Chinese business executives today face a new and unfamiliar challenge. Their companies have become one of the leading targets of securities litigation in the United States.

Despite the fact that they make up less than one percent of the total number of publicly traded companies in the U.S., Chinese companies are named in nearly 25 percent of the securities class action suits filed so far in 2011. The reasons for this, and the steps companies and their directors and officers must take to protect themselves, must be understood by companies that wish to avoid becoming part of this statistic.

Why are Chinese companies suddenly being targeted in U.S. securities litigation? The answer lies in part in the reasons why those businesses are becoming U.S. public companies.

**Going Public in the U.S.**

Simply put, Chinese companies are transforming themselves into U.S. public companies because that is the most efficient way for them to raise capital. One can reasonably assume that Chinese businesses would prefer to go public in China. That is the business and regulatory environment with which they are most familiar.
Unfortunately, it is difficult for companies to list their shares on the Shanghai and Shenzhen exchanges. Companies must obtain the approval of the China Securities Regulatory Committee (CSRC). That can take years. Companies must also have minimum share capital of CNY30 million (roughly US$4.7 million) and must have been profitable for the preceding three years. While the Shenzhen Exchange’s ChiNext board has made it easier for smaller companies to list their shares, the approval process is still lengthy.

The difficulty of becoming a public company in China has led companies to look abroad for opportunities to list their shares. While Hong Kong, Singapore and Canada are popular destinations, companies increasingly are listing their shares in the U.S. One reason for this is the relative ease of using a reverse merger to gain access to U.S. public capital markets. Some refer to this by its more nefarious-sounding name, “backdoor merger.”

By purchasing a publicly held shell company in the U.S. and then merging the Chinese company into it, the Chinese private company and its owners can avoid the delay, burden and expense of conducting an initial public offering (IPO) in the U.S. That may explain why 159 Chinese companies completed reverse mergers with U.S. shell companies between January 1, 2007 and March 31, 2010. During the same time period, only 56 Chinese companies conducted IPOs.

While reverse mergers are also possible in other countries, generally speaking, there are fewer barriers to such transactions in the United States. Those barriers are getting higher though.

Earlier this year, NASDAQ, the New York Stock Exchange (NYSE) and the American Stock Exchange (NYSE Amex) filed proposed rule changes with the Securities and Exchange Commission (SEC) to strengthen the listing requirements for reverse merger companies. On November 8, 2011, the SEC approved changes applicable to companies listing on those exchanges. The new rules require reverse merger companies to:

- Complete a one-year “seasoning period” following the reverse merger, during which the company’s shares are traded in the U.S. over-the-counter market or on another regulated U.S. or foreign exchange.
- File all required reports with the SEC, including audited financial statements.
- Maintain a specified minimum share price for at least 30 of the 60 trading days prior to the date of its listing application.

A company will be exempt from these requirements if it either completes a substantial firm commitment underwritten public offering in connection with its listing, or has filed at least four annual reports containing all required audited financial statements with the SEC and completed the one-year “seasoning period” described above.

**Key Issues Drive Growth of Litigation**

**Reverse Mergers**

Many observers believe the use of reverse mergers has contributed to the problems alleged in the growing number of securities class action suits against Chinese companies.
A reverse merger lacks the thorough scrutiny that an initial public offering typically generates. Some believe this lack of scrutiny prevents Chinese companies from learning what is expected of public companies and their management in the U.S.

An IPO in the United States is a rigorous and lengthy process. Companies spend months working with their auditors and securities counsel, as well as with the SEC, to assure that the company complies with all requirements for public companies. The lack of that level of preparation and review arguably could leave a company ill-prepared for a future as a U.S. public company.

**Underdeveloped Corporate Governance**

Public companies in the United States are expected to adhere to standards of corporate governance that may be different than those that exist in China. Reports published by the credit rating agencies Moody’s and Fitch in July 2011 noted signs of weakness in the corporate governance of the Chinese companies analyzed. The problems noted include:

- The concentration of ownership in a few key directors and officers.
- Independent directors serving on boards for long periods.

