Private Securities Litigation in China: Quasi-U.S. Style Class Action

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Where's the Real Beef?
— Analysis on Chinese Securities Litigation and Quasi-U.S. Style Class Action

By Liang Tao

Chinese companies have drawn serious attention of Chinese entrepreneurs proposing to list the shares of their enterprises on U.S. stock markets. It seems that the free lunch has finished and the delicious supper has not come yet.

Where's the beef

To avoid such frustrated situation, some Chinese entrepreneurs may want to turn to China's domestic stock markets as an alternative for listing purpose. However, please bear in mind that Chinese securities regulator has also been developing and running their own private securities litigation regime, notwithstanding such regime is not as mature as its U.S. counterpart.

Since the inception of China's securities market at the beginning of 1990s, private securities disputes have emerged in a few cases. At that time, Chinese securities regulators did not have a well-established securities disputes resolution system in place. The last 10 years of the 20th century witnessed a rapid development of China's securities market and skyrocketing amounts of securities disputes. To protect investors, certain laws and regulations have been enacted.

Governing rules

The Securities Law of the PRC ("Securities Law") and the Civil Procedure Law of the PRC ("Civil Procedure Law") provide a general framework governing the litigation arising from the misconduct of persons or entities who shall bear the obligation of information disclosure in China's securities markets. However, Securities Law and Civil Procedure Law keep silent on detailed substantive and procedural rules in connection with the institution, hearing and ruling of private securities lawsuits in China.

To ensure the availability of and pave the way for the private securities lawsuits, the Supreme People's Court of the PRC ("Supreme Court") promulgated two judicial interpretations, i.e., Several Regulations Concerning the Adjudication of Civil Compensation Securities Cases Based upon Misrepresentations ("Adjudication Regulations") which became effective in 2003 and Notice on the Acceptance of the Civil Tort Dispute Cases Caused by Misrepresentations in the Securities Markets ("Acceptance Notice") which came into force in 2002. According to the Supreme Court, Adjudication Regulations will prevail if a conflict develops between the Adjudication Regulations and the Acceptance Notice ("Two Rules"). It's worth noting that judicial interpretations of Supreme Court serve as the "mandatory secondary law" with special reference to lawsuits brought in China's court system. For investors damaged by misrepresentations in securities markets ("Damaged Investors"), the Adjudication Regulations and the Acceptance Notice furnish a practical roadmap to seek remedies.

Scope of application

To the extent permitted by the Two Rules, investors damaged by misrepresentations made by persons or entities with information disclosure obligations ("Disclosure Obligors") shall be entitled to take actions against the misrepresenting Disclosure Obligors to recover their actual losses, including investment losses and the losses of relevant commission and stamp duties. However, the Damaged Investors cannot seek punitive damages as U.S. investors.

Here, the investors are composed of individuals, juridical persons or other institutions subscribing to securities in the primary market or trading securities in the secondary market, including stock exchanges and OTC markets. Except strategic investors obtaining shares via specific shares transfer agreements or private placement, institutional investors, e.g. qualified foreign institutional investors, shall be fall within the foregoing scope of investors and entitled to relevant remedies. But, institutional investors shall bear more burden of
proof than retail investors during the substantive phase of trial.

The Disclosure Obligors include but not limited to (i) actual controllers of public companies; (ii) securities issuers or public companies; (iii) securities underwriters; (iv) sponsors; (v) professional intermediaries, e.g. law firms, accounting firms, assets evaluation companies; (vi) liable directors, supervisors, managers and other senior officers of the entities set forth in items (ii), (iii) and (iv); (vii) liable personnel in the entities specified in item (v); (viii) other entities or individuals making misrepresentations.

Under the Adjudication Regulations, “misrepresentations” are defined as false or misleading statements in connection with the material events, material omissions or improper disclosures made by Disclosure Obligors during the process of securities issuance or trading. According to the Securities Law, the material events refer to the events which can exert enormous effects on the securities price, e.g. material changes in a public company’s business guidelines or scope of business, material losses suffered by a public company over 10% of its net assets, making a decision by a public company to merger or dissolve.

