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CHINA MATTERS

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China Reverse Mergers Under Increasing Scrutiny from U.S. Regulators and Plaintiffs' Lawyers

BY THE SECURITIES LITIGATION AND ENFORCEMENT PRACTICE

Over the past few years, reverse mergers have become an increasingly popular way for China-based companies to access U.S. equity markets. For many China-based companies, reverse mergers offer an attractive alternative to an Initial Public Offering ("IPO"), because reverse mergers are faster and less expensive than IPOs. According to a recent report, 159 China-based companies engaged in reverse mergers from 2007 through the first quarter of 2010, while only 56 China-based companies engaged in traditional IPOs during the same period.

In such a reverse merger, a China-based private company allows itself to be acquired by a publicly traded shell company in the United States that has no significant operations, assets or value other than that its stock is publicly traded. Once the shell target is acquired, its board of directors resigns and turns control over to the China-based company's board of directors. The company's name is often changed at this point to the name of the China-based company. The resulting public company, sometimes referred to as a "China reverse merger" or "CRM", is then able to issue equity, which is often done through private investment in a public equity ("PIPE") transactions. Many such PIPE transactions are negotiated with hedge funds, private equity firms and other large investors prior to the reverse merger at pre-negotiated prices, and occur simultaneously with the merger.

CRMs are coming under increasing scrutiny from U.S. regulators. In the last few months, the Securities and Exchange Commission ("SEC") opened formal or informal investigations into more than half a dozen CRMs and filed civil actions in connection with at least two others.[1] In addition, the SEC is conducting a wide-ranging investigation of reverse merger companies, with a focus on CRMs, and the various entities involved in putting the deals together (i.e., investment advisors, law firms, promoters, bankers and accounting firms).[2] Meanwhile, the Public Company Accounting Oversight Board ("PCAOB"), the U.S.'s accountancy watchdog, recently highlighted its own focus on CRMs by issuing a statement discussing what it perceives as chronic flaws in the audits of such companies. The PCAOB's statement is underscored by the auditor woes being suffered by many CRMs. For example, one CRM was recently forced to disclose that its auditor had resigned due to accounting fraud involving the forging of bank statements and other records.[3] As usual, U.S. plaintiffs' lawyers are not far behind the regulators, and a number of CRMs have found themselves targeted by shareholder class action and related lawsuits.

The headlines associated with a few problematic CRMs create potential problems for all China-based companies that have chosen to access U.S. equity markets through reverse mergers.

China-based companies that have accessed and intend to access U.S. equity markets through reverse merger transactions should be sensitive to the current regulatory climate when going public, issuing stock, designing internal controls, and interacting with

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auditors. There are important steps such China-based companies should make sure to take:

- Review Current D&O insurance and/or obtain adequate D&O insurance. This is important if companies are to weather regulatory inquiries and shareholder lawsuits. Such policies typically cover legal costs associated with lawsuits, and may also cover regulatory investigations and perhaps internal investigations.
- Conduct internal investigations as necessary. If shareholders lodge complaints or if any red flags exist, companies should investigate as soon as practical in order to head off claims of improper conduct. Audit committees must be particularly vigilant in this climate. When in doubt, committees should act rather than wait.
- Retain Experienced Counsel. Even if a lawsuit has not been filed, companies should make sure to engage competent outside counsel with significant experience in responding to government inquiries, shareholder litigation and internal investigations.

Although the scrutiny now being applied to CRMs will ultimately benefit those companies with solid business models and strong infrastructure, the short-term promises to present significant legal hurdles for all China-based companies with shares trading on the U.S. markets, especially CRMs.

Paul, Hastings, Janofsky & Walker LLP is a global law firm with 18 offices in Asia, Europe and the United States. Paul Hastings has one of the largest, full-service, multi-jurisdictional legal practices in Asia with legal professionals in Beijing, Hong Kong, Shanghai and Tokyo.

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[1] CRMs reportedly under informal or formal investigation are: (1) China Sky One Medical (CSKI) (formal), (2) Fuqi International (FUQI) (formal), (3) Rino International (RINO) (formal), (4) China Green Agriculture (CGA) (informal), (5) Duoyuan Printing (DYNP) (informal?), (6) China Century Dragon (CDM) (unknown), and (7) China Intelligent Lighting & Electronics (CIL) (informal).

[2] S. Eden, *SEC in Massive Probe of Chinese Reverse Mergers That Have Cost Investors Billions*, *The Street*, December 21, 2010.

[3] The company referenced is China Intelligent Lighting & Electronics.