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Chinese companies face more lawsuits

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Since 2010, there has been a dramatic and unprecedented rise in securities class-action, derivative lawsuits and Securities and Exchange Commission enforcement actions against China-based companies listed on U.S. exchanges. In 2011, close to 40 China-based companies were sued for securities fraud and related violations in the U.S.

During recent years, a significant number of China-based companies came to the U.S. to raise capital on U.S. exchanges. Many of these companies became listed through "reverse merger transactions." In a reverse merger, the Chinese company seeking access to U.S. capital markets merges with an existing American public (shell) company. The acquiring Chinese company then takes control of the board and management of the American public company. The transaction allows the acquiring company to become publicly listed in the U.S. while avoid the usual regulatory scrutiny of an initial public offering.

A recent Public Company Accounting Oversight Board's research shows that between 2007 and 2010, approximately 159 Chinese companies became listed in the U.S. exchanges through reverse mergers. In June 2011, the SEC issued a bulletin warning U.S. investors about potential risk of investing in Chinese companies that enter U.S. securities market through reverse mergers.

The largest number of recent securities suits filed against China-based companies involve challenges to the financial accounting, disclosure and/or management practices of these reverse merger companies. Most of the complaints are rooted in short seller reports highlighting significant discrepancies in the Chinese company's financial statements filed with the SEC and statements filed with China's State Administration for Industry and Commerce (SAIC).

A sampling of the 2011 cases shows that a majority of the suits against Chinese companies have survived the initial pleadings stage. In *Henning v. Orient paper, Inc. et al,* the plaintiff's complaint featured prominently a short seller's report that challenged the Chinese defendant's reported revenues based on a comparison of its SEC and SAIC filings. The U.S. District Court for the Central District of California denied the defendants' motion to dismiss after finding that it was inappropriate for the court to resolve the truth of the short seller's report during the pleadings stage. The court specifically rejected the defendants' argument that the report was not sufficiently reliable to meet heightened pleading standards under the Private Securities Litigation Reform Act.

In *In re China Educ. Alliance,* the plaintiffs relied on a short seller's report claiming that the Chinese defendant company filed false financial statements with the SEC, which were contradicted by accurate financial statements filed with SAIC. The court in *Alliance* dismissed a motion to dismiss based on similar allegations that the defendants "[h]ad filed significantly disparate revenue figures in China and the United States." In finding that the disparity between the SAIC and SEC filings was sufficient to allege falsity, the district court had found that the complaint "adequately alleged that [the issuer's] SEC filings are demonstrably higher than its Chinese filings" and thus "[i]t would be premature to grant a motion to dismiss in light of these factual disputes."

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In *Scott v. ZST Digital Networks, Inc.*, the plaintiff brought a class action against ZST, a Chinese developer of digital and optical networking equipment, alleging that the defendant reported false financial results to the SEC in 2009 and the submissions violated several federal securities laws. The ZST court sustained the plaintiffs' claims for violations of Section 10(b) holding that "discrepancies" between the SEC and SAIC filings "constitute sufficient pleading of both falsity and scienter and that "the issue of which set of reports is accurate is not properly resolved on a motion to dismiss."

However, it remains to be seen how these securities cases will fare for the plaintiffs beyond the initial pleading stage. In predicting the future trend for this type of litigation, one must take into consideration the unique and considerable challenges facing American plaintiffs currently suing Chinese companies, their directors and officers. For example, gathering evidence to build a case when most if not all of the records and witnesses are located in China can be exceedingly difficult for a plaintiff given the distance between the two countries and the obvious language barrier. Effecting service of process on directors and officers who reside in China could be a logistical nightmare. Direct service by registered mail is not recommended for serving individuals and entities in China.

In addition, China does not permit American attorneys in China to take depositions for use in foreign courts. Participation in such activity could result in the arrest, detention or deportation of the attorneys and other participants.

Further, it is nearly impossible to subpoena records from Chinese affiliates of major accounting firms based in the U.S. even if these affiliated auditors may have financial records necessary for the plaintiff to prove his claims. Several outside auditors of Chinese companies have cited Chinese "state secrets" and privacy laws in refusing to comply with subpoenas. The China Securities Regulatory Commission (CSRC) has issued directives to auditors prohibiting them from producing records directly to the SEC. Instead, the SEC must work through the CSRC to obtain access to the auditors' records. Finally, collecting a judgment entered by an American court from a Chinese company with little or no American assets can be extremely difficult, if not impossible.

One should certainly expect U.S. security regulators, plaintiff lawyers and short sellers to be looking at Chinese companies with a great deal of scrutiny from now on. However, after evaluating these "realities," plaintiff complaints may eventually slow down the filings of the securities suits against Chinese companies.