As a requisite condition to the institution of a securities litigation under the Adjudication Regulations, the misrepresenting Disclosure Obligors must have been publicly punished by the China Securities Regulatory Commission (“CSRC”), local counterparts of the CSRC, the Ministry of Finance, or other competent governmental authorities due to their misrepresentations, or have been found guilty of misrepresentation by a Chinese court. With respect to this requirement, China’s threshold of filing private securities lawsuits is radically different from the U.S. one.

In order to meet the two-year statute of limitations for private securities lawsuits under Chinese laws, Damaged Investors shall bring actions against the misrepresenting Disclosure Obligors within two years of imposing the aforesaid administrative or criminal penalties for misrepresentations by competent governmental authorities or courts. The Adjudication Regulations provide that the intermediate court, which is in the place where the defendant is located, has jurisdiction over the private securities lawsuits arising from misrepresentations. Generally speaking, the intermediate court, which is in the place where the public company defendant is located, will further prevail, if a jurisdiction conflict develops among different intermediate courts when the public company and other individual or institutional defendants have been sued.

Two roads diverged in a yellow wood

The Adjudication Regulations only provide plaintiffs with two viable methods of instituting private securities related lawsuits, i.e. filing separate lawsuits or joint lawsuits in China’s courts. The Acceptance Notice explicitly prohibits the application of U.S. style class action in the private securities actions based on misrepresentations. In addition, when various separate lawsuits and joint lawsuits contain the same cause of action and defendant, courts may, at their sole discretion, consolidate these private securities lawsuits into one joint lawsuit.

However, China’s joint actions are not the equivalent of U.S. style class actions. Under U.S. style class action, the competent court will not require the lead plaintiff to specify the name of each plaintiff, namely, U.S. courts can accept class actions with unfixed and unpredictable number of plaintiffs. On the contrary, a Chinese court asks for definitive number of plaintiffs in a private securities action and will further clarify specific compensation for each plaintiff if the judge finally sustains plaintiffs’ allegation.

In practice, Chinese judges typically do not consolidate many private securities separate or joint lawsuits into an extra large joint lawsuit with a big plaintiffs group. Sometimes, they even cause a joint lawsuit to be split into several smaller joint lawsuits, in order to facilitate the lawsuits acceptance process or just improve judge-performance-evaluation results. The performance of Chinese judges is evaluated by an array of parameters, including the number of cases they have heard. Therefore, they have incentives to split a case into several smaller cases to increase the number of case they hear. However, Chinese judges actually decide these private securities lawsuits as one single case on the merits. For example, Qingdao intermediate court accepted 2716 actions brought by 6983 plaintiffs due to the misrepresentations relating to a public company, i.e. Dongfang Electronics Co., Ltd. (“Dongfang”), and finally settled over 99% of these cases under the same terms and conditions in 2007. Hence, from the perspective of the large group of plaintiffs and the unified rulings of judges, the private securities litigation in China may be named as the “quasi-U.S. style class action”, although many differences between them exist.

Upcoming Wuliangye case

Wuliangye Yibin Co., Ltd. (“Wuliangye”), a company listed on the Shanghai Stock Exchange, specializes in manufacturing liquor and related products. According to the public announcement issued by Wuliangye on May 28, 2011, CSRC had imposed administrative penalties on Wuliangye based on material omission and improper disclosure.

As the critical requirement of public penalties has been met, many damaged investors expressed their interests in taking private securities actions against Wuliangye to seek damages over misrepresentation allegations. Several lawyers also began to solicit and collect authorization of the damaged investors to represent them in the upcoming private securities lawsuits.

Many investors have actually filed lawsuits in Chengdu intermediate court with the help of their lawyers. Although the Chengdu intermediate court has not formally accepted these lawsuits till now, we can predict that the court may very likely accept and hear these lawsuits in the near future, as the Chengdu intermediate court has developed compensation calculation software tailored to the batch of upcoming Wuliangye lawsuits. As Wuliangye is a blue chip company over three times bigger than Dongfang by revenues, the potential Wuliangye lawsuits may become the largest series of private securities lawsuits by then.