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CLASS ACTIONS

BNA Insights: Recent Trends in Securities Class Action Lawsuits Filed Against Issuers Based in Latin American and China

BY NICHOLAS M. BERG AND TRACI J. IRVIN

In 2015, nearly 20% of securities class action lawsuits were filed against foreign corporations. These 35 complaints represented a slight increase from 2014 and a large jump from the historical average of 22 per year. (Cornerstone Research, Securities Class Action Filings – 2015 Year in Review 1-2, 16 (2016)) Two regions were particularly hard-hit: Latin America, with five complaints, and China, with an overwhelming 14 lawsuits. (*Id.* at 16-17.) Together, complaints from these two regions made up more than 50% of all securities class action lawsuits filed against foreign corporations. This article considers the reasons why Latin America and China are targets for U.S.-based securities class action litigation. We also provide several important considerations for foreign corporations that are faced with involvement in a securities class action.

Latin American Trends

The five securities class action lawsuits against Latin American companies targeted businesses in the basic materials, utilities, and transportation sectors. Perhaps unsurprisingly, three of the lawsuits allege the defendant corporations and their high-ranking officials made materially false or misleading statements, or failed to disclose, their involvement in corruption schemes. All but one case contained allegations of accounting irregularities.

In *In re: Braskem Sec. Litig.*, No. 15 Civ. 5132 (S.D.N.Y., filed July 1, 2015), the plaintiffs alleged that Braskem, a Brazilian petrochemical company, was involved in a massive kickback scheme to funnel billions of dollars to executives of Braskem's largest shareholder, Petróleo Brasilerio S.A. (''Petrobras''), a state-run oil company. Petrobras supplied Braskem with 70% of Braskem's requirements for flammable liquids, and the complaint claims that between 2006 and 2012 Braskem paid at least $5 million annually to Petrobras in order to purchase raw materials at cheaper prices. The company publicly confirmed that it was undertaking an investigation into the allegations only after a local Brazilian newspaper exposed Braskem's involvement in the bribery scandal.

The suit against Centrais Eléctricas Brasilerias SA (''Electrobras'') in *In re: Electrobras Sec. Litig.* , No. 15 Civ. 5754 (S.D.N.Y., filed July 22, 2015) was based on allegations arising out of the same bribery scheme. The plaintiffs accused Electrobras' executives of accepting bribes and kickbacks from construction company cartels in exchange for awarding those companies contracts on multiple projects. The company supposedly

Nicholas Berg is a partner in the Chicago office of Ropes & Gray LLP. Traci J. Irvin is an associate in the firm's San Francisco office.

misrepresented and omitted material facts by failing to disclose that several executives and insiders were engaged in a massive bribery scandal that directly contradicted the company's code of ethics and by not representing that the company was engaging in illegal activity. Further, the company allegedly improperly recorded the bribe and kickback payments in an effort to conceal the true nature of the expenditures, thus making its publicly-released financial statements false and misleading.

Similarly, a Chilean company was also accused of making false and misleading material statements and failing to disclose illegal payments it made that were discovered during the Chilean Attorney General's bribery and tax evasion investigation of a financial firm. In *Viellella v. Chemical & Mining Co. of Chile, Inc., et al.*, No. 15 Civ. 2106 (S.D.N.Y., filed March 19, 2015), plaintiffs alleged that defendant Sociedad Química y Minera de Chile S.A., a leading producer of potassium, iodine and lithium chemicals, illegally channeled money to bribe Chilean politicians and political parties, falsified invoices in order to conceal the bribery, and lacked adequate internal controls and reporting to prevent such bribery from occurring.

In *Dekalb County Employees Retirement System v. Controladora Vuela Compania de Aviación, SAB de CV, et al.*, No. 15 Civ. 1337 (S.D.N.Y., filed Feb. 24, 2015), the plaintiffs alleged that Volaris' financials were misrepresented in its IPO materials due to the company's improper revenue recognition practices. Volaris, an ''ultra low-cost carrier'' airline based in Mexico, had made public statements that its profitability significantly depended upon revenue generated from ''non-ticket'' activities, such as fees for baggage, seat selections, and carriage of sports equipment and pets. ''Non-ticket'' revenues were typically collected and recognized at the time of the flight, however, according to the plaintiffs, Volaris' offering documents falsely represented that the company's revenue recognition policy required the non-ticket revenue to be recognized at the time of flight, even though the existing reservation system did not allow the company to recognize this revenue after the time of sale.

