

## *Alibaba: More Money, More Problems*

By Timothy Prosky\*

The surge in capital raised by initial public offerings (“IPOs”) in 2014 suggests strong investor confidence in the U.S. marketplace.<sup>1</sup> Last year, the U.S. exchanges released 288 IPOs, raising \$95.2 billion in capital, which was a 54% increase in capital over 2013.<sup>2</sup> With so many eager investors looking to cash in on the next great IPO, the use of class action lawsuits to remedy failed investments has also dramatically increased.<sup>3</sup>

One IPO in particular headlined the 2015 class action outbreak: the offering of Alibaba, the Internet shopping behemoth. Alibaba’s September IPO became the largest ever, raising \$25 billion.<sup>4</sup> Unfortunately, the success of the company’s IPO came to a screeching halt in late January when the stock price plummeted over \$13 in a two-day span.<sup>5</sup> Not surprisingly, a class action lawsuit ensued.<sup>6</sup>

The plaintiff’s complaint was filed on January 30, 2015, in the Southern District of New York on behalf of all persons who purchased Alibaba’s stock between October 21, 2014, and January 28, 2015.<sup>7</sup> It alleges that “Alibaba and certain of its officers and/or directors” violated Rule 10b-5 promulgated under the Securities Exchange Act of 1934, by “issuing materially false and misleading statements regarding the soundness of the [c]ompany’s business operations, the strength of its financial prospects and concealing substantial ongoing regulatory scrutiny.”<sup>8</sup>

In order for the plaintiff to succeed on the class’s 10b-5 claim, there must be shown (i) manipulation or deception (through misrepresentation and/or omission) by Alibaba (ii) that was material and (iii) occurred “in connection with” the purchase or sale of its securities and (iv) was perpetrated with scienter.<sup>9</sup> Scienter refers to intent or knowledge of wrongdoing.<sup>10</sup>

---

\*Timothy Prosky is a recent graduate of Elon University School of Law. He completed his undergraduate work at the University of South Carolina, where he received degrees in Accounting and Financial Real Estate.

<sup>1</sup> Press Release, Ernst & Young LLP, 2014 Realizes Strongest US IPO Numbers in Over a Decade (Dec. 10, 2014), *available at* <http://www.ey.com/US/en/Newsroom/News-releases/news-2014-realizes-strongest-us-ipo-numbers-in-over-a-decade>.

<sup>2</sup> *Id.*

<sup>3</sup> Kevin LaCroix, *Chinese Internet Giant Alibaba Gets Hit with IPO-Related U.S. Securities Class Action Lawsuit*, D&O DIARY (Feb. 3, 2015), <http://www.dandodiary.com/2015/02/articles/securities-litigation/chinese-internet-giant-alibaba-gets-hit-with-ipo-related-u-s-securities-class-action-lawsuit/>.

<sup>4</sup> *Id.*

<sup>5</sup> Complaint for Violations of the Federal Securities Laws at 3, *Khunt v. Alibaba Grp. Holding Ltd.* No. 1:15-cv-00759-NRB (S.D.N.Y. Jan. 30, 2015) [hereinafter *Complaint*].

<sup>6</sup> *Id.* at 1.

<sup>7</sup> *Id.* at 22.

<sup>8</sup> *Id.* at 2–3.

<sup>9</sup> 17 C.F.R. § 240.10b-5 (2011).

<sup>10</sup> *See SEC v. Falstaff Brewing Co.*, 629 F.2d 62, 76 (D.C. Cir. 1980).

The factual basis for the alleged 10b-5 violation revolves around a meeting held in July of 2014 between Alibaba and China's State Administration of Industry and Commerce ("SAIC") during which the SAIC brought to the company's attention a variety of "highly dubious—even illegal—business practices" that the SAIC was then actively clamping down on and that threatened the core of Alibaba's business.<sup>11</sup> The meeting allegedly occurred two months prior to the release of Alibaba's IPO, and the plaintiff claims that Alibaba should have disclosed what the SAIC disclosed to Alibaba so that future statements would not be misleading.<sup>12</sup> The plaintiff's complaint stresses that, without disclosure of the meeting with the SAIC, the statement in its registration statement and during subsequent interviews that Alibaba is a trusted brand is misleading and was never corrected throughout the class period.<sup>13</sup> On January 28, 2015, news broke that the SAIC had released a white paper accusing Alibaba of selling counterfeit and illegal goods and accepting bribes from merchants.<sup>14</sup> In the white paper, the SAIC indicated that it had met with Alibaba and disclosed to company executives in July of 2014 the exact concerns raised in the report.<sup>15</sup> This resulted in a 4% drop (\$4.49 per share) in Alibaba's share price on January 28th, followed by another \$8.64 per share drop on the 29th after the disclosure of Alibaba's underachieving fourth quarter financials were released.<sup>16</sup>

Alibaba Group's Executive Vice Chairman, Joe Tsai, addressed the white paper's allegations on January 29, 2015, claiming that the first time Alibaba had seen the white paper was when it was posted on the SAIC website and that the meeting with the regulators was a regularly scheduled meeting in which the parties "discussed working together to create a process to address key areas of consumer protection and orderly marketplace operations in online commerce."<sup>17</sup> Tsai also pointed out that SAIC had removed the white papers from its website on January 29th and that Alibaba believes the issuance of the white papers was an inaccurate and unfair attack against the company.<sup>18</sup>

At first blush, it would appear that Alibaba clearly violated 10b-5: investors are told in the registration statement and on other occasions that Alibaba is a reputable corporation, and then five months later it is revealed that Alibaba has been engaging in illegal businesses. However, after a closer examination, it is likely that the plaintiff class will face great difficulties proving that Alibaba's misstatement was material and that the corporation acted with scienter.

