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Inequities in Corporate and Securities law: Disabling the Exploitative Chinese Corporation and Charting a Path to International Commercial Accountability

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Inequities in Corporate and Securities Law: Disabling the Exploitative Chinese Corporation and Charting a Path to International Commercial Accountability

JONATHAN P. SCHMIDT*

I. INTRODUCTION .................................................................................................. 360
II. BACKGROUND .................................................................................................... 363
    A. The Sarbanes-Oxley Act of 2002 .............................................................. 363
    B. Private Litigation ..................................................................................... 365
    C. U.S. Jurisdiction over Foreign Defendants under SOX and the Securities Exchange Act .............................................................. 366
    D. Trade Secrets Laws .................................................................................... 367
    E. Criminal Extradition Treaties ................................................................... 368
    F. Enforcement of U.S. Judgments ................................................................. 370
    G. State Reverse Merger Law ......................................................................... 371
III. ANALYSIS OF U.S.-LISTED, CHINA-BASED CORPORATIONS .................. 373
    A. Current Situation and Increasing Litigation ............................................ 373
    B. Exploitation by Chinese Corporations .................................................... 374
       1. The Reverse Merger Loophole .......................................................... 375
       2. FRCP 12(b)(6) Failure to State a Claim ............................................... 376
       3. Securities Class Actions .................................................................... 379
       5. China’s Barriers to Enforcement ........................................................ 384
    C. What Needs to Change .............................................................................. 387

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I. INTRODUCTION

One of the most distinguishing trends in United States (“U.S.”) litigation has been the expansion of class-action securities lawsuits and Securities and Exchange Commission (“SEC”) enforcement actions against U.S.-listed Chinese companies who have gone public through a state reverse merger process in the U.S. Investors in the U.S. have risked billions of dollars on these Chinese companies, principally under a belief that the Sarbanes-Oxley Act of 2002 (“SOX”) protected them against accounting fraud and inaccurate or inflated stock prices. However, once accounting scandal concerns become ostensible, stock prices collapse, and U.S. investors are financially devastated, including some major investors such as John Paulson and former American International Group, Inc. (AIG) CEO Maurice Greenberg. Regrettably, these embattled shareholders and the SEC have little to no recourse or enforcement capacity where gaps in SOX, state reverse merger law, and a lack of international reciprocity allow Chinese and other foreign corporations to exploit U.S. investors.

The federal government and state legislatures must take drastic measures to ensure investor confidence in international corporations listed on U.S. exchanges, and to protect U.S. investors from investing in corporations mired in fraudulent activity. Such measures may include imposing additional requirements on reverse mergers involving foreign companies, so that the SEC may potentially freeze foreign assets, or imposing significant diplomatic pressure on China.


5. Id.
Appreciably, various groups, including the SEC, have taken a number of steps to address and confront the issue head-on. The SEC has issued an Investor Bulletin to educate U.S. investors on the perils of investing in foreign corporations accessing U.S. capital markets through the reverse merger process. In addition, the SEC has brought many actions suspending trading or revoking registration of these China-based corporations. Furthermore, the Public Company Accounting Oversight Board, set up under Sarbanes-Oxley to examine accounting fraud, issued a report examining China-based companies, reverse mergers, and potential audit implications. In that report, the Public Company Accounting Oversight Board identified 159 Chinese companies that have accessed U.S. securities exchanges through reverse mergers, and noted the principal concern that U.S. firms are not conducting thorough, proper audits of these companies, and that Chinese accounting firms may be inaccurate in their assessments. Moreover, Moody’s credit rating agency issued a “Red Flags” report for these companies to focus on investors’ concerns with their financial reporting, and NASDAQ has proposed new, more stringent listing requirements for companies that go public through reverse mergers. These proposed requirements are currently under review for comment.

10. Id.
12. See Securities & Exchange Commission, Notice of Filing of Proposed Rule Change to Adopt Additional Listing Requirements for Reverse Mergers, SEC Release No. 24-64633, at 1–3 (June 8, 2011). Requirements listed are as follows: (1) traded for at least six months in the U.S. over-the-counter market, on another national securities exchange or on a foreign exchange following the filing of all audited financial statements; (2) maintained a bid price of $4 or more per share for at least 30 of the most recent 60 trading days; (3) in the case of a U.S. domestic issuer, the company timely filed its two most recent financial statements (i.e., Form 10-Q or 10-K); and (4) in the case of a foreign-based issuer, the company timely filed a comparable financial statement (i.e., Form 6-
However, these superficial notices, actions, and reporting requirements lack the authoritative weight necessary to stem a burgeoning issue of this magnitude. The SEC itself has about 350 people in its corporation finance division reviewing over 10,000 public companies’ financial reports, and has significant resource constraints that would allow it to find every single reverse merger accounting issue.\textsuperscript{14} And while the SEC may charge China-based companies with fraudulent activity and ultimately win,\textsuperscript{15} Chinese courts do not enforce U.S. judgments,\textsuperscript{16} and the SEC may not have the means to obtain the awarded assets.\textsuperscript{17} Moreover, the lack of an extradition treaty between the U.S. and China allows Chinese managers to evade criminal conviction based on accounting fraud in SOX.\textsuperscript{18} Furthermore, China’s trade secrets laws prevent the gathering of accounting evidence and work papers essential to this type of litigation.\textsuperscript{19} Finally, because state law governs the reverse merger process to permit China-based corporations access to U.S. exchanges, it is difficult for the federal government to stop Chinese companies from the outset.\textsuperscript{20} This article seeks to provide a roadmap for the U.S. federal and state legislatures to come together to protect the U.S. investor from the type of accounting fraud and stock misinformation that was the impetus behind enacting the Sarbanes-Oxley Act of 2002. First, this article will discuss the legal backdrop and legislative policy behind U.S. laws such as SOX and its enforcement mechanisms, and the ability for shareholders to bring securities class action derivative actions for financial fraud. This article will also discuss trade secrets laws, criminal extradition treaties, international enforcement of judgments, and elucidate the reverse merger

K, 20-F or 40-F) that includes an interim balance sheet and an income statement presented “in English.” \textit{Id.}


\textsuperscript{14} Aubin & Shalal-Esa, \textit{supra} note 2.


\textsuperscript{16} “First, reciprocity does not in fact appear to exist. My research has failed to uncover a single case in which U.S. courts have enforced Chinese court judgments without inquiring into the underlying merits of the dispute. Second, Chinese courts do not believe that reciprocity exists sufficient to support the enforcement of a U.S. court judgment. My research has found no cases in which a U.S. court judgment has been enforced on any grounds.” See Donald C. Clarke, \textit{The Enforcement of United States Court Judgments in China: A Research Note}, Geo. Wash. Univ. Legal Studies Research Paper No. 236, at 3 (May 27, 2004).

\textsuperscript{17} Aubin & Shalal-Esa, \textit{supra} note 2.

\textsuperscript{18} \textit{Id.}

\textsuperscript{19} \textit{Id.}

\textsuperscript{20} \textit{Id.}
process in the states, particularly in Delaware. Second, this article will illustrate just how these Chinese corporations exploit the current state of the law and diplomatic relations with the United States to unfairly manipulate U.S. investors. Finally, this article will provide two complementary solutions to pave the way to achieving international commercial accountability, by a protectionist scheme involving both the federal government and state legislatures and by international diplomacy and legal pressure.

II. BACKGROUND

Before addressing the principal issue of China-based corporations entering U.S. capital markets without fear of conviction with respect to their fraudulent activity, the current state of relevant U.S. law and international relations must be fully demonstrated. The U.S. has enacted laws to protect its citizens and provide a cause of action against corporate fraud, felt the effect of trade secrets laws as a hindrance to discovery in international cases, seen the benefit of criminal extradition treaties, appreciated the effect of non-enforcement of its judgments, and developed a reverse merger process in its state legislatures that is being exploited. After fully illuminating the state of the law in each of these five areas, this article will move to the principal issue of how China-based corporations use U.S. state law to fraudulently capitalize on investors, and how to effectively stymie exploitation of U.S. law and diplomacy by Chinese corporations.

