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China

Chinese Companies "Going Dark": Finally Accountable to U.S. Hedge Funds and Other Shareholders

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In the last two years, there has been a growing and insidious trend among valuable, operational and publicly listed Chinese companies in the U.S. to suddenly stop reporting and making requisite financial disclosures with the SEC. After raising millions of dollars on the U.S. capital markets, these companies have either informally, or formally through the filing of a Form 15 with the SEC, "gone dark" – in some cases, with the manifest intention to depress the value of their stock to facilitate an insider-led privatization. As Kathy Chu and Michael Rapoport reported in the Wall Street Journal on December 5, 2012:

> [T]he era of reverse mergers – a back door route to the securities market that involves combining a private company with an inactive, publicly traded shell – may have ended. Another has begun: Chinese companies going private.

At the time of their writing, Chu and Rapoport noted that 25 U.S.-listed Chinese companies had announced plans to go private in 2012, compared with 16 companies in 2011.

Once a company has gone dark, U.S. shareholders are left with little or no current financial information and are deprived of the most basic of shareholder rights: the ability to make reasoned investment decisions, and, if desired, exit their investment. The problem is magnified in the case of thinly traded securities, for which the company's decision to go dark creates an illiquid market.

Hedge funds that have invested in companies that have gone dark and subsequently seen their stock price collapse need not always accept such losses at face value. In some circumstances, legal efforts to recoup investment value may pay rich dividends. Moreover, funds that invested in companies that abruptly stopped reporting may be exposed not only to investment loss but also to investor litigation alleging failure of due diligence. Taking legal action has the added benefit of demonstrating to investors that the fund is vigilant and aggressive in pursuit of its rights as an investor.

Pursuing Fair Market Value When Companies Go Dark

Litigators have recently employed novel strategies to help investors in "self-darkened" Chinese companies exit their position, if desired, at fair market value using a traditional fair value analysis. While strategy varies according to jurisdiction, Delaware has not surprisingly proved to be ground zero for pioneering recovery efforts.

In Delaware, shareholders have a right to inspect the company's books and records pursuant to 8 Del. C. § 220, and the company has five days to respond to inspection requests. In several cases, litigators have sent demands on behalf of investors in such companies and exerted pressure for the company to comply through judicial and extra-judicial means. In the event that the company has not complied, plaintiffs have initiated a Section 220 action in the Delaware Chancery Court.

The test case has been *Peter E. Deutsch v. ZST Digital Networks Inc.* (The authors represent plaintiff Peter E. Deutsch in this case.) After ZST stopped reporting and its price share plummeted, the plaintiff asked the company to produce its books and records. When ZST failed to comply, the plaintiff successfully brought a contempt action and as part of the requested relief obtained an order for: (1) a "put" option at fair market value for the plaintiff's shares; (2) attorneys' fees and costs in bringing the action; and (3) the appointment of a receiver to carry out the court's orders. Because the data points required to calculate fair market value were not available, the court ordered the "put" at the company's last reported book value of $8.21 per share. Before *ZST,* it was all but unheard of for the court to appoint a receiver to collect a judgment against a *solvent* company – a potent new arrow in the quiver for those pursuing the assets of healthy companies that have gone dark.

The exercise of the put option places the plaintiff in a unique position of a judgment creditor with vested property rights, with priority over claims of any other shareholders and other unsecured creditors. The ZST action has proved to be a potent precedent, invoked by other investors to reach several quick and profitable negotiated settlements with U.S. companies with offshore operations.

The Golden Receiver

The appointment of a receiver has been an enormously effective mechanism to enforce court orders and judgments against the defendant (now the judgment debtor). In *ZST* and similar actions, receiver order(s) have provided the appointee with extremely broad powers.

These powers have enabled, among other things, obtaining ex parte (no notice) seizure orders against, among others, the judgment debtor company's CFO, its auditors and investor liaison office, followed by raids conducted with federal marshals in their homes and corporate premises. The raids have yielded hard copy documents as well as mirror images of the hard drive of all electronic devices from computers (including downloads from servers abroad), laptops, PDAs and phones.

The wealth of data is typically analyzed by the receiver's team of forensic experts and provides information and evidence for further actions. These have included commencing suits to void fraudulent conveyances and turnover actions for assets of the judgment debtor held by transferees; obtaining attachment orders against real property; tracing the movement of funds to seize and attach bank accounts worldwide, and issuing subpoenas and restraining notices against scores of individuals and entities to gather information and preserve assets for investors.

The receiver orders in these cases generally provide that the receiver has ownership and authority over the property or assets of the judgment debtor wherever located throughout the world. Plaintiffs' attorneys should work with receivers and attorneys retained by them globally to coordinate a multi-jurisdictional strategy to take over assets. For instance, after identifying the judgment debtor's equity interests in various companies, plaintiffs have changed the ownership structure through board resolutions and other legal means and essentially taken over control of companies in the BVI, Hong Kong and the People's Republic of China.

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Potential Outcomes

There are at least five potential outcomes as a result of the strategies and enforcement mechanisms described above. These include:

1. Private resolution with management.
2. Litigation and collection, through a receiver, through satisfaction of a judgment.
3. Disclosure of books and records so as to permit the investor to engage in fair market value transactions to exit the position.
4. Compelling a filing with the SEC to require the same exit at fair value through private transactions.
5. Ultimate takeover and sale of the enterprise through a sale of any of the subsidiaries in the ownership chain, with the hope to sell the entity owning the China operating entity.

Investors in companies that have gone dark on U.S. exchanges should not assume that their investments are irrecoverable when the stock price collapses. If the company's operations seem to be thriving, the legal tools exist to discover and recover fair market value.

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