- The prevalence of large transactions with related parties.

Fitch noted the effect that weak corporate governance may be having on the rise of litigation in the U.S., stating that “overseas investors are now undertaking the job that China’s underdeveloped capital market has hitherto struggled to address—challenging Chinese corporate management to adopt higher international standards.”

**Inadequate Audits**

Allegations of accounting irregularities are common in shareholder lawsuits against Chinese companies. Problems with financial audits clearly are contributing to the growth of such suits. In a June 2011 Investor Bulletin, the SEC cited this as a risk factor for investments in reverse merger companies, stating:

[S]ome of the foreign companies that access the U.S. markets through the reverse merger process have been using small U.S. auditing firms, some of which may not have the resources to meet their auditing obligations when all or substantially all of the private company’s operations are in another country. As a result, such auditing firms might not identify circumstances where these companies may not be complying with the relevant accounting standards.

The U.S. Public Company Accounting Oversight Board (PCAOB) made similar observations in a March 2011 report. The PCAOB specifically noted that many audits were performed by firms in China other than the ones retained by the company, and that their work did not comply with applicable standards. Some have alleged that audit deficiencies extend beyond shoddy work. Allegations have even been made recently by short seller Muddy Waters Research that partners in Chinese offices of Big 4 accounting firms have conspired with their clients to defraud investors.

A number of recommendations have been made to improve audits of Chinese companies. These include requiring firms auditing Chinese companies to have an office in China, requiring audit letters to be signed by individual partners, and requiring the signing partner to speak Chinese.
PCAOB and Chinese regulators are holding ongoing discussions to facilitate closer cooperation and joint audit inspections.

**Short Sellers**

The activities of short sellers have surely had an effect on the growth of litigation against Chinese companies. Organizations such as Muddy Waters and Citron Research, as well as individual investors, study companies that they believe may be engaged in fraud. They take a short position in the stock, publish reports discussing their findings, and then profit when the stock value plummets in a wave of selling that follows the release of the reports.

After the stock price drops, law firms that specialize in representing aggrieved investors then spring into action and begin their own investigations of the companies. Inevitably one or more firms file class action lawsuits on behalf of investors. Short sellers arguably are indirectly responsible for litigation in the U.S. and Canada against RINO International Corporation, Harbin Electric, Inc., Sino-Forest Corporation and many others.

Some people will argue that the research published by short sellers is no more honest than the frauds it purports to reveal. Companies such as Deer Consumer Products, Inc., and Sino Clean Energy, Inc., have even taken the step of filing defamation lawsuits against short sellers.

The case involving Deer Consumer Products is a good illustration of the problem. In March 2011, reports describing alleged fraud at Deer were published by analyst “Alfred Little.” Deer has alleged that “Alfred Little” is a fictitious character used to disguise the identity of short sellers working together illegally to drive the company’s stock price down. The March 2011 reports led to a shareholder class action lawsuit being filed in May 2011 that Deer asserts is false and defamatory because it repeats the allegations made by the short sellers.

A few months after it filed suit against “Alfred Little,” Deer reported in a press release that “Alfred Little” offered to retract certain articles in return for Deer withdrawing a subpoena in the lawsuit. If accurately reported by Deer, the offer from “Alfred Little” would seem to suggest that its reports may not have been entirely trustworthy. If other short sellers are publishing inaccurate research, they may well be responsible for unwarranted shareholder litigation.
The Current Legal and Regulatory Environment

Regulatory Investigations

When allegations of securities fraud are made against a company and its management, regulators pay attention. In 2010, the SEC began investigations of Chinese companies and the use of reverse mergers to become U.S. public companies. In September 2011, the SEC’s Director of Enforcement, Robert Khuzami, stated that the U.S. Department of Justice (DOJ) is actively involved in the investigations.

