SECURITIES FRAUD LITIGATION AGAINST CHINA-BASED COMPANIES IN THE UNITED STATES

Securities fraud litigation has frequently followed “Chinese reverse mergers” by which Chinese companies merge with U.S. shell companies and become listed on U.S. exchanges. These cases have raised issues of international service of process on individual defendants and the use and effect of Chinese-language documents. Plaintiffs have alleged large discrepancies between company filings in China and with the SEC, as well as sham operations as a basis for pleading securities fraud in some instances. The authors suggest that these cases provide useful guidance, as foreign-based companies increasingly seek access to U.S. markets and listings on domestic exchanges.

By A. Robert Pietrzak, Tom A. Paskowitz, and Benjamin F. Burry *

Since 2004, litigation in the United States against China-based companies alleging violation of the United States securities laws has blossomed into a cottage industry for some plaintiffs’ law firms. Much – but by no means all – of this litigation has been fueled by the well-publicized “Chinese reverse merger” phenomenon. A reverse merger is a process through which a company (here the Chinese company) acquires a U.S.-based shell company that is listed on a domestic stock exchange. By acquiring the listed company, the Chinese company accedes to the listing and becomes a publicly traded company without going through the full process of an initial public offering.¹ Many of the China-based companies that were listed on domestic exchanges in recent years attained their listings through reverse mergers.

As a result, the cases against Chinese issuers generally have involved some peculiar procedural, evidentiary, and substantive issues that will be explored in this article. As international capital markets grow more crowded and companies from around the world continue to list on U.S. exchanges, these issues may continue to arise.

¹ Recent changes in SEC rules have made it more difficult to obtain a listing through reverse merger. See, e.g., SEC Rel. No. 34-65708 (2011) (approving additional NASDAQ, NYSE, and NYSE AMEX listing requirements, including a one-year "seasoning period" whereby the reverse merger company must have been traded on another exchange for at least one year and file information about its reverse merger transaction with the SEC).

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become more common and worthy of interest to the general securities practitioner.

Filings against Chinese issuers peaked dramatically in 2011 and have since trailed off. To get a sense of the scope of this trend, consider the following statistics: from 1997-2009 the average number of securities fraud filings against issuers with Chinese headquarters was twice per year. Twelve such cases were filed in 2010, followed by 40 in 2011 and 18 in 2012.¹

Although the factual claims brought against China-based issuers are sometimes novel, the underlying law is familiar. Generally, these securities fraud suits allege claims against the issuer under Section 10(b) and Rule 10b-5 of the Exchange Act of 1934² or, if in connection with a public offering, Sections 11 and 12(a)(2) of the Securities Act of 1933.³ As with other cases involving claims of securities fraud, cases against China-based companies invariably include claims under Section 20(a) of the Exchange Act or Section 15 of the Securities Act for control persons’ liability against officers and/or directors of the defendant company. In some cases, plaintiffs have also brought claims against the company’s underwriter or independent auditor,⁴ and some plaintiffs have added state law claims.⁵

This article focuses on three issues particular to securities fraud litigation against China-based companies in the United States, all of which have been frequently litigated and sometimes with surprising results.

First, we address international service of process on individual defendants. Plaintiffs have had difficulty serving officers and directors of the defendant company that reside in China pursuant to The Hague Service Convention⁶ and have often resorted to seeking alternate means of service.⁷ Some courts have proven increasingly willing to forgo service under The Hague Convention.

Second, we address the use of Chinese documents in connection with a defendant’s motion to dismiss. Defendants have had to use documentary evidence cited or referred to in the complaint, but courts have sometimes declined to consider these documents in connection with a motion to dismiss when faced with objections to the accuracy of a translation or the authenticity of a foreign document. Some courts have also regarded Chinese-language publications or publications available in China as without effect on the price of the publicly listed security of a China-based issuer.

Finally, we address two common types of allegations that many plaintiffs have made against China-based issuers: claims of fraud based on alleged discrepancies between a Chinese company’s filings in China and filings with the U.S. Securities Exchange Commission (SEC) and claims based on a significant overstatement of the defendant company’s business or facilities. We draw several conclusions from the varying outcomes in these cases and offer an explanation for why the trend of filing claims that allege such allegations appears to be trailing off.

In conclusion we offer the precedent pioneered in litigation against China-based issuers as a useful guide to evaluating the procedural, evidentiary, and substantive

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¹ Cornerstone Research, Securities Class Action Filings – 2012 Year in Review, at 11.
² 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.
³ 15 U.S.C. § 77k(a); 77l(a)(2).
⁴ See, e.g., Dean v. China Agritech, Inc., 2011 WL 5148598, at *1-2 (C.D. Cal. Oct. 27, 2011) (invoking Section 11 claims against the investment bank that served as underwriter for the company’s IPO and the accounting firm that certified the company’s financial statements).
challenges faced when companies of an emerging economy begin to access U.S. capital markets.

**SERVICE OF THE INDIVIDUAL DEFENDANTS**

Securities fraud suits against companies based in China have followed the familiar path of naming current or former officers and directors as individual defendants. The reasons for doing so are obvious. Naming officers and directors as defendants may give plaintiff access to additional insurance coverage separate and apart of any insurance covering the company, and the added pressure against the individuals may improve a plaintiff’s settlement position. Of course, to properly bring an officer or director residing in China within the court’s jurisdiction, a plaintiff must serve the individual defendant with the summons and complaint. Rarely an issue in domestic securities litigation, a plaintiff’s options are limited when it comes to service of individuals in China. Absent an agreement from the defendant companies’ lawyers to accept service on behalf of the individual defendants, a plaintiff must attempt service under The Hague Service Convention or seek a court order permitting alternate service of process.  