A. The Sarbanes-Oxley Act of 2002

Significantly, the impetus behind the implementation of SOX is the same policy reasoning behind protecting U.S. investors from China-based accounting fraud in the U.S. today. When President Bush signed into law the Sarbanes-Oxley Act of 2002, it was in the wake of across-the-board corporate accounting fraud, reduction in shareholders’ equity in Enron Corporation of about 1.2 billion, and the collapse of WorldCom.22 This economic collapse had been preceded by financial reporting irregularities at a number of other public corporations including Oxford Health and Xerox, and investor confidence in U.S. capital markets

was shattered. In an interview with Senator Paul Sarbanes, co-author of SOX, Sen. Sarbanes described the inspiration behind the Act as a result of “problems that were broad, deep systemic and structural” in the marketplace and a result of “highly-regarded public companies, along with their auditors . . . relying upon convoluted and often fraudulent accounting devices to inflate earnings, hide losses, and drive up stock prices.”

Widespread accounting fraud led to a destruction of investor confidence in publicly-traded corporations and a decline in U.S. security prices. The implementation of SOX was precisely to assure reliability of corporate disclosure and accounting standards that ensure economic buoyancy.

Under Sarbanes-Oxley, the SEC has the capacity to regulate accounting standards and engage in litigation to protect against fraud or misrepresentation on its own initiative. In addition, SOX establishes the Public Company Accounting Oversight Board to oversee audit reports of companies subject to securities laws. Furthermore, SOX establishes a number of regulatory provisions to safeguard against accounting fraud. Of critical importance is the section on corporate responsibility for financial reports, which requires officers to assure the public that their financial statements are accurate. Both the CEO and the CFO must certify in each annual and quarterly report that they have reviewed their financial report, that it is true to the best of their knowledge, and that it reflects the financial status of the company; if the information is incorrect or inaccurate, the officers are subject to personal liability. This monetary liability can range up to $5 million with an additional criminal liability of up to twenty years in prison for corporate directors. Notably, criminal liability has acted as a major deterrent for U.S. capital market accounting fraud and misrepresentation.

23. Id.
25. BLOOMENTHAL, supra note 22.
27. Id. § 7211 (2011).
28. BLOOMENTHAL, supra note 22, at § 1:10.
30. See id.
B. Private Litigation

Accordingly, disclosure of financial statements and accounting irregularities from SOX has also led to shareholders filing private actions, which may result in larger judgments and settlements.\textsuperscript{33} However, victimized shareholders have been authorized to file suit against publicly held corporations on the basis of securities fraud since the implementation of the Securities Exchange Act of 1934.\textsuperscript{34} The SEC promulgated a landmark regulation under the Act, which provides that it is unlawful for any person to engage in any scheme or artifice to defraud, or make any misrepresentation of material fact, in the connection of its purchase or sale of its own securities.\textsuperscript{35} Significantly, in order for shareholders to have a successful fraud claim under this section, the Supreme Court has proffered six elements that plaintiffs must prove in litigation, citing a number of influential cases, statutes, and treatises in the process.\textsuperscript{36} In cases involving publicly traded securities, a shareholder fraud action must include: (1) a material misrepresentation or omission; (2) a wrongful state of mind; (3) a connection with the purchase or sale of a security; (4) reliance by plaintiffs on material misrepresentation; (5) economic loss; and (6) loss causation, or a causal connection between the material misrepresentation and the loss.\textsuperscript{37}

In recent years, it has become exceedingly difficult for shareholders to bring derivative fraud claims.\textsuperscript{38} As with any cause of action, in a securities fraud action under Section 10(b), the plaintiffs must plead a claim on which relief can be granted in order to survive a FRCP 12(b)(6) motion to dismiss.\textsuperscript{39} In 1995, Congress passed the Private Securities Litigation Reform Act (“PSLRA”),\textsuperscript{40} which established pleading

\textsuperscript{33} BLOOMENTHAL, supra note 22, at § 1:19.
\textsuperscript{35} 17 C.F.R. § 240.10b-5 (2011).
\textsuperscript{37} Id. at 341–42.
requirements for these actions, which notably contained a higher requirement for proving scienter, or a wrongful state of mind. Under the PSLRA, the plaintiffs must “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” Recently, the Supreme Court in Makor Issues & Rights, Ltd. v. Tellabs, Inc. held that this “strong inference” must be at least as strong as an opposing inference on the pleadings. The plaintiffs must allege facts from which a reasonable person could rationally draw an inference of scienter. Accordingly, as Jonathan C. Dickey notes in the Corporate Law and Practice Series, “Tellabs strengthens the pleading standard set forth by Congress in the PSLRA, and creates a uniformly high bar for pleading . . . in securities fraud cases.” Thus, in the context of foreign corporate directors, shareholders must have access to detailed facts against a foreign corporation at the pleading stage before the discovery process may begin in order to withstand preliminary motions to dismiss.

C. U.S. Jurisdiction over Foreign Defendants under SOX and the Securities Exchange Act

Significantly, U.S. courts can claim a broad swath of jurisdiction over foreign defendants for violations of these federal laws. In determining whether a court can exercise personal jurisdiction, a court must look to the contacts between the defendant and the litigation. In assessing the sufficiency of the contacts, a court should determine whether the defendant has availed himself of the privileges of American law and the extent to which he could reasonably anticipate being involved in litigation in the United States. The court also must determine whether the exercise of such jurisdiction comports with “traditional notions of fair play and substantial justice.”

Section 27 of the Securities Exchange Act authorizes a nationwide service of process for claims under the act, and this entails a “nationwide

43. Tellabs, 551 U.S. at 323.
44. Id.
45. Dickey, supra note 38, at 374.
47. Pinker v. Roche Holdings Ltd., 292 F.3d 361, 368 (3d Cir. 2002).
48. Id. at 370 (quoting Max Daetwyler Corp. v. Meyer, 762 F.2d 290, 293 (3d Cir. 1985)).
contacts analysis” by the federal courts. Under a nationwide contacts analysis, the jurisdiction is not confined to where the federal court resides, but rather the whole of the U.S. A nationwide contacts analysis also passes muster under the U.S. Constitution and due process concerns in federal court for federal question cases. Accordingly, foreign corporate defendants satisfy the minimum contacts test under this analysis, and they may be brought within the purview of U.S. federal courts under federal law.

D. Trade Secrets Laws

For both SEC and private litigants, enforcement of trade secret restrictions make it difficult to obtain the financial statements and facts necessary to properly allege and prevail on claims under SOX or the Securities Exchange Act. National state secrets laws can have chilling effects on transparency for business and trade, and businesses may be unable to predict sanctions or criminal convictions based on their activity. Accordingly, in foreign litigation, businesses may not hand over records in discovery if they could be subject to their own national jurisdiction’s state secrets laws. This could render Rule 37 of the Federal Rules of Civil Procedure, which provides the ability to compel disclosure or discovery in federal court, without force or halt litigation at the pleading stage.

