



June 2011

It's A Small World After All...

By Donna Moser¹, D&O Liability Research Specialist & Priya Cherian Huskins, Esq.², Partner

One consequence of the global, interconnected nature of the economic markets is that plenty of non-U.S. companies list their shares on U.S. Exchanges. For most foreign filers, listing in the U.S. is entirely unproblematic. However, there has been some interesting news in the U.S. securities class action lawsuit arena that involves directors of foreign-based companies.

PEOPLE'S REPUBLIC OF CHINA (PRC)

Since 2004, there have been approximately 350 PRC companies that have entered the U.S. stock market via "reverse merger" transactions for a combined capitalization of more than \$50 billion. Typical reverse merger listing involves the PRC company's acquiring a dormant U.S. company that was trading over the counter, renaming the company, and ultimately raising millions of dollars through the issuance of new stock. The advantage of using this method to raise money is that entry to the U.S. stock market through a reverse merger is a faster and less involved process than listing on a Chinese Exchange. By contrast to the much quicker U.S. process—it can take as little as about two months—listing on a Chinese exchange can involve often a lengthy wait of two years.

Unfortunately, a few of these PRC reverse merger companies have had some disappointing results. In addition, questions have been raised about the validity of the financials of some of these companies. In our last two quarterly Flash Reports we noted that

the plaintiffs' bar has focused on bringing class action suits against some of the PRC reverse merger companies. In the first quarter of 2011, six PRC companies listed in the U.S. were sued. In 2011 through the end of April, nineteen PRC companies listed in the U.S. were sued. This spike in suits against PRC companies is unprecedented.

Both Congress and the SEC have also been ratcheting up the scrutiny of reverse merger companies. In a response letter from the Chairman of the SEC to the Chairman of the House Committee on Oversight and Government Reform issued on April 27, 2011, the SEC Chairman noted that since March, 2011, 24 PRC-based companies have filed Forms 8-K disclosing auditor resignations and/or accounting problems. As a result of the SEC's ongoing reviews and investigations, trading in three companies has been suspended and the securities registration of at least eight companies was actually revoked.

The SEC is also using its best efforts to work with PRC authorities to obtain information from PRC companies, but has encountered certain jurisdictional roadblocks. The difficulties in obtaining the cooperation from problem companies have also been a challenge for the parties involved. An example can be found in Duoyuan Global Water, a company listed on the NYSE. The shareholders of Duoyuan Global Water sued Duoyuan in September 2010 over possible accounting issues. In recent events, the public learned via a resignation letter submitted by the Special Committee of the Board that both the Audit and Special Committees of the Board encountered significant problems in receiving the cooperation of management to assist them in their investigations. This was notwithstanding the fact that, in order to facilitate the process, the Chair of the Special Committee traveled from the U.S. to Beijing to work with management and the investigative team on a full-time basis. When she arrived at the company's offices with the Committee's advisers, no documents had been gathered and no information was available. Management refused to cooperate with the Committee's investigation and even threatened to resign

¹ Priya Cherian Huskins is a partner at Woodruff-Sawyer & Co., a full-service insurance brokerage headquartered in San Francisco, CA. Priya can be reached at phuskins@wsandco.com or 415.402.6527.

² Donna Moser is a research specialist at Woodruff-Sawyer & Co., a full-service insurance brokerage headquartered in San Francisco, CA. Donna can be reached at dmoser@wsandco.com or 415.402.6526

if the Committee did not discharge the forensic accounting expert working on the matter. The resignation letter stated that due to these constraints the Special Committee was unable to conduct a full, fair, independent and transparent investigation and thus the members were regrettably forced to resign en masse. The law firm hired to assist in the special investigation also resigned in frustration.

Lawsuits follow foreign companies
filing in the U.S. at an increasing rate.

INDIA

In early 2009, Satyam Computer Services Limited (now known as Mahindra Satyam) made news headlines as "India's Enron" when the former Chairman disclosed significant accounting improprieties overstating the company's revenues and profits, including a non-existent but reported cash holding of \$1.4B. The public prosecutor's office subsequently alleged that employee numbers were inflated by as many as 13,000 additional fake employees in order to siphon off cash. Shortly thereafter, the Indian government stepped in and replaced the board. Three of the ten defendant former directors and/or officers in the class action lawsuit have been indicted on fraud charges in India.

The company recently announced a settlement with U.S. investors for \$125M. Interestingly, the company's settlement included a clause that stipulated that \$1.0M of the settlement be set aside to fund the case's claims against the non-settling defendants—a highly unusual feature of a settlement that should give future individual defendants (including U.S.-based defendants) cause for concern. Although the company has decided to settle and move on, this set-aside clearly signals the company's desire to keep the pressure on other defendants who have yet to resolve their role in this case.

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