**Service under The Hague Service Convention**

The Hague Service Convention provides that an applicant must send a request for service of judicial process directly to the central authority designated by the government of the receiving country, who then serves the document on the individual (or arranges to have it served by the appropriate agency). Though a party to The Hague Service Convention, China has objected to Article 10 of the Convention, which provides for service by mail or international courier. Thus, a plaintiff seeking to serve by The Hague Service Convention must proceed through China’s central authority.

Using The Hague procedures can be costly, time consuming, and potentially fruitless. As an initial matter, a plaintiff must provide the central authority with both the defendant’s name in Chinese characters and his or her address. Plaintiffs may not know either of these. Although companies list names of corporate officers on SEC filings and elsewhere, such as the company website, these may only be the individuals’ English names and not their official Chinese names. Once a plaintiff knows the official Chinese characters for an individual defendant’s name, it can still be difficult to identify the defendant’s address. And, according to some declarations filed in federal court, even with both a name and an address, serving a defendant living in China through The Hague procedures may still take six months or longer. Under the Private Securities Litigation

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9 Fed.R.Civ.P. 4(e)(1); see Omni Capital Int’l v. Rudolf Wolff & Co., Ltd., 484 U.S. 97, 104 (1987) (“Before a federal court may exercise personal jurisdiction over a defendant, the procedural requirement of service of summons must be satisfied.”).

10 Fed.R.Civ.P. 4(f)(3) permits court-ordered service of process on an individual defendant in a foreign country by means that include international agreements or, “by other means not prohibited by international agreement.” In addition, constitutional due process requires that a method of service must be “reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections.” Rio Prop., Inc. v. Rio Int’l Interlink, 284 F.3d 1007, 1016 (9th Cir. 2002) (quoting Mullane v. Cent. Hanover Bank & Trust Co., 339 U.S. 306, 314 (1950)).


13 See, e.g., Decl. in Support of Plf’s Mot. to Effectuate Service or Lift the PSLRA Stay, Snellink v. Gulf Res., Inc., 11-cv-3722 (C.D. Cal. Nov. 23, 2011) (Dkt. 49 Ex. 1) (indicating that plaintiffs could not serve individual defendants because they could not verify either the CFO’s or the CEO’s official names in Chinese characters).

14 In GLG Life Tech Corp., the court stated that it was “concerned [with] the length of time required for service under The Hague Convention,” citing a report by plaintiff’s process server. See In re GLG Life Tech Corp. Sec. Litig., 287 F.R.D. 262, 266 (S.D.N.Y. 2012) (citing PFLs’ Declaration, 11-cv-9150, at ¶ 7 (Sept. 6, 2012) (Dkt. 49) (estimating that “even if [the individual defendant’s] residential address was already known . . . service of process in China via The Hague Convention . . . would take at least six to eight months to complete”); see also Brown v. China Integrated Energy, Inc., 285 F.R.D. 560, 563 (C.D. Cal. 2012) (ordering alternative service based on plaintiff’s contention that “obtaining the foreign individual defendants’ addresses could cost approximately $15,000 and
Reform Act (PSLRA), defendant’s motion to dismiss stays discovery in a securities fraud suit filed in U.S. federal court, denying a plaintiff the use of ordinary discovery channels to request personal information for the individual defendants.

**Court-ordered Alternative Service**

Courts have disagreed on whether a plaintiff must attempt service under The Hague Convention before asking the court to authorize alternative means of service. The Ninth Circuit now firmly holds that a plaintiff need not attempt service under The Hague Convention and that a court-ordered alternative is an equal means. Moreover, district courts in that circuit have sometimes held that “a method of service that can be effectuated in the United States – i.e., service on [the Chinese company’s] American lawyer, or on its registered agent for service of process . . . need not conform to the requirements of The Hague Convention.” On the other hand, courts in the Second Circuit have been more inclined to require that a plaintiff first attempt service under The Hague procedures before permitting alternate service in the U.S. Although decisions disallowing alternative service in cases against China-based issuers have generally been summary in nature, one possible rationale for this outcome is that allowing alternative service would, to some extent, offend China’s sovereignty and undermine The Hague Convention.

In practice, courts have approached the issue of service on Chinese residents in several ways:

1. **Lifting the PSLRA stay.** While a motion to dismiss triggers a discovery stay under the PSLRA, the court can lift the stay to prevent “undue prejudice.” In arguing for undue prejudice, some plaintiffs have argued that revealing the addresses of individual defendants is virtually costless to the company, while the absence of such critical information could force a plaintiff to respond to duplicative motions to dismiss and the imposition of a second discovery stay when the unserved defendants finally appear. Defendants counter that every discovery stay necessarily imposes some alternative, for the court to order service of certain individual defendants through Douyuan’s U.S. registered agent on the grounds that “Plaintiff must first attempt service through The Hague Convention.”

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that even with the addresses in hand, service could take four to six months or be blocked altogether by Chinese authorities”.

15 U.S.C. § 78u-4(b)(3)(B) (“all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless . . . particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party”).

