*, FORBES (Sept. 30, 2014, 10:19 AM), http://www.forbes.com/sites/pauljankowski/2014/09/30/what-the-core-values-of-alibaba-can-teach-us/.

167. *See* Maria Shao, *Jack Ma: Alibaba Wants to Acquire Yahoo*, INSIGHTS BY STAN. BUS. (Sept. 1, 2011), https://www.gsb.stanford.edu/insights/jack-ma-chinas-alibaba-wants-acquire-yahoo.

168. Matt Sheehan, *Meet Jack Ma: The Steve Jobs of China is Just Getting Started*, HUFFINGTON POST (Jan. 23, 2015, 6:30 PM), http://www.huffingtonpost.com/2015/01/23/jack-ma-davos_n_6535052.html.

169. Neil Gough & Alexandra Stephenson, *The Unlikely Ascent of Jack Ma, Alibaba's Founder*, N.Y. TIMES (May 7, 2014), http://www.nytimes.com/2014/05/08/technology/the-unlikely-ascent-of-jack-ma-alibabas-founder.html?_r=0.

170. *See, e.g.*, Gady Epstein, *Alibaba's Ma Fights to Win Back Trust*, FORBES (Apr. 11, 2011, 6:00 PM), http://www.forbes.com/forbes/2011/0411/features-jack-ma-alibaba-e-commerce-scandal-face-of-china.html.

171. Bill George, *Jack Ma on Alibaba, Entrepreneurs, and the Role of Handstands*, N.Y. TIMES: DEALBOOK (Sept. 22, 2014, 12:46 PM), http://dealbook.nytimes.com/2014/09/22/jack-ma-on-alibaba-entrepreneurs-and-the-role-of-handstands/?_r=0.

172. Ronald J. Gilson & Alan Schwartz, *Corporate Control and Credible Commitment*, 43 INT'L REV. L. ECON. 119, 120 (2015).

173. *Id.* at 120–21.

because the law of the state of incorporation governs the internal affairs of a company.[174]

In the case of Alibaba, the place of incorporation is the Cayman Islands and the principle place of business is in China.[175] Therefore, Alibaba is not subject to the fiduciary laws of the State of Delaware, which is the jurisdiction with which most U.S. investors are most familiar. In addition, Alibaba has adopted the VIE structure, which further suffers from contract enforcement risks. For Alibaba's U.S. investors, the risk of expropriation by the controlling shareholders is relatively high. Hence, the controlling shareholders must make further commitments in order to persuade investors to continue funding their project at a reasonable price. Otherwise, the firm will likely suffer from high costs of capital with substantial discounts on the price of shares or, even worse, may not be able to receive financing in the capital markets at all.

In fact, as the founder and controlling shareholder of Alibaba, Jack Ma did make commitments in the IPO prospectus to assure outside investors that he would not accrue excessive private benefits of control, even with disproportional control over the company. First, with regard to the most controversial dispute over Alipay in 2011, Jack Ma transferred the ownership of Alipay to Ant Financial Services, over which he had total control at the time.[176] This was apparently a self-dealing transaction, which would have been subject to the procedural control and entire fairness scrutiny under Delaware law if Alibaba were to incorporate in the state of Delaware.[177] To eliminate concerns over expropriation by Jack Ma through Alipay, Ma made commitments in the prospectus to reduce his interest in Ant Financial Services to a level that was commensurate with his interest in Alibaba Group and in a manner by which he would not receive any economic benefit.[178]

Second, to alleviate concerns over extraction of private benefits of control, Jack Ma committed to donate all distributions he may receive by virtue of his 40 percent indirect interests in Yunfeng Capital to the Alibaba Foundation, a charitable nonprofit organization.[179] Jack Ma owns a 40

174. This is the so-called "internal affairs doctrine." *See, e.g.*, Edgar v. MITE Corp., 457 U.S. 624, 645 (1982); CTS Corp. v. Dynamics Corp., 481 U.S. 69, 89–90 (1987); Kamen v. Kemper Fin., 500 U.S. 90, 106 (1991); McDermott Inc. v. Lewis, 531 A.2d 206, 216 (Del. 1987).

175. Alibaba Prospectus, *supra* note 25, at 10.

176. *Id.* at 257.

177. The business judgment rule serves as a procedural safeguard of directors' decisions. In *Aronson*, the Delaware Supreme Court held that the business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the company." *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). If the shareholder successfully rebuts the presumption of the business judgment rule, then the burden of proof shifts to the directors to prove that the transaction is entirely fair to the shareholders. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).

