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Securities Litigation Risks for Chinese Companies Post-IPO in the United States

Securities exchanges in the United States remain one of the key locations for companies to raise capital. Listing and remaining listed on U.S. exchanges involve a variety of risks for companies, and numerous law firms specialize in bringing securities class action litigations against issuers, promoters, and underwriters related to the sales and promotion of securities.

China-based issuers are one of the most popular targets for securities class action litigation. From 2012 to May 2021, 186 China-based issuers have listed on the U.S. securities exchanges.[1] In the same period, there have been roughly 2,608 securities class action litigations filed against companies listed on U.S. exchanges.[2] Of these, China-based issuers have seen one of the largest increases in targets for such securities class action litigations, including 64 filed in 2019 (the most of any country for U.S.-listed companies) and a nearly 500% increase from 2016 to 2020.[3]

For China-based issuers, the conflict between the laws and regulations of the United States and the People's Republic of China (China or PRC) regarding information disclosures adds to their vulnerability for securities class action litigations and can create risks for compliance in both countries. Likewise, recent actions by PRC government agencies have illustrated a trend towards heightened scrutiny for China-based issuers around compliance with PRC laws and regulations. The interplay between these two jurisdictions must be carefully managed, and counsel in the United States and China should be coordinated, for a successful IPO and throughout any securities litigation.

Concurrent Federal and State Jurisdiction

Securities law claims can be brought in federal and/or state courts, and both courts have concurrent jurisdiction under *Cyan, Inc. v. Beaver County Employees Retirement Fund*.[4] In a situation where claims are brought in both state and federal court, the federal courts would hear the case under federal securities laws and state courts would hear the case under state securities laws, known as blue sky laws. The state court claims cannot be removed to federal court.

Different Rules for Federal Securities Class Actions

Securities class action litigations operate differently than other civil litigations in U.S. courts pursuant to the Private Securities Litigation Reform Act of 1995 (15 USC § 78u-4) (PSLRA). The PSLRA is a key federal law that is applicable to private actions under the Securities Act of 1933[5] (the Securities Act) and the Securities Exchange Act of 1934.[6] The PSLRA has a number of important and distinguishing features, including establishing the timelines, burdens of proof, etc., for federal securities class action litigations in the United States. Some key features of the PSLRA include:

- Heightened pleading requirements for fraud claims, including:

    - Plaintiff must identify each specific statement alleged to be false or misleading and explain why it is false or misleading;
    - Plaintiff must state particular facts giving rise to a strong inference that the defendant issued the allegedly misleading statement knowing that it was false at the time it was made;
    - Plaintiff must allege that the information in the false or misleading statement, or omission of information, was the cause of the actual loss the plaintiff suffered and prove the causation of loss;[7] and
    - Plaintiff must plead a "strong inference" of scienter, i.e., the required state of mind.
- Automatic discovery stay until after the decision on the motion to dismiss.
- A safe harbor provision for certain forward-looking statements.
- Limits on the amount of and liability for damages.

There is an open question before the Supreme Court of the United States as to whether the discovery stay under the PSLRA applies to state court actions. We have discussed this issue previously here.

Securities Class Actions Arising from IPOs

There are a variety of statutory provisions and multiple legal theories and causes of action that plaintiffs may attempt to assert against those involved with an IPO. Generally, securities class action litigations plead that the defendant company made false statements or misrepresentations that induced investors to purchase securities, but ultimately resulted in the drop of a stock price, causing loss to the investors. Section 11 of the Securities Act is a commonly asserted cause of action against issuers and can serve as a good example.

Section 11 of the Securities Act creates a cause of action based on a registration statement that "contain[s] an untrue statement of a material fact or omit[s] . . . a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. §77k(a). An omission may be problematic where the information was material and the failure to include it made the published statement misleading. Thus, in essence, the Securities Act can create a form of strict liability for issuers for misleading statements in a registration statement.[8]

Because a registration statement is mandatory and the required disclosures within that registration statement are comprehensive, opportunistic plaintiffs and their counsel often seize upon any statement or omission to argue it was misleading, was material, and caused their losses.

When securities class action litigations are initiated, issuers can expect multiple law firms to find one or more investors to serve as plaintiff, and multiple cases will be filed. After a few months, the cases will typically be consolidated, lead plaintiff will be chosen, and scheduling will occur. The first stage of the case will include the plaintiff amending complaints and be concluded with the defendant's motion to dismiss. If the plaintiff is able to survive the motion to dismiss, then the case will proceed to later steps, including class certification and discovery.

