Lawsuits increase while U.S.-listed Chinese companies face regulatory scrutiny

By Henry Ren (reporting) and Joanna Lin Su (data analysis and visualization)
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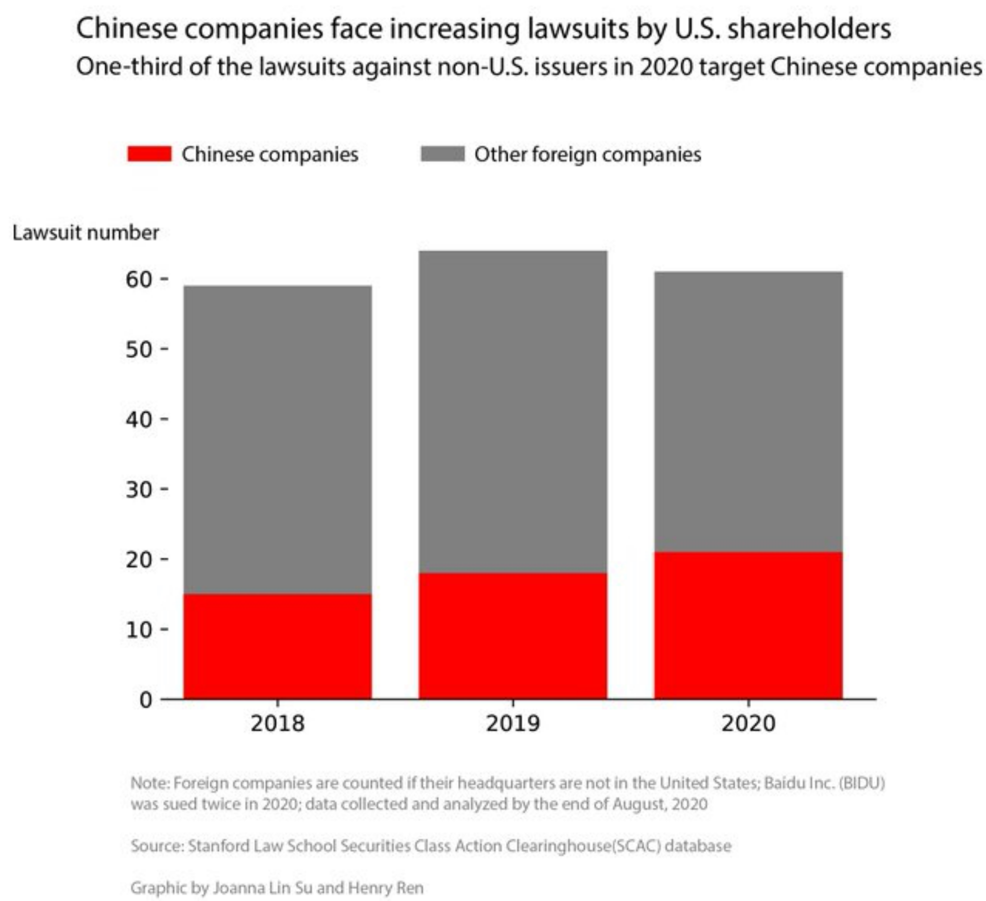
It is not just the Trump administration that plans a crackdown on Chinese companies listed on U.S. stock exchanges. Shareholders want to make them pay, too.

In 2020, U.S. shareholders have sued 20 Chinese companies that currently or used to sell shares on the New York Stock Exchange or the Nasdaq, already more than last year's 18 Chinese companies sued, according to Stanford Law School's data on securities class action litigations.

This means almost one in 10 of the approximately 230 U.S.-listed Chinese companies have been alleged violations of securities laws this year. Chinese stocks are more than twice as likely to be the targets of lawsuits as those of other companies traded on the two exchanges, Stanford data showed.



“The number of cases last year and what we are seeing this year so far against companies headquartered in China is substantial,” said David Kistenbroker, a securities litigation partner at Dechert LLP. “We see that continue for the rest of the year.”

The Trump administration has tightened its grip on Chinese stocks since Luckin Coffee Inc. disclosed in April that it had inflated more than $300 million of sales. Under the administration’s latest plan, Chinese companies can be kicked out of U.S. exchanges in 2022 if they cannot comply with U.S. audit standards.

Luckin Coffee was not the only Chinese company that was alleged to have committed internal frauds. Streaming platform iQiyi Inc. and education group GSX Techedu Inc. are under investigation by the Securities and Exchange Commission after shareholders claimed both companies overstated sales and user numbers.

Following in Luckin Coffee’s footsteps, Chinese jewelry maker Kingold Jewelry delisted its shares from Nasdaq after shareholders sued the company for securing loans with fake gold.

“Luckin Coffee fraud may have the real side effect of increasing the scrutiny of regulators on Chinese companies,” Kistenbroker said. “Certainly, the securities class action plaintiff firms are looking closely at the public statements of Chinese companies as well.”

About half of the securities class action litigations will end up being settled and the median settlement amount last year was $11.5 million, according to Cornerstone Research. However, financial improprieties like sales inflation can drive up the settlement amount, Kistenbroker said.

The recent lawsuits indicate that a number of Chinese companies lack internal financial controls, said Kevin LaCroix, a management liability specialist and executive vice president at RT ProExec. He also said some lawsuits were the result of companies’ failure to prevent transactions by senior management.

“Some Chinese companies that go public are interested in the status that potentially goes with a U.S. listing. But they are not always ready for the scrutiny and transparency requirements,” LaCroix said.

In a bigger picture, non-U.S. issuers are more likely to be sued by shareholders, LaCroix said, accounting for 61 of the 235 complaints filed against companies on the two exchanges this year so far, Stanford data showed.

This is partially because the appeal of U.S. listings to foreign companies has grown in recent years. In addition, many of the companies are in the most frequently sued industries such as technology, financial services and pharmaceuticals, LaCroix said.

To avoid securities class action lawsuits and huge settlements, foreign companies should make sure internal controls are in place and audit committee functions properly. They also should consider purchasing directors and officers liability insurance to mitigate risks, experts suggested.

“The single most important thing is making sure that they have good financial reporting processes, because the most dangerous kind of lawsuit a company could face is an allegation that it did not accurately report true financial condition,” LaCroix said.

(Code snippets link: https://github.com/joannalinsu/code_snippets/blob/main/get_hqs.py)