The U.S. and its administrative agencies have faced this type of hurdle in international litigation before. In an enormous tax-evasion inquiry by the U.S. and the IRS against UBS, a Swiss bank, the federal government sued for the disclosure of 52,000 account holders’ identities. UBS stated that complying with this disclosure demand would violate Swiss law,

52. In re Heckmann, 869 F. Supp. 2d at 535.
54. See In re Heckmann, 869 F. Supp. 2d at 536.
55. See Aubin & Shalal-Esa, supra note 2.
57. Aubin & Shalal-Esa, supra note 2.
58. FED. R. CIV. P. 37(a).
60. Id.
and also that there was no tax treaty negotiated between the two countries.\textsuperscript{61} While high-level government officials in that case came together to settle,\textsuperscript{62} Swiss courts later ruled that its financial regulator broke the law in ordering UBS to transmit tax data to the U.S.\textsuperscript{63} This promised to negatively influence future international litigation,\textsuperscript{64} and Swiss lawmakers later rejected disclosure to the U.S. Justice Department in a further criminal investigation into UBS.\textsuperscript{65} While the IRS later dropped the action against UBS,\textsuperscript{66} trade secrets laws, such as Swiss banking law, have proven troublesome to the enforcement of laws by U.S. administrative agencies, such as the Internal Revenue Service.

\textbf{E. Criminal Extradition Treaties}

In the event that the SEC or shareholders overcome these litigation hurdles and convict foreign directors for accounting fraud, the lack of a criminal extradition treaty may render the U.S. helpless in enforcing judgments against foreign directors. Under U.S. law, when there is a treaty for extradition between the U.S. and a foreign government, any justice or judge may issue a warrant for the apprehension of a person charged with a crime in his or her jurisdiction.\textsuperscript{67} The judicial and executive branches must follow a strict three-step process in determining whether to sustain a criminal charge.\textsuperscript{68} However, a lack of an extradition treaty means a fugitive who flees the U.S. may evade capture and avoid criminal charges, and the U.S. must wait until the individual is arrested.

\begin{footnotesize}
\begin{itemize}
  \item \textsuperscript{61} Id.
  \item \textsuperscript{64} Id.
  \item \textsuperscript{65} Lynneley Browning, \textit{Switzerland Rejects Deal to Share Banking Data}, \textit{N.Y. TIMES}, June 8, 2010, at B3.
  \item \textsuperscript{66} Laura Saunders, \textit{IRS Withdraws its UBS Tax Case, Closing a Chapter, U.S. Taxpayers’ Names Handed Over; More Actions to Come}, \textit{WALL ST. J.}, Nov. 16, 2010.
  \item \textsuperscript{67} 18 U.S.C. § 3184 (2011).
  \item \textsuperscript{68} 18 U.S.C. §§ 3181-96 (2011). \textit{See also} Anna MacCormack, \textit{The United States, China, and Extradition: Ready for the Next Step?}, 12 N.Y.U. J. LEGIS. & PUB. POL’Y 445, 449 (2009) (describing the three-step process as follows: “(1) extradition requests are conveyed to the State Department, which reviews the request to ensure that it includes sufficient evidence regarding the requested individual and alleged wrongdoing; (2) the request is passed to the U.S. Attorney’s Office in the jurisdiction where the person sought is believed to be, and the Office files a complaint in federal district court; a judicial officer may then issue the arrest warrant for the person sought; and (3) once the extraditee is apprehended, the judge conducts a hearing to determine whether there is a valid treaty in operation, the crime is extraditable under the treaty, and probable cause exists to sustain the charge”).
\end{itemize}
\end{footnotesize}
in a cooperative jurisdiction.\textsuperscript{69} While there may be a case-by-case informal avenue to extradition, without a treaty, cooperation between countries is “unsystematic, improvised, and decentralized,” and there is no way to check whether a country is abiding by its own laws or international commitments.\textsuperscript{70} Consequently, with no extradition treaty, obtaining a final criminal conviction is extremely difficult in U.S. courts.

With respect to SOX enforcement, the U.S. has appreciated the value of an extradition treaty in its recent history.\textsuperscript{71} As a result of the Enron debacle, three British citizens, dubbed the “NatWest Three” for their involvement with NatWest Bank,\textsuperscript{72} were indicted by a grand jury in the Southern District of Texas for wire fraud under SOX.\textsuperscript{73} Pursuant to the extradition treaty in 2003 between the United Kingdom (“U.K.”) and the U.S.,\textsuperscript{74} the three were transported to Houston, Texas to stand trial for their criminal activity.\textsuperscript{75} This extradition request by the U.S. and subsequent approval by the High Court in the U.K. in 2006,\textsuperscript{76} can serve as a “successful model for prosecution of white collar crime.”\textsuperscript{77} Both the U.K. and U.S. worked together to gather evidence and information concerning the fraud in question,\textsuperscript{78} and by lowering standards for extradition and working together with national legislation, transnational prosecution has been significantly improved between the two nations.\textsuperscript{79}

\begin{itemize}
\item \textsuperscript{69} MacCormack, \textit{supra} note 68, at 491.
\item \textsuperscript{70} Id. at 492.
\item \textsuperscript{71} See Kate Murphy, ‘NatWest 3’ Sentenced to 37 Months Each, \textsc{N.Y. Times}, Feb. 22, 2008, http://www.nytimes.com/2008/02/22/business/worldbusiness/22ht-natwest.5.10317714.html.
\item \textsuperscript{72} Id.
\item \textsuperscript{73} Indictment, United States v. Bermingham, No. H-02-0597 (S.D. Tex. 2002).
\item \textsuperscript{75} NatWest ‘Fraud’ Trio Arrive in US, \textsc{B.B.C. News}, July 13, 2006, http://news.bbc.co.uk/2/hi/5175058.stm.
\item \textsuperscript{76} Alison E. Lardo, \textit{The 2003 Extradition Treaty Between the United States and United Kingdom: Towards a Solution to Transnational White Collar Crime Prosecution?}, 20 \textsc{Emory Int’l L. Rev.} 867, 894 (2006).
\item \textsuperscript{77} Id. at 893.
\item \textsuperscript{78} Id.
\item \textsuperscript{79} Id. at 903.
\end{itemize}
F. Enforcement of U.S. Judgments

In the case of private litigation and some SEC enforcement, monetary judgments, rather than criminal convictions, will be the remedy in securities actions. Consequently, whether a foreign director’s home country enforces U.S. judgments is a principal concern in protecting U.S. investors. Presently, the United States is not a party to any treaty for reciprocal recognition and enforcement of judgments. However, while the U.S. is generally considered one of the most liberal and receptive nations in recognizing foreign judgments, its size, its expansive notions of jurisdiction, and its excessive jury verdicts are perceived as too imposing for foreign nations to enforce consistently.

Accordingly, recognition and enforcement of a U.S. monetary judgment is naturally determined according to the foreign country’s enforcement law. Foreign courts will typically enforce final judgments that are in line with public policy. Foreign courts, such as Greece, Japan, and Mexico, will often times refuse enforcement of a U.S. judgment if their court would not have jurisdiction under the facts. Other foreign courts, such as Korea, Spain, and Taiwan, will often times refuse enforcement of a U.S. judgment if there was a failure to follow special notice procedures. Further, foreign courts will, at times, view the U.S. federal and state system as lacking uniformity, and deny enforcement on the grounds “that U.S. courts will not reciprocally recognize and enforce foreign judgments.” Consequently, U.S. monetary judgments are often not upheld in foreign jurisdictions.

82. See Matthew H. Adler, If We Build It, Will They Come?—The Need for a Multilateral Convention on the Recognition and Enforcement of Civil Monetary Judgments, 26 LAW & POL’Y INT’L BUS. 79, 93–96 (1994).
84. Adler, supra note 82, at 95.
85. Weems, supra note 83, at 74.
86. Id.
G. State Reverse Merger Law

Appreciably, after the discussion infra of SEC and private litigation against foreign citizens and the general state of the law surrounding enforcement of their potential judgments, it is imperative to discuss the component of state law, which allows for foreign individuals and/or corporations to infiltrate U.S. securities exchanges in the first place. A “reverse merger” is a transaction, under state law, where a privately held corporation acquires a publicly traded shell corporation. A shell corporation is one with little or no assets and liabilities and is not in operation. The shareholders of the privately held corporation then exchange their shares for a majority of the shell corporation, gain a controlling interest in voting power and shares, and take over business operations. After the transaction, the private corporation will transform into a publicly traded company, often with its same name, without going through securities exchange registration and the initial stock offering.