16 *Rio Props., Inc., supra* note 10 at 1016 (“we hold that Rule 4(f)(3) is an equal means of effecting service of process under the [Fed.R.Civ.P.], and we commit to the sound discretion of the district court the task of determining when the particularities and necessities of a given case require alternate service of process under Rule 4(f)(3)”; *In re China Intelligent Lighting & Elecs., Inc. Sec. Litig.*, 2012 WL 538267, at *1 (C.D. Cal. Feb. 14, 2012) (“A court may order service of process under Rule 4(f)(3) even when service of process has not been attempted by other means.”).


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See, e.g., C & F Sys., LLC v. Limpinas, S.A., 2010 WL 65200, at *2 (W.D. Mich. Jan. 6, 2010) (denying plaintiff’s motion for alternative service on a Peruvian company, noting that Peru is signatory to The Hague Convention and “principles of comity encourage the court to insist, as a matter of discretion, that a plaintiff attempt to follow foreign law in its efforts to secure service of process upon defendant”); accord *GLG Life Tech Corp., supra* note 14 at 266 (noting that “there will undoubtedly be many instances where significant efforts to make service under The Hague Convention should be required by a court before alternative service is ordered” but that in this instance court-ordered service on the individual defendant residing in China does not upset “principles of comity” given that he is a Canadian citizen being sued in his role as chief officer of a Canadian corporation).

prejudice, and simply pointing to the consequences of the stay does not show “undue prejudice.”\textsuperscript{21}

Some courts have found prejudice and granted a plaintiff’s motion to lift the PSLRA stay so that the plaintiff may ascertain from the corporate defendant the whereabouts of each of the unserved individual defendants. For example, the court in \textit{RINO Int’l Corp.} granted the plaintiff’s motion to lift the stay, finding that “the discovery sought here is necessary to prevent undue prejudice to Plaintiff – i.e., a substantial delay in this lawsuit that might ultimately result in a defendant escaping liability.”\textsuperscript{22} The court in \textit{China Intelligent Lighting & Elecs., Inc.} (CIL) similarly lifted the stay “for the limited purpose of allowing Plaintiffs to propound special interrogatories on CIL to ascertain the current address, government identification number, and employment status at CIL” for certain individual defendants, finding that “[a] substantial delay . . . might ultimately result in a defendant escaping liability.”\textsuperscript{23}

(2) Service through the Company’s U.S. registered agent. If the Chinese company is incorporated in the U.S., the court may permit individual defendants to be served through the company’s domestic registered agent on the premise that the agent will transmit the documents to the defendants. As compared to alternative methods, courts have been less inclined to order service through a registered agent,\textsuperscript{24} and are particularly unlikely to order it when the individual defendants are no longer employed by the corporate defendant.\textsuperscript{25}

(3) Service effected through a U.S. subsidiary. Although relatively rare, the District Court for the Northern District of California authorized service on unserved individual defendants who resided in China by service on the company’s U.S. subsidiary because it was “reasonably calculated . . . to apprise [the individual defendants] of the pendency of the action and afford them with the opportunity to respond.”\textsuperscript{26}

(4) Service effected through corporate defendant’s counsel. As with service through a defendant company’s registered agent in the U.S., some courts have accepted the premise that the company’s legal counsel in the U.S. is a reasonable means of providing the individual defendants with service of the summons and complaint.\textsuperscript{27} And similarly, whether a court granting plaintiff’s motion for alternative service orders service through the company’s counsel often turns on whether the individual defendant is still employed by the company; is actively participating in the litigation; and whether the court believes the company, its registered

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\textit{Brown v. China Integrated Energy, Inc.}, \textsuperscript{supra} note 14 at 566 (“grant[ing] plaintiffs’ motion to effect alternative service [of individual defendants] by serving China Integrated’s authorized agent for service of process in Delaware or its counsel”).

\textsuperscript{25} See \textit{China Educ. Alliance, Inc.}, \textsuperscript{supra} note 20 at *3 (holding that “authorizing plaintiffs to serve the Unserved Defendants – who apparently no longer work at CEU – through the company’s agent presents a potential due process problem, because there is no guarantee the agent will actually serve each defendant or that each defendant is actually aware of the litigation”); \textit{China Intelligent Lighting & Elecs., Inc.}, \textsuperscript{supra} note 16 at *3 (same).

\textsuperscript{26} \textit{In re LDK Solar Sec. Litig.}, 2008 WL 2415186, at *4 (N.D. Cal. June 12, 2008).

\textsuperscript{27} \textit{In re China Valves Tech. Sec. Litig.}, \textsuperscript{supra} note 18 at 1 (“Lead Plaintiff shall effectuate service on the Unserved Individual Defendants by serving the complaint and summonses on China Valves’ defense counsel”); \textit{Vanleeuwen v. Keyuan Petrochemicals, Inc.}, 2012 WL 5992134, at *4 (C.D. Cal. Nov. 30, 2012) (granting plaintiffs’ motion to effect service on Chinese company’s Chairman/President/CEO/Director “via [the company’s] registered agent or counsel in the United States.”). But see \textit{Fuqi Int’l, Inc.}, \textsuperscript{supra} note 18 at 2 (denying a request by the lead plaintiff to serve the individual defendants through the company’s U.S. defense counsel).
agent, subsidiary, or counsel, has had contact with the individual defendant.\textsuperscript{28}

It is not uncommon to see courts permitting alternative service to order service of individual defendants residing in China through more than one of these methods.\textsuperscript{29} Since the goal is to employ methods reasonably designed to apprise the defendant of the pending action, a court may order multiple methods when concerned that not a single method may provide adequate notice.