178. Alibaba Prospectus, *supra* note 25, at 269.

179. *Id.*

percent stake in the general partnership of funds sponsored by Yunfeng Capital.[180] Yunfeng Capital regularly enters into co-investment transactions with the Alibaba business group, such as Youku Tudou and CITIC 21 investments.[181] These investments also constitute self-dealing transactions between directors and the company. However, like Ma's commitments with respect to Alipay, his commitment to donate the distributions received from Yunfeng Capital help to eliminate shareholders' concerns over potential expropriation.

Third, under the VIE structure, the variable interest entities in China will, by contractual arrangements, transfer substantially all of the economic risks and benefits to the WFOE in China, which is controlled by Alibaba Group Holding Limited, the NYSE-listed company. Such structure enables U.S. investors to share the profits of the business in China, which otherwise would be impossible given China's foreign investment restriction. Ma, being the major shareholder of these variable interest entities in China, has considerable control over the business and finance of the variable interest entities in China.[182] To address the concern over the VIE structure, Jack Ma also committed to disclaim all economic benefits from his ownership for the benefit of Alibaba and to enter into agreements to transfer any benefits to Alibaba when permitted by applicable law.[183]

Finally, there was a concern over the control premium received by disproportional controllers in the event of a change of control. The fear was that these controlling shareholders would receive higher consideration for selling their block shares, while noncontrolling shareholders would not benefit from the controlling shareholders' inflated share value. This control premium was regarded as one form of a private benefit of control.[184] Thus, Alibaba's Articles of Association prohibit partners from receiving control premiums in the event of a change of control and require that all common-share shareholders receive the same consideration.[185]

V. POLICY RECOMMENDATIONS

The unique corporate ownership and control structure of U.S.-listed Chinese firms poses a new and complex set of risks for regulators in the

180. "Jack Ma has an indirect 40% interest in . . . Yunfeng Capital, including Yunfeng Fund, L.P., which was established in June 2010, Shanghai Yunfeng Fund, which is an RMB fund established in May 2011, and Yunfeng Fund II, L.P., which had its final closing on May 15, 2014. A trust established for the benefit of Jack and his family has committed US$26 million and US$4 million as a limited partner and as a general partner, respectively, to Yunfeng Fund II, L.P., which has over US$1.0 billion in capital commitments." *Id.* at 269.

181. *Id.*

182. *Id.* at 10–11.

183. *Id.* at 269.

184. Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN 537, 538 (2004).

185. Alibaba Prospectus, *supra* note 25, at 233.

United States. The SEC, which has administrative authority over companies listed on U.S. exchanges, has struggled with the complexity of regulating VIE structures involving mainly overseas operations. Below are several regulatory proposals for mitigating the risks posed by the VIE and disproportional insider control structures.

A. ADEQUATE DISCLOSURE OF RISKS

Due in no small part to geographic distance and different legal systems, investors often lack the resources to complete due diligence on U.S.-listed Chinese firms like Alibaba. The complex contractual arrangements behind a VIE structure as well as the bewildering partnership control structure compound this risk of misunderstanding. Full disclosure of risk is often not forthcoming. For instance, a recent shareholder lawsuit against Alibaba and its Partnership Committee alleged that the company failed to disclose the rampant sale of counterfeit goods and other business practices posing legal risk in China.[186] Even with full disclosure, it would likely take a lawyer days to fully understand the governance structure of Alibaba, let alone an individual investor who may have no legal knowledge.

Effective regulation of companies employing the VIE structure will necessarily require more overt explanations of the risks to shareholders. Requiring companies who use the VIE structure to list under a name or ticker symbol indicating its legal structure and its status under Chinese law could help. Current regulations permit a company like Alibaba to mention discretely in its prospectus that a partnership reserves the right to nominate the majority of the seats on its board and in fact, in the case of Alibaba, a five-member partnership committee controls over the partnership.[187] For most investors, however, this level of disclosure offers an insufficient warning of risk.

Furthermore, current securities disclosure regulations do not sufficiently require companies to disclose weaknesses in their corporate governance structure. Buried behind eighteen pages of risk disclosure in Alibaba's prospectus, including risks such as natural disasters and currency

186. *See* Khunt v. Alibaba Grp. Holding Ltd., 102 F.Supp.3d 523, 527 (S.D.N.Y. 2015).