The sole lawsuit against a Latin American company that did not contain any allegations of accounting irregularities or bribery was *In re: Vale S.A. Sec. Litig.*, No. 15 Civ. 9539 (S.D.N.Y., filed Dec. 7, 2015), Vale, a Brazilian mining and metals corporation, and certain executives allegedly made false and/or misleading statements or failed to disclose material facts surrounding the accidental collapsing of a dam by initially concealing the fact that the collapse caused toxic waste to be spilled. Moreover, plaintiffs claimed that Vale had a contract that allowed the company to deposit iron ore waste from its treatment plants into the dam, which might have put extra pressure on the dam and been a contributing factor in the dam bursting.

China

The fourteen complaints filed against Chinese companies were more similar than the lawsuits against Latin American companies, both in terms of the types of companies targeted and the thrust of the allegations. As one would expect, ten of the fourteen defendants are in the technology sector. The themes of liability involved false, misleading or omitted statements related to one of three categories: government notices of illegal business practices, significant financial events, and company valuations. More than half of the complaints contained related allegations of accounting irregularities.

One set of complaints alleged that the defendant corporations failed to disclose government notices about the defendants' illegal business practices. The complaint in *Khunt v. Alibaba Group Holding Ltd., et al.*, No. 15 Civ. 759 (S.D.N.Y., filed Jan. 30, 2015) focused on the alleged failure to notify investors of local authorities' enforcement actions. Alibaba, an online and mobile commerce company in retail and wholesale trade, supposedly failed to disclose warnings from Chinese governmental authorities regarding its business practices. According to plaintiffs, Alibaba concealed the fact that company executives had met with China's State Administration of Industry and Commerce (''SAIC'') in July 2014, two months before Alibaba's multi-billion dollar IPO, and that regulators had brought to Alibaba's attention a variety of highly dubious and potentially illegal practices that threatened Alibaba's business, such as the sale of counterfeit goods, bribes employees had taken, and merchants using false and misleading advertising. The complaint further alleged that before the opening of trading, SAIC released a white paper accusing Alibaba of engaging in the illegal conduct of which SAIC had previously warned Alibaba's executives.

In *Fragala v. 500.com Limited, et al.*, No. 15 Civ. 1463 (C.D. Cal., filed Feb. 27, 2015), the plaintiffs' claims centered around 500.com's allegedly materially false and misleading statements concerning a license they were purportedly granted by China's Ministry of Finance to engaged in online lottery sales. According to the amended complaint, 500.com made illegal bribes and kickback arrangements with government officials in order for the company to receive a tentative license allowing them to sell online lottery products. 500.com, however, had claimed that it had been granted a permanent license. Plaintiffs alleged that the temporary license was granted only because of illegal bribes and kickbacks, and, more importantly, the company was illegally using the temporary license outside of the permitted province. Additionally, 500.com supposedly maintained that its operations were functioning normally even after receiving notice from a Chinese regulatory agency that it had not authorized any sports lottery websites and that it would suspend online lottery purchase orders for lottery products.

Several of the complaints alleged that defendants had made false and/or misleading statements relating to significant financial events. In *Xu v. ChinaCache International Holdings, Ltd., et al.*, No. 15 Civ. 7952 (C.D. Cal., filed Oct. 9, 2015), ChinaCache, a leading provider of internet services and application delivery, was accused of failing to disclose material adverse information concerning the company's new cloud-based content delivery network and its negative impact on financial performance. ChinaCache had stated that its next generation cloud-based content delivery network would be the foundation for the company' future business growth and that the migration was not only completed on schedule, but was, in fact, more successful than expected. A few months later, however, the company changed its tune and acknowledged that it was experiencing platform issues that impacted the company's net revenues.

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In *Sun v. Telestone Technologies Corp., et al.*, No. 15 Civ. 703 (D.N.J., filed Feb. 2, 2015), plaintiffs alleged that Telestone, a telecommunications community, was improperly recognizing revenue in its SEC filings. Telestone disclosed that it earned most of its revenues from three of China's largest telecommunications providers. In reality, the company collected only a small fraction of its sales from the three companies and had internally determined that they were breaching their contractual obligations but there was little Telestone could do. Thus, revenues from sales to those companies were not reasonably certain to be collectable and should not have been recognized under GAAP accounting guidelines.

In *Garcia v. Hetong Guo, et al.*, No. 15 Civ. 1862 (C.D. Cal., filed March 13, 2015), the plaintiff claimed that Lentuo International, an operator of automobile franchises and auto-related retail services, failed to disclose that an affiliated company had issued approximately RMB 250 million of debt to finance new dealerships, that Lentuo did not have sufficient working capital for 2015, and that its cash position was so dire that the company had borrowed money from employees at a 30% interest rate.