Being a target of an investigation by the SEC, DOJ and other regulatory and law enforcement entities can be very costly. A company must retain lawyers to help it prepare responses to broad requests for information and documents. If individual directors and officers are targeted, they too will need legal representation. An investigation can also be costly in terms of the time required of a company’s senior management and other staff to respond.

The SEC is also investigating Chinese companies’ advisors, and is pursuing settlements of perceived misconduct by them. For example, the SEC investigated the audit work performed by accounting firm Moore Stephens Wurth Frazer & Torbet LLP (MSWFT) for China Energy Savings Technology, Inc. (China Energy), and found that the firm’s improper work allowed China Energy to overstate earnings per share and revenues in several quarterly and annual reports filed with the SEC. The SEC’s December 2010 settlement with MSWFT included a requirement that audit fees be disgorged as well as a number of nonmonetary elements.

Securities Litigation

While investigations by the SEC and others may be worrisome for Chinese companies, securities suits by shareholders may be a bigger concern.

Under U.S. law, a single shareholder may bring suit on behalf of all of a company’s shareholders. Those suits, known as class actions, carry the potential for immense damage recoveries against a company and its directors and officers who face possible personal liability. A shareholder may also bring a suit on behalf of the company against the company’s directors, alleging that the directors breached their fiduciary duties owed to the company. These actions are known as shareholder derivative suits. Chinese companies are seeing increasing numbers of both types of lawsuits.

Litigation against Chinese companies and their directors and officers poses unique challenges to American plaintiffs. The fact that the companies, their records, their management, their records, and most if not all of their board members are located in China creates logistical problems for plaintiffs and their attorneys which can be difficult and expensive to overcome. These problems do not appear to be deterring suit filings, however.

Securities litigation typically is very expensive to defend. Legal expenses frequently total several million dollars by the time the litigation is resolved. These costs can increase substantially if it becomes necessary for certain directors and officers to be represented by separate counsel. One of the main drivers for litigation expense now is the discovery of a company’s electronic records. Costs to prepare and produce such records for disclosure to a plaintiff can easily exceed US$1 million.

At the risk of stating the obvious, the cost to settle securities litigation also can be very significant. According to a report published by Cornerstone Research, in 2010 the average settlement in a securities class action was US$36 million while the median settlement was US$11 million.

Settlements are driven by the reduction in a company’s market capitalization when the alleged fraud is disclosed to the
investing public. Companies with a large market capitalization will generally expect to see larger settlements than will smaller companies.

In addition to being financially expensive, securities litigation can be a tremendous distraction to a company’s management. Executives’ attention necessarily is diverted to responding to the allegations made, selecting counsel, responding to discovery, answering inquiries from regulators and possibly the exchanges where the company’s shares are traded, and many other matters related to the lawsuits.

D&O Insurance—Getting Coverage for a Securities Claim

One of the distractions a company may face is managing its directors and officers liability insurers. This comes as a surprise to many companies who buy D&O insurance for the peace of mind it brings.

D&O insurers may have grounds to reject all or part of a securities claim. For example, if a company’s financial statements are not accurate, and they were submitted to insurers as part of the company’s application for coverage, the insurer may be able to assert that the inaccuracies preclude coverage or possibly that they allow the policy to be voided as to some or all insureds. While this is a problem that can be minimized through appropriate changes to policy language, it cannot be eliminated completely.

Other significant issues that could cause a D&O carrier to refuse coverage include:

- The ability of insurers to decline coverage for claims and parties that are not covered under the policy.

If a D&O insurer believes that it has a valid defense to coverage, it will inform the company and may conduct an investigation of the facts that bear on that defense. That investigation may add distractions to the swirl of challenges facing a company from the securities litigation.

While D&O insurers may decline coverage in some cases, it is far more common for insurers to reserve their rights on issues that may affect the availability of coverage and to work closely with companies to defend the litigation. The insurers may have the right to appoint or approve defense counsel and will insist on being consulted throughout the course of the litigation.