\textbf{COURTS' WILLINGNESS TO CONSIDER CHINESE DOCUMENTS}

Defendants accustomed to submitting and relying on documents referenced in the complaint in support of a motion to dismiss\textsuperscript{30} may face significant hurdles to using Chinese-language documents, even where the plaintiff’s claims expressly rely on those very same documents. Although some courts rely on translations of Chinese documents submitted by a plaintiff, either as an attachment to the complaint or excerpted in the text,\textsuperscript{31} a plaintiff may object to either the authenticity or translation of a foreign document proffered by a defendant in support of its motion to dismiss. These unequal rights have a number of implications for Chinese companies facing securities fraud litigation.

\textbf{Plaintiff's Objection May Prevent Courts from Considering Foreign-Language Documents Offered by Defendant on a Motion to Dismiss}

Courts have proven unwilling to consider Chinese-language filings offered by a defendant where the plaintiff objects to the authenticity of the document. For example, in cases where a plaintiff has attacked a Chinese company’s SEC filings as false on the grounds that the financial results reported in those filings differ from the financial results reported in the filings that the company made with the PRC,\textsuperscript{32} many courts have refused to allow the defendant to put forward foreign-language documentary evidence, such as other PRC filings, that are more consistent with its SEC filings. In \textit{China Educ. Alliance, Inc.}, for example, the plaintiffs alleged that the company’s SEC filings falsely overstated its revenue, as shown by the vastly lower figures reported in its filings with the Chinese government. Even though the plaintiffs alleged that their counsel’s investigators had obtained the company’s filings with the Chinese State Administration of Taxation (SAT) and cited in their complaint figures allegedly taken from the company’s 2009 SAT filing,\textsuperscript{33} the court refused to take judicial notice of the 2009 SAT filing offered by defendant on the grounds that the plaintiffs disputed the document’s authenticity and the defendant conceded that it was not a foreign public document.\textsuperscript{34} In effect, the company’s filings in China were deemed to be what the plaintiffs said they were despite the defendants’ attempt to demonstrate otherwise. In another case, the defense counsel seeking to admit its client’s filings with the PRC’s State Administration for Industry and Commerce (SAIC) took the extraordinary step of making a trip to the SAIC office in China, obtaining copies of the defendant’s SAIC filings, and having them notarized by a Chinese government agency.\textsuperscript{35} Even there the court would not rely on the filings over the plaintiffs’ authenticity.

\textsuperscript{28} See, e.g., GLG Life Tech Corp., \textit{supra} note 14 at 267 (“Of course, a party seeking leave to serve an individual by counsel must show adequate communication between the individual and the attorney.”).

\textsuperscript{29} See, e.g., \textit{Morningstar v. Dejun}, 2013 WL 502474, at *2 (C.D. Cal. Feb. 8, 2013) (“Plaintiffs may serve Foreign Defendants by doing all of the following: (1) serving the summons and complaint upon RINO’s California office; (2) serving RINO’s registered agent for service of process, with instructions to forward to summons and complaint to Foreign Defendants; and (3) serving the Foreign Defendants’ California counsel, with similar instructions.”).

\textsuperscript{30} See, e.g., \textit{Plumbers & Pipefitters Local Union No. 719 Pension Trust Fund v. Conseco Inc.}, 2011 WL 1198712, at *2 (S.D.N.Y. Mar. 30, 2011) (when deciding a motion to dismiss, “the Court may consider documents that are referenced in the complaint, documents that the plaintiff relied on in bringing suit and that are either in the plaintiffs’ possession or the plaintiffs knew of when bringing suit, or matters of which judicial notice may be taken.”).

\textsuperscript{31} See, e.g., \textit{Sinay v. CNOOC Ltd.}, 2013 WL 1890291, at *3 (S.D.N.Y. May 6, 2013) (relying on various sources excerpted in plaintiff’s complaint including a report by China’s State Oceanic Administration); \textit{In re China Valves Tech. Sec. Litig.}, 2012 WL 4039852, at *2 (S.D.N.Y. Sept. 12, 2012) (relying on an online report published by Citron Research, which the plaintiff alleged revealed the defendants’ fraud).

\textsuperscript{32} People’s Republic of China (PRC) in this article refers to both China and the Chinese government.


challenge and assumed the content of the filings in the plaintiffs’ favor for purposes of ruling on the defendants’ motion to dismiss.\textsuperscript{36} Although on some occasions a defendant has successfully challenged the authenticity of documents offered by the plaintiff, these reported cases are less common.\textsuperscript{37}

A similar problem arises where the parties disagree over the proper interpretation or translation of foreign-language documents. In many situations, courts have viewed this as a factual dispute and assumed that the plaintiff’s interpretation is true at the motion-to-dismiss stage. One notable example arose in \textit{Buxbaum v. Deutsche Bank AG},\textsuperscript{38} where the plaintiff alleged that a Deutsche Bank spokesman falsely stated in a German interview that a takeover had not been discussed. The defendant there argued that the plaintiff’s claim was based on an incorrect translation of the German word “Übernahmegerätschaft.”\textsuperscript{39} The parties submitted competing translations of the term, and the court found both interpretations plausible, deeming the translation a disputed question of fact that must be assumed in the plaintiff’s favor.\textsuperscript{40} Although this translation issue does not yet appear to have arisen in any case involving a Chinese issuer, defendants in such cases may not fare any better than the defendants in \textit{Buxbaum}.