The crux of a reverse merger deal is the availability of a shell company already listed on a U.S. stock exchange. Accordingly, private corporations will contact “shell brokers” who acquire shell corporations in a “secrecy-friendly state such as Delaware, Utah or Nevada,” and these brokers


89. Sec. & Exch. Comm’n v. M&A West, Inc., 538 F.3d 1043, 1046 (9th Cir. 2008).

90. Id.


92. M&A West, 538 F.3d at 1047.

93. Byrnes & Browning, supra note 88.

94. Id.
will coordinate the transaction, prepare documentation, and act as conduits for negotiation.\(^{95}\) Because these transactions are conducted under state law, they often avoid oversight by federal SEC regulators and avoid registration.\(^{96}\) While the private company avoids the initial public offering,\(^{97}\) they still must comply with continuing listing requirements once trading begins.\(^{98}\)

Foreign corporations have been conducting these reverse mergers and accessing U.S. securities markets.\(^{99}\) There are a number of reasons why foreign private operating companies may pursue a reverse merger. First, a reverse merger allows a private company cheap access to securities exchanges, without the expense of a public offering.\(^{100}\) Second, private companies can gain access to public investors, providing their firm with more forms of equity.\(^{101}\) Third, they engender lower legal and accounting fees than entering exchanges through an initial public offering.\(^{102}\) Openly, reverse mergers are a great way for smaller companies, who can’t afford a public offering, to access capital for their business.\(^{103}\) The issue lies in the exploitative corporations who misuse it.\(^{104}\)

Notably, the purpose of registration with the SEC is “to protect investors by promoting full disclosure of information thought necessary to informed investment decisions.”\(^{105}\) When the express purpose of a reverse merger is to access capital markets “without making the extensive public disclosures required at the initial public offering,”\(^{106}\) it deprives U.S. investors of particularly important protections.\(^{107}\) It is with this in mind that the SEC promulgated an investor bulletin warning of investment in reverse merger companies in 2011.\(^{108}\) The SEC warned investors that foreign companies using reverse mergers might have questionable financials, operations, and management.\(^{109}\) The SEC further warned that investors should fully research these companies before making investment

\(^{95}\) See M&A West, 538 F.3d at 1047 (broker Medley assisted co-defendants with transactions).
\(^{96}\) Byrnes & Browning, supra note 88.
\(^{97}\) M&A West, 538 F.3d at 1047.
\(^{98}\) Aubin & Shalal-Esa, supra note 2.
\(^{101}\) Id.
\(^{102}\) Id.
\(^{103}\) Byrnes & Browning, supra note 88.
\(^{104}\) Id.
\(^{105}\) See id.
\(^{106}\) M&A West, 538 F.3d at 1053.
\(^{107}\) See id.
\(^{109}\) Id.
decisions. Finally, the SEC added a consideration that foreign companies have been using small auditing firms without resources to meet accounting obligations required by the Public Company Accounting Oversight Board.

III. ANALYSIS OF U.S.-LISTED, CHINA-BASED CORPORATIONS

Predictably, the SEC only had one foreign country in mind when it promulgated the investor bulletin on reverse mergers: China. The principal issue that has developed is that China-based corporations are accessing U.S. securities and fraudulently capitalizing on U.S. investors and U.S. law. As aptly stated by Republican Rep. Patrick McHenry, a member of the House Committee on Oversight and Government Reform, “it appears that some Chinese firms have seen a way to access the strongest public markets in the world, but through the weakest area of enforcement.” First, this section will offer a more detailed vision of the current state of affairs. To follow is a roadmap-style analysis of the U.S.-listed, China-based corporation from its inception under lax state reverse merger laws, U.S. investor injection of equity, fraudulent activity resulting in stock collapses, and finally to SEC and private litigation and to problems faced in enforcement against the Chinese.

A. Current Situation and Increasing Litigation

Approximately thirty shareholder securities class action suits were filed against U.S.-listed, China-based companies in the first half of 2011, alleging securities fraud and violations of Section 10(b) of the Securities Exchange Act of 1934 for derivative actions and false and misleading financial statements. Lawsuits against Chinese reverse mergers amount to near one-fourth of the ninety-four U.S. securities fraud class action suits filed from January to June. The SEC has recently stepped into suspend trading in a number of reverse merger entities including:

110. Id.
111. Id.
112. See Das, supra note 6.
113. Byrnes & Browning, supra note 90.
114. Das, supra note 6.
(1) Heli Electronics Corp.; China Changjiang Mining & New Energy Co.; (3) RINO International Corporation; (4) Advanced Refractive Technologies, Inc.; (5) HiEnergy Technologies, Inc.; and (6) Digital Youth Network Corp. The SEC cited its reasons for suspension in each case, principal among them were the inaccuracy and incompleteness of financial information, failure to make periodic listing filings, failure to disclose independent auditors, and resignation of auditors after reports of financial fraud. The SEC has also revoked the securities registration of several reverse merger China-based corporations for failure to make important periodic filings to U.S. investors. Between March and December 2012, thirty Chinese firms had their auditors resign and twenty were delisted by the SEC, certainly with more accounting issues on the horizon. From the perspective of the SEC and agitated shareholders, it is becoming increasingly clear that Chinese corporations are seeking out and exploiting U.S. markets and investors in order to financially benefit at their expense.

B. Exploitation by Chinese Corporations

A systematic, detailed look into recent judgments by courts in various jurisdictions, including those in New York, Delaware, and California, as well as China’s trade secrets law and policy of judgment recognition, serves to present the steps each China-based company takes in order to exploit investors and evade judicial reproach. First, the Central District of California aptly illustrates a reverse merger operation and consequent U.S. listing by China Agritech, Inc., which resulted in a class action lawsuit under the Securities Exchange Act. Second, the Southern District of New York reveals the difficulty for such class actions against China-based corporations to even survive a motion to dismiss, and an inspection of China’s trade secrets law highlights the difficulty in obtaining the requisite evidence to have a well-pled complaint. Third, the District of Delaware, in two separate cases, demonstrates the fraudulent schemes and misrepresentation emblematic of the exploitative U.S. listed, China-based companies. Fourth, the Eastern District of New York in Securities and Exchange Commission v. China Energy, presents

117. Id.
118. Id.
an instructive judgment against a Chinese corporation and the available
legal remedies.\(^\text{123}\) Finally, an examination of China’s civil procedure law,
recognition policy, and absence of a bilateral treaty with the United States
elucidates the barriers to remedial enforcement.

\section{The Reverse Merger Loophole}

The Chinese corporations targeted by the SEC and beleaguered
shareholders typically access U.S. exchanges through the state reverse
merger process.\(^\text{124}\) In the currently ongoing case in the Central
District of California, \textit{Dean v. China Agritech}, plaintiff investors brought a class
action under Section 10(b) of the Securities Exchange Act against such a
corporation, China Agritech, a holding company based out of Beijing,
China.\(^\text{125}\) Agritech is emblematic of the typical Chinese company entering
U.S. securities markets under reverse merger laws.