187. All foreign private issuers must submit Form F-1 to the SEC as their registration statement under the Securities Act of 1933, which should include information under Part I of Form 20-F in the prospectus. *See* U.S. Sec. & Exch. Comm'n, Form F-1: Registration Statement Under the Securities Act of 1933 (requiring disclosure in accordance with Form 20-F). Item 6 of Form 20-F requires a company to disclose "any arrangement or understanding with major shareholders" with regard to director election. *See* U.S. Sec. & Exch. Comm'n, Form 20-F: Registration Form/Annual Report/Transition Report/Shell Company Report. Item 7 requires a company to disclose "whether the company is directly or indirectly owned or controlled by" another entity. *See id.*

fluctuations, are disclosures of risks associated with the VIE structure.[188] Amongst its disclosures, Alibaba reveals its most telling risk:

> If the PRC government deems that the contractual arrangements in relation to our variable interest entities do not comply with PRC governmental restrictions on foreign investment, or if these regulations or the interpretation of existing regulations changes in the future, we could be subject to penalties or be forced to relinquish our interests in those operations.[189]

For a risk that could strike at the heart of a company's operations, this is paltry disclosure.

As more Chinese companies begin listing on U.S. exchanges, the SEC will need to consider new ways to ensure that investors understand their structure, whether it be a VIE or otherwise, that their risks are disclosed more prominently and clearly, and that investors can make informed decisions based upon an understanding of those risks.

B. PROBES ON CHINESE CASE LAW AND REGULATIONS

A fundamental part of understanding the risks associated with the VIE is determining what Chinese law has to say regarding foreign investment in China. Although the legality of the VIE structure is still very much ambiguous, Chinese court opinions and regulations shed some light on the legality of the VIE.

In 2012, China's highest court, the Supreme People's Court, invalidated contracts designed to give a 6.5 percent stake in the China Minsheng Banking Corporation Ltd. (Minsheng Bank) to Chinachem Financial Services (Chinachem), a Hong Kong-based company.[190] In 1995, Chinachem and China Small and Medium Enterprises Investment Co. Ltd. (SME) entered into an entrustment agreement and a loan agreement, through which Chinachem provided funding through the loan agreement to SME for it to purchase shares in Mingsheng Bank and SME held shares of Minsheng Bank on behalf of Chinachem to circumvent the foreign investment restriction in the financial industry.[191] The Court held that the agreements amounted to "conceal[ing] illegal intentions within a lawful form,"[192] in violation of

188. Alibaba Registration Statement, *supra* note 30, at 39. Such risks entail anti-takeover provisions and the aforementioned dominance of the partnership structure, which limits the ability to nominate and elect members of the board of directors. *Id.*

189. *Id.* at 40.

190. Ming Si Zhong Zi Di 30 Hao (华懋公司与中国中小企业投资有限公司委托投资纠纷上诉案，最高人民法院 (2002) 民四终字第 30 号终审判决) [Chinachem Fin. Servs. v. China Small and Medium Enters. Inv. Co.] Sup. People's Ct. (Oct. 29, 2012) (on file with the *Brooklyn Journal of Corporate, Financial & Commercial Law*); *see also* Charles C. Comey et al., *China VIEs: Recent Developments and Observations*, MORRISON & FOERSTER (Aug. 15, 2013), http://media.mofo.com/files/Uploads/Images/130716-Variable-Interest-Entities-China.pdf.

191. Li, *supra* note 41, at 594.

192. *See* Comey et al., *supra* note 190.

Article 52 of PRC Contract Law.[193] Despite the significant differences in the deal structure of the agreements between Chinachem and SME and typical VIE agreements, they both share a similar purpose of circumventing foreign investment restriction.[194] Although the Chinachem-Minsheng case did not directly involve a VIE structure, it did raise some red flags regarding the validity of the VIE structure.[195] As a result, the SEC began a lengthy correspondence with Beijing-based BAIDU Inc., China's number one search engine, regarding its VIE structure and recent developments under Chinese law.[196]

This type of correspondence should be obligatory. In light of China's Draft Foreign Investment Law, the viability of the VIE structure has only begun to be called into question. Creating a rigorous correspondence mechanism can go a long way toward mitigating the risks associated with it. Furthermore, the SEC must keep up-to-date with developments in Chinese law, both legislative and case law. This can ensure that investors, and the regulatory authorities charged with protecting them, are not one-step too late.