\textbf{Chinese-language Documents Are Not Deemed to Have an Effect on the U.S. Market for a Chinese Company’s Shares}

Defendants in securities fraud cases often rely on efficient capital market theory to argue that a plaintiff was on notice of particular facts relevant to its claim. Plaintiffs similarly rely on the theory to argue that news about defendant’s business was the cause of a contemporaneous decline in defendant’s stock price. Underlying this theory is the notion that market participants have perfect information and the price at which securities are traded is deemed to accurately reflect disclosure of even arcane or technical issues facing a company as soon as they become public information.\textsuperscript{41} However, some courts have implicitly carved exceptions to this theory in ways that affect Chinese defendants.

For example, some courts have been unwilling to find that foreign-language documents, including newspaper articles, affect the market for the company’s shares. As one judge put it: “[W]here such information is published in a foreign language, it is strong evidence against it being, quote, general public knowledge.”\textsuperscript{42}

Several other courts have followed this logic. In \textit{Fuwei Films}, the company was sued for alleged non-disclosure of government investigations and legal proceedings related to the company’s purchase of two production lines. The court held that the publication of three Chinese-language newspaper articles regarding the subject matter did not “transform the information contained within the articles into ‘matters of general public knowledge’ that may properly be imputed to Fuwei’s stockholders.” It therefore ruled “that these articles do not excuse Defendants, as a matter of law, from their respective duties to disclose the allegedly misleading information identified by Plaintiffs in this

\textsuperscript{36} Id. at 937 (“even if these SAIC documents are public record, whether the documents contained truthful financial data is a question of fact. For these reasons, the Court finds it inappropriate to take judicial notice of SCHC and SYCI’s SAIC documents obtained by Gulf.”).

\textsuperscript{37} See \textit{In re A-Power Energy Generation Sys. Ltd. Sec. Litig.}, 2012 WL 1983341, at *8 n.9 (C.D. Cal. May 31, 2012) (noting that “A-Power persuasively indicates that Plaintiff has not sufficiently explained the origins of the documents it contends represent A-Power’s subsidiaries’ SAIC filings and why it believes they represent the actual SAIC filings”); see also \textit{Intercontinental Indus. Corp. v. Wuhan State Owned Indus. Holding Co., Ltd.}, 2:10-cv-04174 (C.D. Cal. Jan. 11, 2013) (Dkt. 74) (upon concession by plaintiff, striking plaintiff’s uncertified translations and granting request that court consider defendants’ court certified translations of plaintiff’s Chinese-language exhibits for purposes of defendants’ motion to dismiss). \textit{But see Snellink v. Gulf Res., Inc.}, supra note 35 at 939 (where plaintiffs alleged a discrepancy between the Chinese company’s reported production and production data presented in an industry report, the court permitted the evidence even though plaintiffs “do not actually possess or have access to the CCM report, but relied on an Internet article . . . which allegedly used the information contained in the CCM report”).

\textsuperscript{38} 196 F. Supp. 2d 367 (S.D.N.Y. 2002).

\textsuperscript{39} Id. at 372-377.

\textsuperscript{40} Id. at 374-375.

\textsuperscript{41} See, e.g., \textit{Bovee v. Coopers & Lybrand}, 216 F.R.D. 596, 606 (S.D. Ohio 2003) (“[A] well-developed and impersonal market, such as the New York or Pacific stock exchanges, will instantaneously incorporate all publicly available information about a given security into the market price of that security.”) (quoting \textit{Deutschman v. Beneficial Corp.}, 132 F.R.D. 359, 368 (D. Del. 1990)).

Likewise, in *Snellink v. Gulf Res., Inc.* the court held that even if the company’s filings in China with the SAIC were public documents, the documents are not readily accessible for U.S. investors and therefore did not affect the company’s share price. Another district court reached the same conclusion with respect to Italian publications.

These decisions have some import for Chinese companies subject to securities fraud litigation. If alleged misrepresentations or material omissions come to light in Chinese-language publications or documents, a court, depending on specific circumstances, may not regard the disclosure as a “corrective disclosure,” meaning that purchasers of stock even after the date of such a disclosure could still be regarded as victims of an undisclosed fraud. This may hold true even if the company holds a Chinese-language press conference or news release with important and relevant information.

**NOVEL ALLEGATIONS AGAINST CHINA-BASED COMPANIES**

**Discrepancies between SEC and Chinese filings**

Over the past several years, an increasing number of China-based companies have become the subject of media reports that publicize apparent differences between the financial information reported to the SEC and the PRC. These reports have often been published anonymously on blogs by investment analysts that have admittedly taken a large short position against the company’s stock and therefore stood to profit from the sell-off that followed. Plaintiffs invariably file suit shortly thereafter, sometimes working closely with the short sellers to obtain information to prosecute the action.