China Agritech is incorporated in Delaware, but manufactures and
distributes organic compound fertilizers for agricultural uses in China.\(^\text{126}\)
Agritech became a publicly traded company through the reverse merger
financial technique, merging with a publicly traded shell company in
2005 and offering its stock on the NASDAQ stock exchange.\(^\text{127}\) Plaintiffs,
five individual investors who purchased Agritech stock, alleged four
claims of financial fraud in this case: (1) Agritech materially misstated
its net revenue and income for the third quarter of 2009 on its SEC Form
10-Q filing; (2) Agritech materially misstated its net revenue and income
for fiscal years 2008 and 2009 in its 2009 SEC Form 10-K filing; (3)
Agritech’s managers and Crowe Horwath, LLP (Agritech’s independent
auditor) concealed subsidiary and third-party supplier transactions; and
(4) Agritech’s managers filed a registration statement in 2010 with the
SEC in anticipation of public offering, incorporating false financial
statements for fiscal years 2008 and 2009.\(^\text{128}\)

Agritech’s financial filings inflated 2008 and 2009 revenues by 1,444% and
900\%, respectively,\(^\text{129}\) and a subsequent report by independent research
group Lucas McGee Research illustrated the dearth of production by its

\begin{footnotesize}
\begin{enumerate}
\item LaCroix, \textit{supra} note 1.
\item \textit{Dean}, 2011 WL 5148598 at *1.
\item \textit{Id.}
\item \textit{Id.}
\item \textit{Id. at *2.}
\item \textit{Id. at *3.}
\end{enumerate}
\end{footnotesize}
factories in China. The Lucas report also highlighted the substantial discrepancy between levels of net revenue in Agritech’s filings with the Chinese State Administration for Industry and Commerce and the SEC. As a result of this report, Agritech’s stock declined by a significant percentage and plaintiffs then brought the abovementioned securities action. In bypassing “certain regulatory requirements” to access U.S. private equity markets, Agritech’s practices demonstrate how Chinese companies take “unfair and improper advantage of aspects of the reverse merger process” in order to conceal their true financial conditions and swindle U.S. investors.

The court in Dean ruled, in its preliminary judgment, that China Agritech’s motion to dismiss under FRCP 12(b)(6) for failure to state a claim upon which relief could be granted was denied. In discussing the claims under the Securities Exchange Act, the court found ample evidence of financial fraud using the independent Lucas McGee Research report on China Agritech in conjunction with its SEC filings. While defendants suggested that differences in Chinese and U.S. accounting principles were the source of the financial inconsistencies, the evidence in the Lucas report was sufficiently compelling to find fraudulent intent on the pleadings.

2. FRCP 12(b)(6) Failure to State a Claim

In assessing whether slighted investors have an actionable fraud claim under the Securities Exchange Act, however, a court often does not have access to such independent, detailed, and dispositive reports during the pleading stage. Accordingly, many of the securities claims against these China-based companies are denied as a result of preliminary motions to dismiss. While, illustratively, the Southern District of New York dismissed such a securities action for failure to state an adequate claim, a meticulous look at China’s trade secrets law explains the recurrent absence of compelling facts needed to survive a 12(b)(6) motion.

In In re China Life Securities Litigation, plaintiff investors brought a class action claim under Section 10(b) of the Securities Exchange Act.

130. Id. at *2.
131. Id.
132. Id.
133. Id. at *1.
134. LaCroix, supra note 1.
136. See id. at *3.
137. See id.
138. LaCroix, supra note 1.
139. See In re China Life Sec. Litig., 2008 WL 4066919 at *7.
against China Life Insurance Company Limited and its officers. China Life offered its stock on the New York Stock Exchange and filed its financial information with the SEC in 2003. A year earlier, China’s National Audit Office (“NAO”), which is the Chinese government’s highest-level audit institution, began auditing the historical finances of China Life and found the company, prior to its restructuring as China Life, had committed wrongdoing and ordered negligible financial sanctions. Subsequently, the SEC itself opened an investigation of accounting irregularities pertaining to China Life.

As a result of these regulatory investigations, China Life’s stock fell just as Bloomberg News and Xinhua Financial Network News publicized reports detailing substantial misappropriation of funds in billions of Yuan, as well as other illegal activities. Once the stock price fell, plaintiffs alleged that China Life engaged in fraudulent misrepresentation by not disclosing accounting irregularities found by NAO, as well as the SEC inquiry itself. Further, plaintiffs alleged that such misrepresentation by China Life prior to restructuring affected the current China Life corporation and inflated stock prices. The court in the Southern District of New York granted China Life’s motion to dismiss, because it found no misrepresentation of the NAO audit and no compounding fraudulent denials about the SEC inquiry. The court further suggested that since the SEC had not ascertained any accounting documents, the SEC had dropped its inquiry. It based its decision on the fact that the stock price rose after NAO disclosure, no connection between NAO disclosures and the new China Life, and reliance on China Life’s own assertion that it was unaware of any SEC inquiry.

The court found that no “loss causation” had occurred and it dismissed the claim before even reaching a discussion of the higher plausibility standard for “scienter” established in Tellabs. Accordingly, In re China

140. See id. at *1.
141. Id.
142. Id. at *2.
143. Id.
144. Id.
145. Id. at *2–3.
146. Id. at *3.
147. Id. at *8.
148. Id. at *5.
149. See id.
150. See id.
151. See Tellabs, 551 U.S. 308.
Life highlights the difficulty shareholders face in obtaining the information necessary for a well-pled derivative complaint. As Mimi Justice, head of Deloitte’s forensic and dispute practice in Orange County, California, stated at a recent conference, “[Chinese executives] believe they should not have to respond if they feel any request is too intrusive and believe that they can tell the SEC no.”152 Such an attitude limits the effectiveness of any investigation into a China-based company’s knowledge and intent, as well as any resulting securities claim.153

However, the attitude of Chinese executives and the ensuing scarcity of dispositive information can be attributed to the laws of their home country. China’s State Secrets Law effectively shrouds much of the substantive information about Chinese state-run organizations,154 akin to NAO and China Life,155 as well as the private Chinese accounting and financial paperwork necessary for SEC and shareholder derivative claims.156 As a result, not only do claimants face the preliminary motions due to lack of evidence, but they also may be frustrated in compelling discovery through FRCP 37157 during the litigation process.

China’s State Secrets Law pressures ethnic Chinese with foreign citizenship and Chinese nationals into not sharing information with foreign businesses or governments “out of a fear of arrest.”158 Indubitably, the Revised form of the 1989 State Secrets Law contains a broad and uncertain classification of what constitutes a state secret.159 The Revised Law lists policy decisions, national defense and armed forces, foreign relations, national economic and social development, science and technology, and state security and criminal offenses that harm “state security and national interests” as categories of state secrets.160 However, it also provides a “catch-all provision” to extend criminal liability to “other secret matters” determined by the “department administering and managing the protection of state secrets.”161 This vague classification is coupled with severe criminal penalties ranging from five years in prison to the death penalty, with all related proceedings being held closed to the public.162 A particularly egregious example of the application of this law is in the case of Xue Feng, an American citizen who was convicted

152. Aubin & Shalal-Esa, supra note 2.
153. See id.
156. Aubin & Shalal-Esa, supra note 2.
157. See supra note 58 and accompanying text.
159. Id. at 318.
160. Id.
161. Id. at 318–19.
162. Id. at 319–20.
and sentenced to eight years of imprisonment in China. In that case, Mr. Feng was convicted for conveying public oil and gas information to the U.S. through his business. In convicting Mr. Feng, not only did the Chinese government determine post hoc that this information was in fact a state secret, but it also subjected him to numerous human rights abuses, denied him an attorney for over a year, and prevented visitation by his family.

