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Surge of Securities Litigation Against U.S.-Listed Chinese Companies Raises Critical D&O Insurance Issues

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One of the most distinctive U.S. litigation trends over the last twelve months has been the surge of securities class action lawsuits filed against U.S.-listed Chinese companies. In the year ending June 30, 2011, at least 32 Chinese companies were hit with U.S. securities suits. In addition, the U.S. Securities and Exchange Commission has launched a number of enforcement actions and other proceedings against U.S.-listed Chinese companies, issued a formal bulletin warning investors about the risks of investing in Chinese companies that have gone public through reverse merger transactions, and launched a task force to investigate U.S.-listed Chinese companies that have sold stock to investors in the U.S. Directors of all such companies should be closely scrutinizing their D&O policies and asking the kinds of questions listed in this Advisory. Where appropriate, they should also be seeking supplemental coverage, such as Independent Director Liability insurance.

This sudden onslaught of litigation and enforcement activity means that the exposure to liability for all U.S.-listed Chinese companies and their directors and officers has increased significantly. The SEC is focusing on not only issuers, but also financial advisors who help entrepreneurs in China raise capital in the U.S. As a result of this increased exposure, the risk mitigation policies and D&O insurance program that these companies have in place and plan to employ are now more important than ever. Unfortunately, the risk assessment and insurance programs of many U.S.-listed Chinese companies are not well calibrated to provide either the kind or amount of protection these companies and their directors and officers could require in the event of a U.S. securities lawsuit.

To the extent individual directors and officers have not done so already, they are well advised to seek an independent review of the insurance coverage available to them, and, if appropriate, consider purchasing supplemental coverage, such as Independent Director liability (IDL) coverage. IDL coverage and related insurance products are designed to protect outside directors and officers individually from the types of private securities class actions and SEC enforcement proceedings looming over so many Chinese companies.

This article briefly explores the developing U.S. litigation trend involving U.S.-listed Chinese companies, identifies the critical D&O insurance issues involved, and provides an overview of options available to these companies.

The Emerging Litigation Against U.S.-Listed Chinese Companies

Most of the lawsuits filed against U.S.-listed Chinese companies over the past twelve months have followed largely the same pattern and involve allegations of accounting fraud, inadequate disclosure and improper transactions between so-called related parties (i.e., non-arms' length transactions between a company and its inside directors and officers or their family members which operate to the detriment of the Company's stockholders) .

Many of these allegations first originated with Internet-based securities analysts and short sellers who may have financial motivations to try to undermine the companies' share prices. Although the specific allegations have varied, the common theme has been that the companies' financial statements do not reflect the companies' true financial conditions. Allegations have included charges of fictitious or overstated assets or revenues and discrepancies between regulatory filings made by the Company in China and the Company's financial statements. Other cases have alleged improper, non-arm's length related party transactions involving company executives or other interested parties that are unfair to the companies or their shareholders. Another trigger for litigation and investigations has occurred when a company "upgrades" its auditing firm from a small accounting firm to a Big Four accounting firm or internationally recognized accounting firm, which during the course of a new audit engagement, notes irregularities in historical financial statements and is forced to resign or insist upon an internal investigation conducted by the audit committee. Unsurprisingly, many questions from regulators and investors and a spate of lawsuits followed the auditor resignations.

A large number of the companies targeted in these cases became U.S. public companies and obtained their U.S. exchange listings through a so-called "reverse merger," in which the Chinese company merged with a publicly traded U.S. shell company. While the use of a reverse merger as a financing or going-public technique is a generally accepted mechanism, as well as a cost-effective and streamlined way for a private company to go public, some of the less scrupulous financial advisors and unsavory companies, both in the U.S. and in China, have taken unfair and improper advantage of aspects of the reverse merger process. As a consequence, the SEC is now focused on Chinese companies as a sector and particularly those that have gone public through the reverse merger process.

