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Crouching Tiger, Hidden Fraud

M. NORMAN GOLDBERGER AND LAURA KRABILL

The authors suggest that unless and until Chinese regulators and U.S. regulators agree to work cooperatively on enforcement issues, investors should not assume the same comfort level in relying on financial statements and disclosures of Chinese reverse merger companies as they do traditional public companies.

On June 9, 2011, the Securities and Exchange Commission ("SEC") issued an Investor Alert warning investors of the risk of investing in foreign companies who enter the U.S. markets through reverse merger transactions. This alert appears to have been prompted by the significant numbers of China-based operating companies that have recently been suspended from trading by the SEC as a result of discoveries of false or misleading financial statements or other SEC filing irregularities, and the resignation of a number of auditing firms that have uncovered misrepresentations by company management and oftentimes the companies' Chinese bank branches.

In fact, in the past year alone, there have been more than 40 China-based companies that have stopped trading, been subject to securities fraud allegations from the SEC or private investors, and/or had auditors resign citing lack of confidence in or actual knowledge of misstatements by company management. In December 2010, *TheStreet* reported that a

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large-scale SEC investigation was under way to weed out fraud that appeared to be endemic in companies whose primary assets were Chinese operating companies that went public through a reverse merger. That report appears to have been well founded. Since December 2010, the SEC has reported numerous reverse merger companies that it has charged with fraud or has delisted or initiated stop-order proceedings against, including, for example, China World Trade Corp.; Global Peopleline Telecom, Inc.; China Digital Media Corp.; China Intelligent Lighting and Electronics; China Century Dragon Media, Inc.; Heli Electronics Corp.; China Changjiang Mining & New Energy Corp.; RINO International Technologies; and many more.

Some Chinese companies that have gone public through reverse mergers have simply stopped making required SEC filings and disappeared, leaving investors holding the bag. Several others have admitted to improper accounting, misstatements regarding company contracts, or misrepresentations about cash or assets held by the company. Still others have had outside auditors discover serious discrepancies between the companies' financial reports and information from the companies' customers and banks, prompting the auditors to resign and withdraw audit opinions on which the companies' registrations were based.

The SEC, therefore, warned investors to "proceed with caution when considering whether to invest in reverse merger companies." The SEC specifically noted that "there have been instances of fraud and other abuses involving reverse merger companies" and that "some 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 its auditing obligations when all or substantially all of the private company's operations are in another country," thus inhibiting the auditing firms from "identify[ing] circumstances where these companies may not be complying with the relevant accounting standards." The SEC, therefore, suggested that "individual investors should take into account their own financial situation, consult their financial adviser, and perform thorough research before making any investment decisions concerning these types of companies."

HEIGHTENED RISKS ASSOCIATED WITH INVESTING IN CHINESE COMPANIES LISTED ON U.S. EXCHANGES AS A RESULT OF "REVERSE MERGERS"

Of course not all public companies (or all Chinese companies) that are formed through reverse mergers are corrupt. The use of the reverse merger to take a company public is not new, and there is nothing inherently wrong with performing a reverse merger. In fact, the parent company to the New York Stock Exchange itself was formed through a reverse merger. A reverse merger, however, does provide a potentially greater opportunity for fraud to occur than going public through an initial public offering ("IPO"). In a reverse merger, a public "shell" corporation "acquires" the assets of a private operating company by paying the operating company in shares of itself. The private operating company then becomes the majority shareholder and thus controls the voting for the public company, and typically the private company's corporate officers and directors take over the management and board of directors of the public company. The public company must report the transaction in SEC filings (such as an 8-K) but can then sell additional shares and raise capital that essentially flows to the private company. This allows a private company to acquire public investors with less regulation and less scrutiny than accompany an IPO. Therefore, while the fact alone that a Chinese company went public through a reverse merger is not a red flag that there is fraud or a problem with the company, it should cause investors to be more wary and to take additional precautions before making the decision to invest.

One additional risk factor in investing in Chinese companies is that the use of a reverse merger is often accompanied by the creation of a variable interest entity ("VIE"). VIEs allow the public company to gain control of a private Chinese company and its assets through a series of contractual arrangements, rather than through a strict parent-subsidiary relationship or direct ownership of the operating Chinese company or its assets. The VIE structure is used to avoid Chinese regulations prohibiting foreign ownership of Chinese companies and assets. The VIE arrangement, however, creates further risk and complication for U.S. investors of public companies whose assets and operations are in China. In particular, the contractual arrange-

ments providing for control by the public company are only as strong as the enforcement mechanisms that can be effectively used — generally Chinese law and Chinese courts. There may be incentives for the Chinese company or its insiders or their friends and family (who are likely the other parties to the VIE contracts) to simply renege on the contracts, and it might be impossible for the contracts to be enforced in China. Or, despite their best efforts to perform under the contracts, the VIE contracts could be nullified as a result of intervention by the Chinese government. Whatever the reason, the fact that VIE contractual arrangements may ultimately be unenforceable creates a substantial risk that investors in a public company whose only assets arise from VIE arrangements will be left with nothing.

REGULATORY ACTIONS ARE NOW ATTEMPTING TO ABATE THESE RISKS

There have been a number of changes recently made in various regulations and by some exchanges to attempt to reduce or eliminate the harm to investors that can result from these known risks.

For example, accounting regulations (FASB Interpretation 46(R) and SFAS 167) have recently expanded to require more disclosure of VIE arrangements. Before this expansion, the fact that the assets of a Chinese operating company were only managed and controlled by the public company rather than actually owned was oftentimes not sufficiently disclosed or was not disclosed at all. Additional disclosure requirements, if they are followed, can provide investors with valuable information to assess the risks of losing the benefit of the VIE altogether.