C. SHAREHOLDER DEMOCRACY AND LONG-TERM SHAREHOLDER VALUE

Overall, empirical results tend to show that the disproportional control structure and anti-takeover measures negatively correlate with firm value and thus are value destroying.[197] In the case of Alibaba, however, value creation by the founders and the growth of the Chinese Internet industry might outweigh the costs of private benefit extraction from the IPO. There is no guarantee that Alibaba's founders will continue to create value or that the Chinese Internet industry will continue to grow. However, this extreme partnership-control governance structure will nevertheless continue indefinitely, as any change to the Partnership's nomination rights and related provisions would require 95 percent of shareholder votes.[198] Such a high threshold implies that the Partnership will continue to rule the empire as long as Alibaba remains a public company.

In the years to come, Alibaba may face succession problems, just as family firms do. Unfortunately, evidence from family firms suggests that

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193. Contract Law of China, *supra* note 60, art. 52(3) (A contract is invalid when "there is an attempt to conceal illegal goals under the disguise of legitimate forms.").

194. Li, *supra* note 41, at 594–95.

195. *Id.*

196. *See* Baidu, Inc., SEC Comment Letter, 2013 WL 5757152 (Oct. 18, 2013); *see also* Shai Oster & Dune Lawrence, *Baidu Forced to Add Warnings as Regulators Focus on China Stocks*, BLOOMBERG (Dec. 17, 2013, 5:27 PM), http://www.bloomberg.com/news/articles/2013-12-15/baidu-forced-to-add-warnings-as-regulators-focus-on-china-stocks.

197. *See* Gompers, Ishii & Metrick, *supra* note 13; Gompers et al., *supra* note 136; Bebchuk & Cohen, *supra* note 136; Bebchuk, Cohen & Ferrell, *supra* note 136; Bebchuk, Cohen & Wang, *supra* note 136.

198. Alibaba Prospectus, *supra* note 25, at 231.

successors usually perform worse than founders do.[199] The balance between value creation and value destruction of corporate control will change once the successors take over. The inflexibility of Alibaba's governance structure will begin to harm shareholder value once the agency costs of control begin to outweigh the benefits. This is partly due to the controlling shareholder's decision to demolish the voting mechanism, which is designed to enable the firm to adapt to different situations through constant shareholder votes. Shareholders are the residual claimants of firm value and are most suitable to make business decisions. Destroying the shareholder voting mechanism might bring short-term gains to the firm, however, it risks leading to eventual harm of long-term shareholder value.

There is no single governance model that will fit all kinds of firms in all stages. Even within the same firm, adjustments must be made in order to adapt to a fast-changing environment. Shareholder voting is one of the governance mechanisms designed to keep the governance structure evolving. Therefore, even though granting Jack Ma and the other founders excessive control might be efficient at the time of Alibaba's IPO, it is inefficient in the long term because it blocks the opportunity for change by shareholder vote. Alibaba's 95 percent threshold is almost unachievable for public listing companies. Thus, this super-majority provision has a de facto effect of ruling out the possibility for change by shareholder votes. A sustainable governance design should ensure that shareholders can pursue shareholders' welfare and change an inefficient governance structure through voting. Accordingly, this Article argues that the SEC should use its discretion to reject governance structures that require shareholders to meet an unreasonably high threshold to amend the articles of association for public companies.

CONCLUSION

The innovative corporate ownership and control arrangements of Alibaba pose a unique set of challenges for U.S. regulatory authorities. On the one hand, they are a testament to the attractiveness of U.S. equity exchanges, and provide an opportunity for American investors to participate in China's economic growth. On the other hand, these unique corporate governance and control arrangements are poorly understood and thereby improperly governed. The VIE structure carries the risk of being declared illegal under Chinese law, which creates inherent (and potentially excessive) risk for investors, especially those unfamiliar with the VIE. The unusual partnership control structure, together with various anti-takeover measures adopted by Alibaba, significantly increase the entrenchment agency costs to U.S. investors. Crafting an effective internal and external governance mechanism for managing such risks and allowing investors to make informed decisions

199. Villalonga & Amit, *supra* note 157, at 406–08; Isakov & Weisskopf, *supra* note 157, at 11–13.

will be crucial. As more Chinese companies seek to raise capital abroad, especially in the United States and other advanced capital markets, this mandate will only become more important.