The issue of materiality in this case can be analyzed through the lens of *Longman v. Food Lion*.<sup>19</sup> In *Longman*, the court makes it clear that, if an alleged misstatement or

---

<sup>11</sup> Complaint, *supra* note 5, at 1–2.

<sup>12</sup> *Id.* at 2.

<sup>13</sup> *Id.* at 6–11.

<sup>14</sup> *Id.* at 6–7.

<sup>15</sup> *Id.* at 2.

<sup>16</sup> *Id.* at 3.

<sup>17</sup> Press Release, Alibaba Grp., Joe Tsai Addressed Recent Interaction with SAIC (Jan. 29, 2015), available at <http://www.alibabagroup.com/en/news/article?news=p150129a>.

<sup>18</sup> *Id.*

<sup>19</sup> 197 F.3d 675, 685 (4th Cir. 1999).

omission is already incorporated into the total mix of information available to the investor and the market has had a full opportunity to evaluate these claims and reflect their risks in the market price, then the alleged omission is not material to the company's stock price.<sup>20</sup> In *Longman*, the court determined that the alleged omission of information pertaining to unfair labor practices was not material because the information had already been incorporated into the price of the stock through the efficient market, since the news of Food Lion's unfair labor practices were already known to the public due to a national news broadcast exposing the labor violations.<sup>21</sup> Although not identical to *Longman*, Alibaba may claim that, prior to the release of Alibaba's IPO and the start of the class period, the U.S. Trade Representative had declared Alibaba a notorious market for counterfeit goods (this label was later removed) and former executives had been previously cited for corruption and bribery.<sup>22</sup> Therefore, similar to *Longman*, the efficient market may have incorporated the previously released information about Alibaba's history with bribery and dealings of counterfeit goods into the price of the stock, thus making the alleged misstatement(s) immaterial.

If the class period had begun on the initial release of the IPO, plaintiff would have a much stronger argument against the efficient market defense, since the market would not have been setting the price, but rather, the lead underwriter would have been the price setter. However, since the class period began a month after the release of the IPO, the market had the opportunity to incorporate all available information into the price of the stock.

In addition, the swift denial by Tsai coupled with the removal of the white papers brings into question whether the Alibaba executives possessed scienter. As mentioned above, the mysterious fact that the white papers were removed from the SAIC website the day after its release, in addition to Tsai's statements on January 29th, casts some doubt as to whether the executives were aware of the SAIC investigation. Without knowledge of the potential violations, the plaintiff will have a difficult time showing scienter.

Furthermore, the fact that Alibaba's financials never faltered amidst similar allegations of bribery and dealings in counterfeit goods may have influenced Alibaba executives to believe that the issues raised by SAIC would not materially affect the stock price. If Alibaba believed that the allegations would not materially affect the stock price, then the company's objective in concealing the information was not to deceive its investors by omitting the information.<sup>23</sup>

Even if the plaintiff can prove materiality and scienter, the plaintiff is still left with the difficult task of collecting on the judgment. Specifically, collection would be

---

<sup>20</sup> *Id.* at 685.

<sup>21</sup> *Id.*

<sup>22</sup> Gregory J. Millman, *Alibaba Class Action Suit Faces Unusually Long Odds*, WALL ST. J. (Feb. 3, 2015, 3:22 PM), <http://blogs.wsj.com/riskandcompliance/2015/02/03/alibaba-class-action-suit-faces-unusually-long-odds/>.

<sup>23</sup> *Id.*

problematic because foreign court judgments are unenforceable in China.<sup>24</sup> This means that the plaintiff would only be able to collect against Alibaba's assets outside of China, which may be limited since the company's operations are concentrated in China.

Due to these hurdles, a section 11 claim, in addition to the 10b-5 claim, would have been more appropriate in this situation. A section 11 claim can be brought against any person who signed the registration statement or any director of the corporation, and the plaintiff does not need to prove that the defendants possessed scienter.<sup>25</sup>

Another interesting aspect of this class action lawsuit involves Alibaba's Articles of Association, which contain a fee-shifting provision.<sup>26</sup> Alibaba's fee-shifting provision would force the plaintiff to pay the Alibaba's attorney's fees and court costs if Alibaba and the other defendants were to prevail in court or on a motion to dismiss. This creates a lose-lose situation for the plaintiff class, since, if it is successful on its claim, it will face the uphill battle of collecting on Alibaba's assets in China, and if it loses this class action lawsuit, it will have to reimburse all of the company's legal fees.

Although class action lawsuits in the wake of major IPOs are not uncommon, there is reason to be concerned as to this particular class action due to the fact that, even if the plaintiffs can prove that the misstatement was material and that the company's executives acted with scienter, the inability to collect on Alibaba's China-based assets leaves little optimism for a major payday.

---

<sup>24</sup> Marcus Wang, *Dancing with the Dragon: What U.S. Parties Should Know About Chinese Law When Drafting a Contractual Dispute Resolution Clause*, 29 NW.J. INT'L L. & BUS. 309, 312 (2009).

<sup>25</sup> 15 U.S.C. § 77k(a) (2006).

<sup>26</sup> Alibaba Group Holding Ltd. Memorandum and Articles of Association (2013), available at <https://www.sec.gov/Archives/edgar/data/1577552/000119312514333674/d709111dex32.htm>.