Second, Sarbanes-Oxley requires inspections of auditing firms auditing public companies whose securities are traded in the United States. The Public Company Accounting Oversight Board ("PCAOB"), created as a result of Sarbanes-Oxley, has nonetheless been unable to inspect auditing firms based in China, even ones that are associated with and share the name of the Big Four U.S. accounting firms, because the Chinese government has prohibited the inspections. Indeed, in several lawsuits brought after allegations of fraud by Chinese companies arose, the plaintiffs sought auditors' records to help establish the fraud. The auditors refused to provide the documents, citing Chinese law that prohibits the disclosure of

those auditing records. In October 2010, the PCAOB issued a statement acknowledging that it had previously allowed registration of auditing firms from countries outside the United States where inspections were not permitted on the belief that inspections would ultimately be allowed. Recognizing that the obstacles to inspection continued, the PCAOB strengthened its rules regarding inspections of auditing firms outside the United States. Earlier this month, the PCAOB, for the first time, rejected the registration of a foreign auditing firm (Zhonglei CPA Co. (Zhonglei)) based primarily on the PCAOB's inability to inspect the firm's work for companies based in China. In May, the PCAOB met with counterparts at the China Securities Regulatory Commission in an effort to broker agreements that would allow inspections to occur. No resolution has yet been reached, but the PCAOB's rejection of Zhonglei may be a strong signal to China that allowing inspections of auditors' papers is necessary to ensure continued access to the U.S. capital markets for Chinese companies.

Finally, the NASDAQ has recently proposed new rules requiring additional delay (seasoning) between the time a company conducts a reverse merger and the time it may be initially listed on the NASDAQ exchange. This would require at least two quarterly reports to be filed with the SEC, allowing the SEC and investors to have more information and more opportunity to investigate before the company's shares are traded on the NASDAQ.

The SEC is also engaged in diplomatic discussions with its Chinese counterpart to attempt to expand enforcement options between the two nations. While these talks appear to be preliminary, China has an economic incentive to ensure that American capital markets and investors remain comfortable with Chinese companies so that money fueling China's economic growth continues to flow into the country. The recent spate of fraudulent practices by Chinese companies has already tempered investments to some degree and may help prompt quicker action from the Chinese government to stem the heightened concern of Western market participants.

HOW INVESTORS CAN MINIMIZE THEIR RISKS

Not surprisingly, U.S. investors have been eager to try to profit from China — the world's fastest-growing major economy. This is even truer

in the past several years since China has continued to grow during an extended period of global recession elsewhere. China has an enormous population of potential consumers, and those consumers have in recent years had more disposable income than ever before. Because of all of these factors, investment in Chinese companies has been steadily rising for the past several years.

But, where there is rapid expansion and intense interest in a market sector, there is a greater opportunity for investors to be taken in by fraud. What can investors and professionals who advise them do to minimize the risk of being duped by these "reverse merger" Chinese companies? The SEC alert suggests:

(1) Researching the company;

(2) Reviewing its SEC filings;

(3) Being particularly wary of companies that do not file or that make available information about the public "shell" only, not about the private operating company that merged with it; and

(4) Being skeptical of tips or information on blogs, social networking sites, and "even a company's own website" since it "may be inaccurate and sometimes intentionally misleading."

Essentially, the overriding principle of the SEC's tips is: Look for reliable information. Easier said than done, particularly where the SEC is warning investors that the companies themselves may be intentionally falsifying information on their Web sites and even in their SEC filings.

So what is an investor or adviser to do? The only way to really perform due diligence on these companies is to actually conduct investigations where the assets and operations exist — in China. Obviously, that is not a realistic option for most individual investors, but presumably some of the parties who were involved in the reverse merger transaction did conduct that due diligence. Particularly for institutional investors, consider the parties who were involved in the reverse merger (investment bankers, auditors, etc.) and ask for detailed information about the due diligence that was conducted. Investors can also take a page out of the short sellers'

handbook and do a little investigation on key transactions that are touted by the company. In fact, several analysts and short sellers have recently reported their analysis of Chinese companies' SEC filings and research done on the Internet, and through phone calls to the companies' purported customers or vendors, which have resulted in the Chinese companies' stock values plummeting and several securities fraud lawsuits being filed.

Other inquiries to make that can lead to more or less comfort in investing include:

(1) Where are the company's assets? Does it have offices or manufacturing facilities in the United States or only in China?

(2) Where are the company's officers and members of its board of directors? Are there U.S. residents in upper management or on the board who could be subject to prosecution and civil liability if the company's filings are false?

(3) Does the company have director and officer liability insurance? If so, what is the retention (deductible) and what are the limits? Who issued the policy?

(4) Who are the company's accountants and auditors? Are they large firms with sufficient resources to have conducted appropriate audits? Are the auditors one of the Big Four or a Chinese affiliate that has not been inspected by the PCAOB, cannot provide documents under Chinese law, and may not be subject to litigation in the United States if the financial statements turn out to be false?

Investors should not be shy about contacting a company's investor relations group and asking for information that is not in the SEC filings. The company may refuse to disclose the information requested, but that can be as telling to a potential investor as the information itself. And, finally, if a company's financial reports seem too good to be true, they probably are, particularly for Chinese reverse merger companies.

In short, unless and until Chinese regulators and U.S. regulators agree to work cooperatively on enforcement issues, investors should not assume the same comfort level in relying on financial statements and disclosures

of Chinese reverse merger companies as they do traditional public companies. Many are legitimate and may be good investment choices, but there have been enough instances of serious securities fraud in these companies (and enough instances where investors have been seriously damaged and left with absolutely no recourse) that the old adage "buyer beware" is particularly true. Institutional investors, investment managers, and advisers who fail to heed that adage and do more than the usual research before investing in this sector may be facing liability themselves.