Companies need to treat their insurers as partners who have the right to be involved in the litigation. It typically benefits a company to tap the insurers’ wealth of experience to resolve claims on the best possible terms.

Constant and effective communication with insurers is essential. Companies and their defense counsel should speak regularly with insurers, including any excess insurers, to discuss strategies for managing and settling the litigation and any investigations by regulators. Insurers need to be fully informed about the facts and evidence relevant to the claim. This will assure that the insurers are able to respond quickly when they are asked to make decisions concerning the claim.

It is critically important for companies to understand and anticipate insurers’ coverage positions. If coverage problems can be identified and proactively addressed early in a claim, they can often be minimized. That can result in a larger claim payment. The failure to do this may make it extremely difficult to resolve the insurance claim on favorable terms.
Managing the Risk of Securities Litigation

Fundamentally, a company can manage the risk of securities litigation by mitigating the problems that could lead to a suit being filed and by transferring the financial risk of litigation to insurers.

Directors and officers can manage their own risk of personal liability by assuring that the company is obligated to indemnify them to the maximum possible extent.

Mitigating the Risk

A growing number of Chinese companies are responding to the risk of securities litigation in the U.S. by going private. This trend is being fueled in part by the effect that the wave of investor skepticism is having on the share prices of Chinese companies. The existence of bargain share prices is attracting the attention of private equity groups that reportedly are working with companies to take them private.

While ceasing to be a U.S. public company will eliminate the scrutiny and regulatory burden that public companies must endure, it also chokes off the access to capital that motivated companies to become public in the first place. Privatization clearly is not the answer for most companies.

Companies interested in mitigating the risk of being sued in securities litigation in the U.S., or being targeted by the SEC or other regulators, must focus on transparent management of the company, good corporate governance, and honest and full disclosure of business and financial information. We are confident the vast majority of U.S.-listed Chinese companies do this now.

Transferring the Risk

A robust D&O insurance program is essential to transfer the financial risks that securities litigation and investigations create. Companies should carefully consider the following issues when evaluating their D&O insurance needs:

- Is the company purchasing enough insurance coverage given the costs inherent in securities litigation?

In our experience, many Chinese companies buy amounts of D&O coverage that are not sufficient to cover the cost to defend and settle securities suits brought against them.

- Are the terms and conditions of the company’s current policy state-of-the-art?

D&O insurers have become increasingly innovative over the past two years and are willing to expand coverage in significant ways. Companies must assure that their policy wordings incorporate as many new enhancements as possible.

- Should the company purchase additional policies that respond only to loss incurred by directors and officers that is not indemnified by the company (known as Side A coverage)?
Side A coverage typically is broader than what is available under policies that cover loss that a company does indemnify. A large percentage of U.S. public companies add such coverage to their existing D&O insurance programs because of the enhanced protection it provides to their directors and officers.

- Are the company’s D&O insurers highly experienced in securities litigation?

Insurers that handle numerous securities claims acquire detailed knowledge about the law, the courts, the lawyers representing the claimants, and even the mediators who are often used to help broker a settlement. This knowledge is tremendously valuable to insureds and their lawyers.

**Indemnification of Directors and Officers**

Statutes in the various U.S. states permit companies to indemnify their directors and officers for claims brought against them for acts allegedly performed by them in their roles with the company. Where the claim is successfully defended, indemnification may be mandatory. Many companies provide broader indemnification rights in their bylaws. These rights vary from company to company though, and can be changed by a company’s board of directors at any time.

It is increasingly common for directors and officers to enter into indemnification agreements with the companies they serve. These agreements typically provide enhanced indemnification rights that cannot be changed or rescinded by the company.

Well-crafted indemnification agreements combined with strong D&O insurance programs provide directors and officers with the best possible financial support in the event of a securities claim.

**Dealing With Risks and Distractions**

The reality of being a public company in the U.S. is that a company faces the prospect of distracting and very expensive securities investigations and litigation. The risks associated with that can and must be managed well. The consequences of a failure to do so can be ruinous.