In view of the broad scope and alarming nature of China’s State Secrets Law and its enforcement, Chinese accounting firms and executives often withhold financial records in fear of violating it. U.S. auditing firms have experienced difficulty in obtaining bank accounts, balances, and transactions, and have even received false information directly from Chinese banks. As Alan Linning, a partner at Sidley Austin in Hong Kong, aptly observes, “[Chinese firms and auditors] have a real dilemma on their hands as to how to respond to the U.S. regulators when to do so might expose them to criminal sanctions in China.” Consequently, many of the U.S.-listed, China-based corporations in the U.S. may contemplate and execute fraudulent schemes knowing that, out of fear, any related evidence in China may be shielded from probing U.S. administrators and judicial officers.

3. Securities Class Actions

Nevertheless, when enough evidence is ascertained, plausible facts are pled, and jurisdiction is inevitably granted over Chinese executives.

163. Id. at 322.
164. Id.
165. Id.
166. See id.
168. Das, supra note 6.
170. See, e.g., Dean, 2011 WL 5148598 (China Agritech misrepresented financial status and production levels to profit and benefit director-owned third-party suppliers); In re Heckmann, 869 F. Supp. 2d 519 (China Water executives falsified financial information to profit and induced shareholders to approve merger absolving them of personal liability); China Energy Sav. Tech., 636 F. Supp. 2d 199 (China Energy executives engaged in “pump and dump” scheme in which they artificially increased stock price and sold their shares at inflated price).
171. See, e.g., Dean, 2011 WL 5148598 (surviving a motion to dismiss based on evidence provided by an Independent Lucas McGee Research report).
172. See infra Part I(c).
the courts have captured and illuminated the elements of fraud and misrepresentation by U.S.-listed, China-based corporations against their shareholder victims.\footnote{See Dean, 2011 WL 5148598; In re Heckmann, 869 F. Supp. 2d 519.} Recently, the District Court of Delaware, once in a brief preliminary memorandum order,\footnote{See Vandevelde, 2011 WL 2580676.} and again in a more exhaustive opinion,\footnote{See In re Heckmann, 869 F. Supp. 2d 519.} illustrated the basic elements of fraud continually perpetrated by Chinese companies under the Securities Exchange Act.

In \textit{Vandevelde v. China Natural Gas}, plaintiff shareholders filed a securities class action against China Natural Gas, Inc., a natural gas pipeline provider in China that is publicly traded in the United States.\footnote{Vandevelde, 2011 WL 2580676 at *1.} Plaintiffs alleged that China Natural Gas misclassified in an SEC filing, and then subsequently failed to disclose, a debt restructuring from long-term to short-term liabilities.\footnote{Id.} When China Natural Gas failed to disclose any financial information about the debt restructuring in a late press release, its stock price declined substantially, and the shareholders filed this class action under Section 10(b) of the Securities Exchange Act.\footnote{Id. at 527–30.} At the very least, \textit{Vandevelde} describes the type of fraudulent misrepresentation by China-based corporations that is actionable under Section 10(b) and SEC Regulation 10(b)-5.

In \textit{In re Heckmann Securities Litigation}, plaintiff shareholders also brought a claim under Section 10(b) alleging fraud and material misrepresentation.\footnote{In re Heckmann, 869 F. Supp. 2d at 526–27.} However, the intricate scheme devised by China Water and Drinks, Inc. demonstrates just how diabolical and dangerous Chinese executives may be in manipulating and defrauding U.S. investors.\footnote{See id. at 527–30.} In \textit{Heckmann}, China Water set out to merge with the Heckmann Corporation, a company incorporated in Delaware looking to acquire an operating company for its shareholders.\footnote{Id. at 527.} China Water manufactures and distributes bottled water products in China.\footnote{Id. at 528.} Plaintiffs allege that China Water and Heckmann Corporation misrepresented China Water’s financial condition in its merger agreement with the SEC, and fraudulently coaxed shareholders into approving the merger in order to profit and absolve themselves of any previous liability.\footnote{Id. at 531–32.}

The criminal activities of Heckmann Corporation, China Water, and its chief executive, Xu Hong Bing, are noteworthy, especially in light of

\begin{thebibliography}{9}
\item 173. See Dean, 2011 WL 5148598; In re Heckmann, 869 F. Supp. 2d 519.
\item 174. See Vandevelde, 2011 WL 2580676.
\item 175. See In re Heckmann, 869 F. Supp. 2d 519.
\item 176. Vandevelde, 2011 WL 2580676 at *1.
\item 177. Id.
\item 178. Id.
\item 179. In re Heckmann, 869 F. Supp. 2d at 526–27.
\item 180. See id. at 527–30.
\item 181. Id. at 527.
\item 182. Id. at 528.
\item 183. Id. at 531–32.
\end{thebibliography}
the SEC’s registration statement form filed in 2008. Heckmann Corporation filed a registration statement form for the proposed merger with China Water. In that form, several risk factors about China Water were disclosed: (1) China Water could not maintain effective controls over internal auditing and financial statements; (2) extensive due diligence by Credit Suisse could not identify all material issues with China Water; and (3) the acquisition of China Water could negatively affect Heckmann Corporation’s stock, net worth, image, and could potentially force the company to write-down assets. Regardless, Heckmann filed a joint proxy with the SEC recommending the China Water merger to its shareholders.

Five months after shareholders approved the merger, Xu resigned and received windfall stock gains. Then, the company issued its financial results for the first quarter and disclosed significant financial inconsistencies and China Water’s extreme debt and incapacity, leading to massive shareholder loss. China Water’s executives had been reporting a separate set of financial numbers to Chinese officials and the SEC, respectively. In addition, Xu falsified his educational and employment history, his name, and was, in fact, a convicted felon. As a result, China Water’s misinformation campaign financially devastated Heckmann shareholders, and represents the scope of fraudulent exploitation of U.S. private citizens achievable by Chinese corporations in U.S. equity markets.


The U.S. government, acting through the SEC in its administrative capacity, has also commenced its own securities actions to stem this upsurge in fraudulent activity. Principal amongst these actions is Securities and Exchange Commission v. China Energy, in which the SEC alleged that China Energy, in cooperation with other third-party actors, engaged in a “pump and dump” scheme of artificially inflating stock prices in

184. Id. at 528.
185. Id. at 528–29.
186. Id. at 529.
187. Id. at 530.
188. Id.
189. Id. at 531.
190. Id.
191. See id. at 530.
order to profit.\textsuperscript{192} While China Energy’s unlawful securities activity is another typical example of Chinese exploitation, the Eastern District Court of New York’s description and subsequent application of the SEC’s available court remedies is particularly instructive.\textsuperscript{193}

In the case, China Energy entered U.S. stock markets through a reverse merger with a Nevada shell corporation, Rim Holdings, which was owned by the other third-party defendants.\textsuperscript{194} China Energy’s principal business involved “developing, marketing, distributing and manufacturing energy saving products” for commercial and industrial use in China.\textsuperscript{195} For a short period after market entry, China Energy and the other defendants artificially increased the price of China Energy stock through a series of sham transactions between them.\textsuperscript{196} As a result, China Energy’s stock rose from $12 to $28 per share, at which time defendants sold millions of shares for a windfall gain.\textsuperscript{197} Subsequently, the NASDAQ suspended trading in China Energy stock, China Energy announced the “mass resignation of its officers and directors” to the SEC, and disconnected all phone lines and returned all mail as undeliverable.\textsuperscript{198}

As China Energy and the third-party defendants did not respond to the complaint or otherwise appear before the judge, the court entered a default judgment for the SEC.\textsuperscript{199} Accordingly, the court could bypass the preliminary evidentiary issues because all allegations of liability in the complaint were deemed true in default.\textsuperscript{200} As a result, the SEC sought an order utilizing various court remedies including: (1) permanent injunctions; (2) disgorgement of unlawful profits; and (3) appropriate civil remedies under the Securities Exchange Act.\textsuperscript{201} The SEC also sought a preliminary injunction to freeze the assets of defendants located in the U.S., as alleged in the complaint.\textsuperscript{202}

First, the SEC sought to enjoin defendants from future securities violations and from acting as a director or officer in any capacity.\textsuperscript{203} For potential future securities violations, the court has broad discretion to

\begin{footnotes}
\item 195. Id.
\item 196. Id.
\item 197. Id. at 200–01.
\item 199. See id.
\item 200. Id. at *6; see Greyhound Exhibiting, Inc. v. E.L. U.L. Realty Corp., 973 F.2d 155, 158 (2d Cir. 1992).
\item 201. See id.
\end{footnotes}
award an injunction after considering four factors: “(1) the degree of scienter involved; (2) the isolated or recurring nature of the fraudulent activity; (3) the defendant’s appreciation of his wrongdoing; and (4) the defendant’s opportunities to commit future violations.”