In *Knox v. Yingli Green Energy Holding Co. Ltd., et al.*, No. 15 Civ. 4003 (C.D. Cal., filed May 28, 2015), Yingli Green Energy, one of the world's largest solar panel manufacturers, repeatedly portrayed the company positively in its 2013 and 2014 press releases and SEC filings, stating that shipments had increased, demand was increasing, and the company was achieving significant results in several markets. Then, in a May 2015 SEC filing, Yingli admitted that there was substantial doubt about the company's ability to continue operating because it was unable to obtain commercial loans, raise capital, and meet debt payment obligations. The company also disclosed for the first time that it had incurred significant net losses in 2012, 2013 and 2014.

Misconduct related to company valuations was yet another focus of the Chinese complaints. NQ Mobile, a global provider of mobile internet services, was accused of hiding information from investors and diluting stock through numerous acquisitions of small, private Chinese companies of little or no value, and funding those acquisitions in large part with company equity. *See Fincchiaro, et al. v. NQ Mobile, Inc, et al.*, No. 15 Civ. 6385 (S.D.N.Y., filed Aug. 13, 2015). NQ Mobile also accused of manufacturing its revenue by including as its largest customer a payment processing company controlled by NQ Mobile itself. Similarly, in *Huang v. AirMedia Group Inc., et al.*, No. 15 Civ. 4966 (S.D.N.Y., filed June 25, 2015), AirMedia, an operator of advertising platforms, was alleged to have omitted from public filings and statements announcing the sale of 5% of its advertising unit several significant terms, including: (i) that it was required to pay the acquiring company 10% interest per year if the transaction fell through; (ii) the transaction was subject to significant conditions, including achievement of profit targets; and (iii) it could not achieve those profit targets imposed by the proposed transaction given the company's historical and current financial performance. As a result, plaintiffs alleged that the implied valuation of the transaction was unreasonable and unrealistic.

Key Takeaways

The increased number of securities class action complaints filed foreign corporations in 2015 highlights several important considerations.

1. **Brazilian corporations.** Three of the five Latin American defendants were Brazilian companies. Not only is Brazil a growing hotbed for FCPA-related enforcement actions, but due to Brazil's severe economic downturn it appears to be a growing target for plaintiffs seeking to use U.S. securities laws to recoup perceived lost value from declining share prices.

2. **Corruption scandals as the basis for securities lawsuits.** While Chinese and Latin American companies should be sensitive to the legal risk that results from their employees' involvement in bribery and corruption schemes, they must remember that these scandals not only expose them to liability under local and international anticorruption laws, but also to potential shareholder liability.

3. **The technology sector's specific risks.** Technology continues to be most targeted sector overall, and this is no different for foreign technology companies. The failure or underperformance of new products and inaccurately disclosing adverse government notices or warnings is risky not only from a business perspective, but also from a legal perspective. Balancing the fine line between business needs and legal disclosure obligations continues to be a difficult — and litigated — task.

4. **Accounting claims**. Allegations of accounting irregularities were found in more than half of the lawsuits filed against Chinese companies and in all but one case filed against a Latin American company. In fact, the number of cases containing accounting claims filed in 2015 against foreign companies generally increased to 43% and was at the second highest level in the last 10 years. (Cornerstone Research, Accounting Class Action Filings and Settlements – 2015 Review and Analysis 6 (2016)) Securities class action cases involving accounting irregularities take, on average, more than three years to reach a settlement and they tend to settle for the highest amounts in relation to estimated damages. (Cornerstone Research, Securities Class Action Settlements – 2015 Review and Analysis 14 (2016)) This, combined with the fact that Latin American and Chinese corporations seem to be less successful at early dismissal on the merits, means a potentially lengthy and expensive road to case completion.

5. **Institutional Plaintiffs.** The lead plaintiffs in four lawsuits against Latin American corporations and in four cases against Chinese corporations were institutional investors, and the overwhelming majority of those institutional investors were public pension funds. Public pension plans tend to be lead plaintiffs in larger cases, and they have consistently proven to be challenging adversaries. Their median settlements are nearly three times the median settlements of institutional investors who are not public pension funds, and nearly *seven* times the amount of lead plaintiffs who are not institutional investors. (*Id.*)

Whether the marked uptick in securities class actions will be repeated in 2016 is still unknown, but Latin American and Chinese corporations should be cautious of the unique cultural and business characteristics that may make them particularly vulnerable to securities class actions.

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