The uptick in the number of judicial opinions involving analyses of claims based on alleged discrepancies between U.S. and Chinese filings has been remarkable. While there were five such decisions in 2011, there were at least 18 in 2012. This trend is

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43 *In re Fuwei Films Sec. Litig.*, 634 F. Supp. 2d 419, 438 (S.D.N.Y. 2009). The same court later provided additional color on this holding. See *In re UBS AG Sec. Litig.*, 2012 U.S. Dist. LEXIS 141449, at *108 (S.D.N.Y. Sept. 28, 2012) (“In *Fuwei*, this Court held that seven newspaper articles did not constitute ‘matters of general public knowledge’ attributable to investors because only three of the articles were published before the offering in question and even those were published in Chinese-language newspapers lacking a wide distribution.”).


45 *In re Immucor Inc. Sec. Litig.*, 2006 U.S. Dist. LEXIS 72335, at *37-38 (N.D. Ga. Oct. 4, 2006) (“Although the parties dispute whether the Italian reports were ‘publicly available,’ the parties concede that the reports were written in Italian, not readily available in English, and not equivalently reported in the American press. The nature of these reports casts doubt upon the Defendants’ claim that the information contained in them ‘credibly entered the market’ during the class period. The public availability of the Italian media reports is an issue of fact not appropriate for determination at the motion to dismiss stage.”).


47 See, e.g., *Redwen v. Sino Clean Energy, Inc.*, 2012 WL 1991762, at *6 (Plaintiff defends its reliance on accusations published by short sellers, submitting a declaration stating that “counsel for Lead Plaintiff has spoken with Geoinvesting LLC and Alfred Little on a number of occasions to investigate the basis of the claims found in their reports, and that during these conversations Geoinvesting LLC shared documentation to support its conclusions”).


meaningful, as we noted above, filings against Chinese issuers more than doubled from 2010 to 2011, suggesting that differences in financial reporting was a significant driver of filings against Chinese issuers.\textsuperscript{50}

Plaintiffs have had significant, although not uniform, success with these allegations. A survey of the 18 decisions in 2012 shows that in only six decisions the court granted defendants’ motion to dismiss. This track record is noteworthy considering that approximately half of the motions to dismiss filed by defendants in federal securities class actions filed after 2005 have been granted.\textsuperscript{51} Of those six successful motions to dismiss, in only one has the defendant won a final judgment dismissing the claims against it.\textsuperscript{52} In two of the six, plaintiffs repled their claims and prevailed against the defendants’ subsequent motions to dismiss;\textsuperscript{53} in two others plaintiffs took leave to replead, and defendants’ subsequent motions to dismiss are still pending;\textsuperscript{54} and in one case the parties settled.\textsuperscript{55}

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\textsuperscript{50} As noted, from 1997-2009 the average number of securities fraud filings against Chinese issuers was 2 per year: followed by 12 in 2010; 40 in 2011; and 18 in 2012. See Cornerstone Research, Securities Class Action Filings – 2012 Year in Review, at 11. In other words, in 2012 there were appreciably more decisions on U.S./Chinese filing discrepancies than there were total securities fraud filings against China-based issuers in any year until 2011.


those discrepancies,” created “the strong inference that the Chinese statement reflected an overstatement in revenues reported to the SEC [] sufficient to constitute falsity and scienter under the PSLRA.”57 The same was true in China Agritech, Inc. where, as compared to the company’s Chinese filings, the U.S. 10-Q and 10-K filings reported 2008 and 2009 revenues “approximately 1,444% and 900%” higher, respectively.58 Denying defendant’s motion to dismiss, the court did “not find it reasonable to infer that such large discrepancies in revenues are attributable only to differences in accounting principles.”59

Other plaintiffs have avoided dismissal by pointing to concrete numbers within a defendant’s filings, such as where the plaintiff cites SAT records showing the company and its subsidiaries paid Chinese taxes significantly less than the figures reported to the SEC.60 In contrast to aggregate measures like revenue and income, items like taxes paid give defendants less opportunity to explain discrepancies as computational differences.

Finally, rather than compare a company to itself, some plaintiffs have compared financial information reported in the U.S. and the PRC to the figures reported by its competitors. In Snellink v. Gulf Res., Inc., the district court upheld plaintiffs’ claim, in part because “Gulf’s numbers are so high that its financial statements must be false – a 50% profit margin based on an inventory turnover rate between 59 to 209 times for Gulf in the years 2008-2010, compared to a profit margin below 20% based on an inventory turnover rate of seven times for Gulf’s competitors.”61 According to the Gulf’s SEC filings, the company was “one of the largest manufacturers of bromine in China” and reported bromine output that would have made it the number one producer, accounting for over 40% of China’s bromine production.62 Plaintiffs successfully challenged these impressive results by pointing out that Gulf was conspicuously absent from industry publications listing the 30 bromine producers who accounted for nearly the entire Chinese market.63

(2) Comparing filings by a U.S. parent and Chinese subsidiaries. Chinese companies publicly traded in the U.S. sometimes conduct operations through subsidiaries organized under Chinese law, wholly owned by a U.S. parent company. In this situation, the Chinese company files with SEC on behalf of the publicly traded parent company incorporated in the U.S., and files with the SAIC and SAT only on behalf of Chinese operating subsidiaries.