In China Energy’s case, the company engaged in systematic wrongdoing, failed to provide assurances against future violations to the SEC, and failed to acknowledge its wrongdoing. Accordingly, China Energy and the individual defendants were permanently restrained from securities violations directly or indirectly. For the officer and director bar, the court has broad discretion to award an injunction after considering six factors: “(1) the ‘egregiousness’ of the underlying securities law violation; (2) the defendant’s ‘repeat offender’ status; (3) the defendant’s ‘role’ or position when he engaged in the fraud; (4) the defendant’s degree of scienter; (5) the defendant’s economic stake in the violation; and (6) the likelihood that misconduct will recur.” In China Energy’s case, the individual defendants engaged in fraud and deceit in their capacity as executives and were consequently restrained from holding any director position for a public securities issuer.

Second, the SEC sought to disgorge profits in accounts controlled by defendants in the amount of $50,755,892.04. Once federal security law violations have been found, the court has broad discretion to order disgorgement of wrongful profits. In addition, the court has broad discretion to further award prejudgment interest on the amount disgorged. In China Energy’s case, the court could determine only that $29,665,625.28 located in certain specific bank accounts was a result of the illegitimate, criminal conduct. Further, the court awarded $3,652,554.34 to be disgorged by defendants as prejudgment interest.
Third, the SEC sought to level civil penalties against defendants for fraudulent actions causing millions of dollars in China Energy investor losses. Congress enacted the civil penalties as a further financial disincentive to engage in securities fraud, and the court has discretion to determine said penalties in light of the circumstances of the case. In China Energy’s case, the court assessed civil penalties totaling $1,075,000 against various defendants.

Finally, the SEC moved for a preliminary injunction and temporary restraining order (“TRO”) to freeze the assets of defendants. In support of the motion, the SEC produced evidence that conclusively showed funds located in accounts in the U.S. directly traceable to the fraudulent proceeds. Accordingly, the court entered the TRO against defendants, limiting the asset freeze to the “disposition, transfer, or dissipation of any proceeds from the sale of China Energy stock.”

Using all of the abovementioned methods, the SEC made a concerted effort, through traditional court remedies, to hold executives and related parties to China Energy’s fraudulent activity. Moreover, while there has yet to be a reported case where criminal liability has been imposed on Chinese executives pursuant to SOX, criminal conviction may also be an additional court remedy for fraudulent activity through SEC misrepresentation. However, even in the face of evidentiary findings, consequent court judgments, federal corporate and securities law, and U.S. administrative action, Chinese corporations continue to unabashedly exploit U.S. shareholders.

5. China’s Barriers to Enforcement

Conspicuously, U.S.-listed, China-based companies’ recklessness with regard to U.S. securities law can be attributed to the fact that Chinese courts do not enforce U.S. judgments. Furthermore, China and the U.S. are not currently parties to a bilateral criminal extradition treaty, so China is under no obligation to extradite a Chinese national to the U.S. pursuant to any U.S. criminal conviction. Consequently, a closer look at

214. Id. at *14.
215. Id. at *15.
216. Id. at *17.
218. Id.
219. Id.
221. See supra notes 21–32 and accompanying text.
222. See supra notes 116–17 and accompanying text.
223. See Clarke, supra note 16, at 1.
224. MacCormack, supra note 68, at 446.
Chinese civil procedure law, as well as the state of U.S.-China criminal cooperation, may serve to illuminate the logical impetus behind the continuing fraudulent activity by Chinese executives.

Initially, U.S. judgments have virtually no force or effect in Chinese courts under China’s domestic law and policy. The Civil Procedure Law of the PRC of 1991, Articles 267 and 268, outline the standards and rules for enforcement of foreign judgments by Chinese courts. However, the law has proven quite dubious and uncertain. These provisions allow Chinese courts to review recognition of judgments on the merits and enforce recognition of judgments based on reciprocity. The Law does not specify circumstances under which Chinese courts may refuse to enforce foreign judgments and provides a “catch-all” ground for non-recognition where enforcement would be contrary to “state sovereignty, security, and/or public policy.” Additionally, since Chinese courts rarely publish decisions, there is a lack of empirical evidence as to the effectiveness or interpretation of any of these terms, which leads to further prospects of non-recognition. Moreover, Chinese courts’ “parochial protection of Chinese parties,” as well as other factors, such as “the lack of judicial independence in China, the prevalence of local protectionism, the unimaginable social consequences of bankrupting state-owned enterprises, the paucity of necessary legal provisions curbing debtor fraud and facilitating judgment collection, and the lack of understanding of and conceptual conflict between the Chinese and U.S. legal systems,” render U.S. judgment enforcement in China practically nonexistent.

Pertinently, the enforcement of U.S. judgments in China directly impacts whether Chinese nationals choose to violate U.S. securities law. Concededly, in China Energy, the Eastern District Court of New York found for the SEC in its judgment requiring the defendants to disgorge upwards of $34,000,000 in wrongful and fraudulent profits. However,
as Chinese courts typically do not enforce U.S. judgments, close to $30,000,000 will not be recovered by the SEC or the United States government. While $4,000,000 will be recovered pursuant to the preliminary motion for a TRO freezing assets located in the U.S., China Energy executives and third-party defendants may conceivably travel back home to China with a handsome surplus, courtesy of victimized U.S. investors. For all practical purposes, then, it seems no civil remedial enforcement mechanism exists as a disincentive or consequence to fraudulent securities activity.

Second, no potential criminal liability serves as a disincentive for Chinese executives contemplating exploitation of U.S. equity markets, due to a lack of both a bilateral extradition treaty and the prospect of cooperative state efforts. Currently, no extradition treaty exists between the two countries primarily because of the U.S.’s insistence on China’s improvement in human rights, public corruption and the rule of law. While China has expressed a desire to enter into a treaty with the U.S., until a significant Chinese social policy overhaul, the advantages of “regularity, clarity, and predictability” in extradition will be absent from the current “case-by-case approach.”