In securities class action litigations, damage awards or settlements can be substantial for a company. It is not uncommon for settlements to be in the tens and hundreds of millions of dollars, and occasionally reach billions of dollars.

Key Issues in Securities Litigations at Motion to Dismiss

Materiality

The PSLRA includes a safe harbor provision protecting forward looking statements where either: (1) the statements were immaterial; (2) the plaintiff fails to establish that the defendant had actual knowledge the statements were false or misleading at the time the statements were made; or (3) the statements were identified as forward-looking and including meaningful cautionary language calling attention to important factors that could cause actual results to differ from the forward-looking statements.

Whether a statement or omission is "material" is a flexible and regularly disputed standard. The U.S. Supreme Court in TSC Industries said that the standard for "materiality" contemplates "a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[9] However, the U.S. Supreme Court also went on to say that even though it provided this standard, it accorded judges deference in determining whether an omission or misstatement was in fact material.[10]

Scienter

Scienter is a mental state "embracing intent to deceive, manipulate, or defraud."[11] The PSLRA requires a plaintiff to state with particularity the facts giving rise to a strong inference that the defendant acted with the required scienter.[12] A strong inference "must be more than merely plausible or reasonable – it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent."[13]

Specific Challenges to Disclosures for China-Based Issuers

China-based issuers face unique challenges to completing an overseas IPO, particularly around the required disclosures in registration statements and the subsequent ongoing disclosures. China has one of the most advanced legal regimes for protecting the data of individuals and companies within its borders. This legal regime also comprises multiple provisions that govern a variety of outbound data transfers, particularly those to a foreign enforcement body. On July 10, 2021, the PRC National Internet Information Office issued draft Cybersecurity Review Measures (the Draft Measures) for public comment. Once finalized and enacted, the Draft Measures would force China-based companies possessing personal information of more than one million users in China to go through a cybersecurity review before proceeding with an IPO—in short, giving the PRC government the ability to approve or deny a China-based company's ability to list overseas.

A number of other current and pending laws and regulations control the data that can be transferred abroad, including the PRC Securities Law, the PRC Civil Procedure Law, and the PRC State Secrets Law. Likewise, China has additional laws soon to be applicable that will further add to the protection of China-based information and the cross-border transfer of data and information: the PRC Data Security Law set to come into force on September 1, 2021, and the PRC Personal Information Protection Law that is currently in deliberation and anticipated to be passed later this year.

Where there is an investigation by a Chinese government agency, China-based issuers face more complex issues regarding the decision to disclose the investigation. In practice, most government agency investigations in China are handled confidentially according to the agency's design. The government agency would want to control the decision of whether and when to disclose an investigation. An unauthorized disclosure of the investigation by the company, particularly to a foreign jurisdiction, could lead to additional penalizing measures being levied against the company.

For SEC enforcement actions against China-based issuers, scattered throughout a number of PRC laws and regulations are relatively clear requirements and procedures for providing information to foreign enforcement authorities. Depending on the scenario, PRC law may require approval from various government agencies before any provision of data, information, documents, or materials can be made to a foreign government agency, or even simply across China's borders. In recent years, the PRC implemented such requirements as an attempted "blocking" framework; that is, it is attempting to counter long-arm jurisdiction assertions of foreign governments and seeking to re-route those requests through diplomatic channels and mutual cooperation treaties.

In the context of securities class action litigations in civil court (particularly in U.S. courts), PRC law is less clear on how China-based issuers may handle discovery requests, and the China-based issuers will be faced with complex decisions from an operations and legal strategy standpoint. However, pursuant to the PSLRA, all discovery in U.S. federal securities class action litigations is stayed until after the motion to dismiss, meaning that all complaints, amended complaints, and the motions to dismiss will be based on public information or independent investigation.

Takeaways

The U.S. exchanges remain one of the key destinations for foreign issuers. China-based issuers are frequently the target of securities law class actions. For China-based issuers, there are unique considerations for the approach to these cases based on both U.S. and PRC law.

Our team has successfully obtained dismissals for China-based issuers brought into securities class action litigation in the United States. There are specific strategies and issues unique to China-based issuers that may be implemented with an understanding of how to navigate the interplay between PRC and U.S. law, and how new PRC laws could impact compliance with securities class action litigation, cross-border securities investigation, or U.S.-based IPO disclosure requirements.

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