This poses a hurdle for plaintiffs who must show that discrepancies between lower numbers reported by a Chinese subsidiary and higher numbers reported by the parent to the SEC are attributable to fraud rather than structural differences. For example, in Mecox Lane Ltd., the court found that the plaintiff failed to show that the discrepancy between the $3.5 million profits Mecox reported to the SEC and $825,544.41 profits reported to the SAIC was false or misleading because “the profits Mecox reported to the Chinese government in 2008 related only to Mecox subsidiaries and affiliated entities in the [PRC], while in the registration statement [filed with the SEC], Mecox reported its profits related to all entities.”64 Similarly, in A-Power Energy Generation Systems, the court questioned whether it was “sensible and accurate” for plaintiff to aggregate different SAIC filings as a basis for comparison to SEC reported revenue where the company filed with the SAIC separately on behalf of six different subsidiaries.65 In contrast to Mecox Lane and A-Power Energy Generation Systems, some courts have been willing to overlook some incongruence in the identity of the reporting entity, especially, as noted above, where the discrepancy in financial results is large. In Sino Clean Energy, Inc., the company reported SEC revenue of more than $14 million in 2008 and more than $46 million in 2009, while its operating subsidiary reported SAIC earnings of just $60,000 and $181,000, respectively. There, the court rejected Sino Clean’s explanation that the SAIC

57 Id. at ¶8.

58 Dean v. China Agritech, Inc., supra note 5 at ¶5.

59 Id.


62 Id. at 934, 938.


figures were lower due to not including revenue from its subsidiary.  

(3) Chinese GAAP. Defendants have experienced some success when arguing that the allegations against them fail to state a securities fraud claim because Chinese accounting standards are different from U.S. GAAP. For example, defendants prevailed in A-Power Energy Generation Systems where the court found that the plaintiff had failed to allege that the financials filed with the SAIC were prepared in compliance with GAAP and therefore “the Court would have no way of knowing whether it was comparing apples-to-apples or instead apples-to-oranges.”

The court likewise granted defendants’ motion to dismiss in China Valves Tech., finding that plaintiff “does not allege what accounting standards, if any, are required for [S]AIC filings [and] the similarities or differences between those standards and U.S. GAAP.” But where figures differed by a factor of several hundred, as was the case in Duoyuan Global Water, Inc., the court held that “Defendants’ argument that the differences can reasonably be attributed to differences in U.S. GAAP and Chinese GAAP is unpersuasive given the large margins of disparity between the figures reported in the two filings.” In such situations some courts appear to have upheld plaintiff’s claim based only on allegations that Chinese companies are required to file with the SAIC financial statements audited by a certified public accountant pursuant to “Chinese GAAP” and that Chinese GAAP are “substantially the same” as U.S. GAAP. On other occasions plaintiffs have pointed to the company’s own representations that the Chinese and U.S. accounting standards are comparable, such as in China Century Dragon Media, Inc., where plaintiffs introduced a letter from the company to the SEC to that effect.

(4) Defendants’ U.S. filing, not Chinese filing, must be false. Courts have held that securities fraud must be based on the company’s representations to the SEC, not to the Chinese authorities. As an extension of this principle, some defendants have argued that, even if the filings in the two countries are irreconcilable, the plaintiff failed to show that the SEC filings are false. This has been a steady thread throughout the decisions that side with defendants. Plaintiffs generally respond by arguing that a Chinese corporation has more incentive to lie to the U.S. government than to the Chinese government because Chinese companies face harsh fines and serious criminal penalties for false statements in China whereas the SEC has no ability to enforce

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70 See, e.g., Transcript of proceedings, Stanger v. China Electric Motor, Inc., supra note 42 at 6 (finding plaintiff adequately pleaded Chinese GAAP and U.S. GAAP are substantially similar where the complaint stated simply that the “accounting principles governing revenue recognition are substantially the same,” Consol. Compl., Dkt. 35, at ¶ 111).

71 Katz v. China Century Dragon Media, Inc., 2012 WL 1656929, at *1 (C.D. Cal. May 7, 2012) (“Defendants have sufficiently pleaded the similarity of the accounting standards, especially given the letter from China Dragon’s attorneys to the SEC in October 2010 in which they allege such similarity.”). Notably, in its earlier decision granting China Century Dragon Media’s motion to dismiss the plaintiffs’ prior complaint, the court dismissed that complaint because it had found that, although the plaintiffs had pled that the SAIC numbers differed from the SEC numbers, this was “merely consistent with” the SEC numbers’ being false, and did not suffice to make that claim plausible. The plaintiffs had not alleged that Chinese and American accounting standards are sufficiently similar such that the SAIC and SEC numbers should be substantially the same or that the defendants relied on the same underlying financial data in preparing the SEC and SAIC reports. Katz v. China Century Dragon Media, Inc., 2011 WL 6047093, at *4 (C.D. Cal. Nov. 30, 2011).

72 China Valves, supra note 68 at *6 (“plaintiff must allege at least some facts to support that . . . the SEC figures, and not the [S]AIC filings, are false”); see also Snellink v. Gulf Res., Inc., supra note 35 at 942 (holding that Chinese regulatory filings were neither public nor accessible to U.S. investors).

73 China Valves, supra note 68 at *6 (finding that plaintiffs fail to allege “any basis for concluding that the SEC filings – and not the SAIC filings – are inaccurate”); Mecox Lane Ltd., supra note 64 at *12 (“the Amended Complaint does not allege the registration statement’s 2008 figures to be false, only that a different figure was filed with the Chinese government”); A-Power Energy Generation Sys. Ltd., supra note 37 at *8 (finding plaintiff has not “satisfactorily alleged why the SEC filings were false as opposed to the SAIC filings”).
violations of U.S. criminal laws over the defendants who are domiciled in China.  