Encouragingly, there have been instances of cross-border cooperation between the U.S. and China regarding financial criminal activity. In a case involving the Bank of China, managers embezzled $485,000,000 from the Bank of China and laundered the money into the U.S. through casino accounts. When one of the managers was convicted of racketeering in the U.S., he spent twelve years in jail and then was extradited to China for further incarceration. In a case involving Randolph Guthrie, an international DVD piracy kingpin, Guthrie was arrested in Shanghai pursuant to a joint U.S.-China investigation, and then extradited to the U.S. for sentencing. However, the distinguishing characteristic in both of these cases was how decidedly advantageous the outcomes were to both the U.S. and China. Absent a bilateral extradition treaty, the case-by-case approach proves to be much more limited for traditional criminal conduct in each country. Significantly,
where political, economic, religious or social matters complicate a criminal conviction, collaboration between the countries or state agencies may be even more strained.242

Here, a criminal conviction for securities fraud by Chinese nationals in the U.S. not only benefits the U.S. exclusively, but it also involves sensitive socio-political and economic interests. Accordingly, no instances of criminal extradition pursuant to federal SOX legislation seem likely under these circumstances. As attorney Phillip Kim explains, “If you’re a CEO of a company based in China and sign a false Sarbanes-Oxley certification, it’s very difficult for the U.S. government or Justice Department to charge you with that crime, indict you and bring you to justice.”243 Furthermore, some Chinese executives resist answering to U.S. authorities at all.244 While SOX legislation applies to any company that sells securities in U.S. markets, whether they are based in the U.S. or another country, “few Chinese executives fear being led away in handcuffs because of the lack of an extradition treaty.”245 Accordingly, the SOX legislation does nothing to deter Chinese companies in the same way that it deters domestic accounting misconduct by criminalizing financial misrepresentation.246

C. What Needs to Change

In view of the gross violations perpetrated by these foreign corporations, as well as the international and domestic impediments to judicial reproach, the U.S. government must realize that its legislative regulatory power is diminishing in the global marketplace. Transnational corporations are now the major players in world trade, and foreign direct investment has been steadily increasing, most notably in developed countries.247 The growing economic interdependence of the world’s economies is demonstrated by the growing importance of transnational companies investments and the significance of private investment for developed nations,248 such as the

242. Id.
244. Id.
245. Id.
246. Id.
Moreover, these foreign companies are increasingly tempted to engage in foreign corruption absent any civil or criminal liability. In this increasingly volatile, global corporate environment, Congress and state legislatures need to address these private and public regulatory issues with Chinese companies, while also charting a broader path toward international commercial accountability.

III. RECOMMENDATIONS AND CONCLUSION

To solve the immediate problem of U.S.-listed, China-based companies’ exploitation of U.S. investors, federal and state governments must work together under a two-pronged approach. First, the U.S. government should engage in a proactive diplomatic policy with China to make accounting and other such practices more transparent, move toward a bilateral extradition treaty, provide political and legal pressure to relax trade secret laws in litigation, and promote flexibility. Second, the U.S. should engage in a more protectionist domestic economic policy. For instance, Congress should pass a bond requirement for foreign-based corporations entering U.S. securities markets and state legislatures should require a more stringent registration process for foreign-based reverse mergers. The federal government should also seek to lower the corporate tax rate to counter these additional regulations and incentivize lawful foreign investment. As a result, this two-pronged approach may serve as a model for solving future foreign-based corporate accountability issues.

A. International Diplomacy and Pressure

Preliminarily, the U.S. should open up diplomatic channels with China while also promoting a more transparent and flexible corporate foreign policy. Specifically, the U.S. should look to the 2007 E.U. Directive on Shareholders’ Rights (“E.U. Directive”) as a guide. Furthermore, the SEC should engage with the China Securities Regulatory Commission (“CSRC”), the SEC’s Chinese counterpart, to formally assess corporate regulations and solutions, similar to the 2008 SEC pilot mutual recognition program with Australia. Moreover, the federal government should put political and legal pressure on China during this type of international litigation as the U.S. and the IRS did during the Swiss UBS litigation.

251. See Aubin & Shahal-Esa, supra note 2.
Finally, the U.S. should make strides toward a bilateral extradition treaty or increase further step-by-step cross-border cooperation for corporate criminal prosecutions.

First, China’s corporate access to operation in U.S. securities markets must be more transparent and flexible to protect U.S. shareholders. Pertinently, the E.U. Directive addressed corporate scandals in a “cross-border context” with respect to European capital markets. It contained reforms designed to strengthen shareholder rights, promote flexibility, and increase standards of transparency and accountability in the E.U. without burdening over-regulation. While these reforms addressed current shareholder obstacles between European nations, the U.S. could apply these transparency and flexibility principles in a similar directive with China.

Second, the SEC should more effectively coordinate with the CSRC to address reporting regulations, conflicts of corporate laws, and promote cooperation between the U.S. and China. In 2008, the SEC entered into a pilot mutual recognition program with Australian corporate regulator ASIC in order to assess each other’s regulatory system and determine appropriate levels of investor protection. The SEC should look to engage in a similar program with the CSRC to find solutions to root out corporate fraud both in the U.S. and in China.

Third, during the inevitable securities litigation against U.S.-listed, China-based corporations, the U.S. should put political and legal pressure on China to relax the China State Secrets laws when U.S. investors are directly injured. As in the Swiss tax-evasion litigation, U.S. government officials should meet with Chinese officials to settle differences and relax applicable trade secrets laws that prohibit the necessary discovery in corporate securities litigation.

Finally, while a bilateral criminal extradition treaty with China is unlikely absent significant Chinese social reform, the U.S. must continue to build on the step-by-step approach for criminal extradition with China.

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253. See supra notes 59–60 and accompanying text.
254. Hill, supra note 250, at 827.
255. Id.
257. See supra notes 59–60 and accompanying text.
258. MacCormack, supra note 68, at 446.
259. Id. at 467–70.
These instances of cooperation for financial criminal activity\textsuperscript{260} are encouraging and the U.S. must properly articulate to Chinese officials why mutual law enforcement cooperation benefits both the U.S. and China.

\textbf{B. Protectionist Domestic Economic Policy}

Next, the U.S. should look inward and promote a more protectionist domestic economic policy. This requires a concerted effort by both the U.S. Congress and state legislatures to combat investor exploitation by these U.S.-listed, China-based corporations. On the federal level, Congress should pass a bond requirement for foreign-based corporations to place a certain amount of investment assets in the U.S. At the state level, the U.S. should encourage state legislatures to require more stringent requirements narrowly tailored for reverse mergers by foreign-based corporations. Furthermore, Congress should consider lowering corporate tax rates to counter these additional requirements and to encourage lawful foreign investment.

First, Congress should pass a bond requirement for foreign-based corporations, specifically those merging or buying a subsidiary in the U.S. and entering U.S. securities markets, in order for the SEC and courts to have access to assets in the event of litigation. As in the \textit{China Energy} litigation, the SEC or securities plaintiffs would be able to freeze or attach these assets when litigation begins. The assets would only be required in the U.S. for a limited time period, or until determination of lawful accounting practices. Accordingly, this bond would provide some restitution for the SEC and aggrieved U.S. investors, and it would bypass many issues with regard to China’s non-enforcement of U.S. judgments.

Second, state legislatures should enact narrowly tailored, stringent requirements for foreign-based reverse mergers in their respective states. Since the SEC and the federal government cannot root out every exploitative corporation,\textsuperscript{261} the states have the responsibility to take steps to prevent easy access to U.S. securities exchanges through state corporate law.

Finally, to combat these additional regulations and disincentives, the U.S. Congress should consider lowering the corporate tax rates to incentivize foreign investment. The U.S. corporate tax rate is one of the highest in the world.\textsuperscript{262} As such, lowering corporate tax rates may

\textsuperscript{260} \textit{Id.}
\textsuperscript{261} \textit{See supra} notes 14–17 and accompanying text.
“encourage inbound foreign direct investment.” Accordingly, while the U.S. needs to protect itself and its investors from the exploitative Chinese corporation through protective regulations, the U.S. still needs lawful foreign investment to make the economy grow in this global marketplace.

C. Conclusion

China-based corporations have been exploiting U.S. investors through fraudulent, manipulative schemes, while hiding behind a veil of trade secrets laws, criminal impunity, and non-enforcement of judgments. However, the U.S. federal and state governments may, and should, take proactive steps to make international corporate activities more transparent and flexible, and consequently hold these Chinese companies accountable. While the increasingly global economy poses many domestic dangers, cooperative and coordinated action by all levels of government may protect U.S. investors not only from these China-based companies, but also from any exploitative foreign corporation in the future.

263. Id.