

Chinese IPO Boom Spurs Securities Litigation Wave

By **Evan Weinberger**

Law360, New York (February 14, 2011) -- Chinese companies listing in the U.S. are facing a wave of securities class actions as investors question the companies' financial statements and their preferred method of coming to market, with attorneys saying the boom will continue unless the companies adapt to American disclosure standards.

"I think it is true that some Chinese companies are learning the hard way that they need to adjust their practices to conform to more stringent U.S. disclosure and regulatory regimes," said Joseph de Simone, a partner at Mayer Brown LLP.

According to a January report from Cornerstone Research, Chinese companies listed on U.S. stock exchanges were hit with 12 securities class action complaints in 2010. While that number may seem small, it made up 42.9 percent of the filings against all foreign issuers listed on U.S. exchanges.

Securities class action filings against Chinese companies have continued apace in 2011, with at least three having been launched as of Feb. 4.

But the relatively large number of suits against Chinese companies is hardly surprising, given that between 200 and 250 Chinese companies are listed in the U.S. right now, said Robert Q. Lee, a partner at Diaz Reus & Targ LLP who heads the firm's office in Shanghai.

"You play the odds, the numbers are going to reflect that appropriately," Lee said of the rise in securities litigation against Chinese companies launching initial public offerings in the U.S.

The complaints against Chinese companies run the gamut of the securities realm. Some claim there were problems with registration; some assert material misrepresentation of financial data; and others allege outright, knowing fraud, according to the Cornerstone report.

Many of the class action complaints against Chinese companies right now are driven by Chinese reporting requirements that vary significantly from those required by the U.S. Securities and Exchange Commission and other U.S. regulators, Lee said.

In short, many of the complaints allege that Chinese companies report higher earnings in the U.S. than they do in China.

Because the two countries use different accounting standards, financial documents are bound to look different and are not necessarily indicative of fraud, Lee said.

Reporting different revenues to different regulators makes sense, said Victor T. Shum, a partner at Jeffer Mangels Butler & Mitchell LLP. In the U.S., companies have to comply with U.S. regulations, but in China, the companies want to avoid paying taxes, he said.

While those reporting differences may seem an ordinary part of doing business for Chinese companies, they are also a natural attraction for plaintiffs attorneys, Shum said.

“When you're looking for evidence of fraud or misrepresentation, that's about as good evidence as you may get,” he said.

There is a simple way to blunt plaintiffs' claims, however, according to attorneys. Chinese companies could simply add a footnote explaining the discrepancy to their U.S. financial documents.

Though adding a footnote seems like a no-brainer, many Chinese companies would find it extremely difficult to do, Lee said. A U.S. company would not have a problem listing an exception on a financial statement, but a Chinese company may see it as admitting there is a problem, he said.

While the numbers Chinese companies report may raise eyebrows, their method of coming to market has also led to suspicion among investors.

Many of the companies use reverse mergers to list on U.S. exchanges rather than going the traditional IPO route. In a reverse merger, a private company purchases an existing, publicly traded shell company and trades under that name. Usually the merger targets are listed on the so-called pink sheets or traded over-the-counter bulletin board.

The benefit is that companies don't have to go through the arduous road shows and other disclosures required for a traditional IPO, but the downside is that the lack of disclosure opens the reverse mergers up to regulatory investigations and allegations from shareholders that a company withheld key information prior to listing, attorneys said.

“It's a much quicker way to get to market and it's a process that has come under substantial criticism and scrutiny both in the press and from regulators,” de Simone said.

The prevalence of reverse mergers highlights a key paradox of the situation, according to Shum. While reporting requirements are stricter for companies once they've listed in the U.S., the reporting requirements to list on a Chinese exchange are far stricter than rules on the OTC market in the U.S., he said.

According to the Cornerstone report, nine of the 12 companies hit with class actions in 2010 listed through the reverse merger mechanism.

Beyond filing and disclosure problems, Chinese companies listed in the United States may also be a magnet for securities class actions because they've lost a lot of money, according to attorneys.

De Simone noted that some sources have estimated that investors have suffered approximately \$30 billion in losses in China-based small-cap stocks listed on American exchanges in the past five years.

"When you do have big losses, you tend to have a substantial increase in lawsuits," he said.

But that's not to say that everything can simply be chalked up to cultural differences, according to Labaton Sucharow LLP partner Christopher J. Keller.

A large percentage of Chinese companies come to the U.S. to raise quick cash, but provide inaccurate information to investors, he said.

"I think that they very much like our capital markets, but they don't like our law," Keller said.

Fearing the potential for such fraud, the SEC has reportedly opened several investigations against auditors, law firms and investment banks that help Chinese companies complete reverse mergers. On Friday, the commission revoked the registration of China Digital Media Corp., a company trading on the pink sheets that had been tagged in a pump-and-dump investigation.

Shum said that while many of the Chinese companies that pursue reverse merger were strong ones that do what they claim, many were "short-term companies that realize liquidity for the founders and then disappear."

Because of the doubts that have been raised about Chinese filings, the pressure is on both companies and attorneys right now to improve disclosures and help keep investor fears at bay, attorneys said.

"They just question the veracity of what is being disclosed," Lee said. "We need to do a better job of educating them regarding compliance on regulatory issues."

--Editing by Chris Giganti.