Defendants have disputed both contentions with varying success. In China Educ. Alliance, Inc., the company unsuccessfully argued that Chinese companies generally report “inaccurate” data in SAIC filings “in order to prevent competitors from gaining an advantage by reviewing them.” In ZST Digital Networks, the company disclaimed the relative harshness of China’s laws, arguing that the filing of financial reports with the SAIC is “viewed generally as an administrative function” and that filing a false statement or omission with the SAIC only meant the company would have to revise the report, pay a fine equivalent to $1,600–$7,800, or, perhaps, have its business license revoked.

More recently, the court in L & L Energy pointed out that this issue involves a comparison between countries, and therefore courts cannot conclude that a Chinese company’s SEC filings are false based only on the alleged harsh consequences for filing false statements with the SAIC. Harsh as SEC penalties may be, this still leaves open the possibility that penalties in the PRC are even harsher: “[C]onspiciously absent” from plaintiff’s analysis is that punishment for “[w]illful misstatements in an SEC filing” include “imprisonment for up to 20 years, and/or criminal fines up to $5,000,000 for individuals or $25,000,000 for corporations.” The court ruled that, even accepting the alleged discrepancy between U.S. and Chinese filings, plaintiff failed to show that the company’s SEC filings overstated its revenue and income simply by virtue of being inconsistent with its SAIC filings.

Notably, securities fraud cases that turn on discrepancies between SEC and Chinese filings

74 Sino Clean Energy, 2012 WL 1991762, at *5 ("penalties for false SAT filings are substantially harsher than the penalties Sino Clean would face in the U.S."); see also Miller Inv. Trust v. Morgan Stanley & Co., Inc., supra note 6 at 164 (“The SAIC filings are more likely to be accurate than the SEC filings because, while ShengdaTech’s PRC subsidiaries are subject to stiff penalties for filing false statements with the SAIC, Chinese extradition policies make it difficult to hold Chinese officers and directors of American corporations liable for violations of the SEC’s filing requirements” and upholding plaintiffs’ state securities non-scienter fraud claim).


76 Scott v. ZST Digital Networks, Inc., supra note 56 at *3.

77 L & L Energy, Inc., supra note 54 at *4.

78 Id.

overwhelmingly concern financial statements filed from 2006 to 2010, before the wave of short-selling reports and related lawsuits. There have been fewer filings in 2012 than in 2011 and, so far, even fewer in 2013. We may then see the continued disappearance of Chinese companies’ filings with the PRC government as a fruitful source for demonstrating misstatement in SEC filings, as Chinese companies may have learned that meaningful differences between performance reported in U.S. and PRC filings could be the basis for liability in the U.S.

### Phantom Corporations

Allegations against China-based issuers somewhat uniquely include claims that the company’s entire business and operations are a sham. These claims posit that, after posting a track record of profits, successful publicly listed Chinese companies have turned out to be works of fiction, created by insiders seeking to profit from a pump-and-dump scheme.

For example, the court in China MediaExpress Holdings, Inc. denied a motion to dismiss where the company described itself to U.S. investors as having the “largest television advertising network on inter-city express buses in China,” with a network of 16,000 inter-city buses. From 2009 to 2011, CCME continually posted outstanding financial results until several years after its reverse merger when short seller investigators questioned CCME’s industry presence, reporting that “[n]one of the major media buyers with whom we spoke — including several who represent CCME’s purported customers — had even heard of CCME.” An investigator visiting the company’s corporate headquarters in Hong Kong allegedly discovered that “during the middle of the work hours, no one was working,” instead “[i]ts workforce . . . plays cards and sleeps in the middle of the day.”

Other plaintiffs have made similar claims. This scenario played out in China Agritech, Inc. where the plaintiff alleged that its investigation showed the company’s factories “either sat idle with no production or operated substantially below capacity” and in China Educ. Alliance, Inc., where “investigators toured CEU’s on-site ‘state-of-the-art’ facility in China only to find it

79 L & L Energy, Inc., supra note 54 at *2.


81 Id. at *6.

82 Dean v. China Agritech, Inc., supra note 5 at *4.
to be an empty building; [] witnesses in China told plaintiffs’ investigators that CEU was not the owner of the building” and “many of the links on CEU’s website did not work properly despite its online segment purportedly deriving millions of dollars each year.”

Plaintiffs in these three cases were successful in defeating defendants’ motions to dismiss. However, the ‘phantom corporation’ allegations were only one red flag among many alleged by the plaintiff, and it remains unclear whether such allegations, standing on their own, would be sufficient to defeat a motion to dismiss. As with the ‘filing discrepancy’ cases, allegations against phantom companies may continue to diminish as a means to establish securities fraud liability. The wave of private securities litigation and enhanced regulatory scrutiny has imposed higher costs on would-be China-based issuers, and U.S. exchanges have imposed heightened listing requirements for reverse merger companies that make a U.S. listing a less attractive source for ready capital.

**CONCLUSION**

The topics explored above represent key issues litigated during the recent wave of lawsuits against Chinese issuers, but they may prove representative of issues faced when any emerging economy enters global commerce. As foreign-based companies increasingly seek to access the U.S. capital markets and list on domestic exchanges, courts may increasingly deal with similar procedural, evidentiary, and substantive questions. If so, the course charted by courts and the parties in cases against China-based companies provide useful guidance.

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