The private civil lawsuits that have been filed in U.S. courts to date generally are seeking to recover damages allegedly incurred as a result of violations of U.S. securities laws, on behalf of an economically harmed class of the company's shareholders. Litigants of this type are typically represented by a handful of smaller plaintiffs' law firms with savvy securities litigators working on a contingency fee arrangement, which can be very expensive to defend. Given the geographic distances, language differences and the latest cases against U.S.-listed Chinese companies, these lawsuits could be particularly expensive to defend.

More distressing to U.S. directors, the lion's share of the liability may fall only upon persons over whom a U.S. court has jurisdiction or who have significant assets in the United States.

Some of these cases will be dismissed on preliminary motions. Generally, about one-third to 40 percent of all securities class action lawsuits are dismissed. But the remaining 60 percent or more of these cases go forward and typically settle. Very few securities class action lawsuits actually go to trial. Securities class action lawsuits can be very expensive to settle – for example, the average securities class action lawsuit settlement in 2010 was $36.3 million, with settlements ranging from $1 million to hundreds of millions.

Because of the significant defense expense and settlement costs associated with these kinds of lawsuits, most companies whose shares trade on the U.S. securities exchanges have agreed to indemnify directors and officers for claims made against them as a result of their services to the Company and most companies also carry Director and Officer liability insurance. However, recent experience has proven that the amount of coverage is frequently insufficient, or that limits of coverage may be exhausted in defense costs alone.

D&O Insurance Considerations

D&O insurance provides financial protection for individual directors and officers and their companies for securities claims. The policies also provide financial protection for the individuals in many other types of claims, including some regulatory and enforcement proceedings. The policies provide protection for claims-related defense expenses as well as for settlements and judgments.

There is no standard D&O insurance policy form. Terms and conditions vary widely and are often the subject of extensive negotiation, or “manuscripting.” The wordings of basic terms such as “Claim” or “Loss” and of the policy exclusions can directly affect claims outcomes, so the precise policy language employed can be critically important.

In addition, the way in which the insurance program is structured—through placement of layers of excess insurance or through the inclusion of auxiliary policies designed to provide catastrophe protection for individuals—can be critically important. An example of this type of auxiliary policy is a so-called Independent Director Liability policy, which is designed to provide an extra measure of financial protection for the outside directors under certain circumstances. IDL coverage is generally purchased by or for the benefit of the individual directors only, so limits cannot be exhausted by the company. Similar to IDL policies in this respect is a product known as “Side A Difference-in-condition (DIC)” coverage, which is likewise designed to protect individual directors and officers and is generally purchased by the company.

D&O Insurance Concerns

As the lawsuits against U.S.-listed Chinese companies have emerged over the past twelve months, it has become apparent that while most of these companies have purchased D&O insurance, in some instances, the companies purchased only minimal limits of liability, meaning that the current financial protection available is very limited. These minimal amounts of insurance may not be sufficient to fund all of the defense costs the lawsuits will entail, much less provide funds for any settlements or judgments.

In addition, some of the U.S.-listed Chinese companies' policies have not been negotiated to fully address the companies' U.S. litigation exposure, particularly the companies' exposures to U.S. securities lawsuits. In some instances where the policies were negotiated or issued outside the U.S., the policies may not contain the terms and conditions necessary to address fully the insurance issues that a U.S. securities class-action lawsuit presents.

Also, the Chinese companies' insurance programs often are not structured to assure protection for individuals, particularly the outside directors. For example, very few companies' insurance programs include a layer of protection that is reserved for individual directors. The result is that companies may exhaust coverage just by defending the company. Or a single bad act or director may do the same. This should concern outside directors who are based in the U.S. and therefore most susceptible to U.S. court processes.

Due to the highly publicized problems involving some U.S.-listed Chinese companies, U.S.-based plaintiffs' law firms and the SEC are devoting considerable resources to scrutinizing Chinese companies. Consequently, the securities litigation exposure of U.S.-listed Chinese companies has increased significantly.

Because of the increased litigation exposure, it is now more important than ever that U.S.-listed Chinese companies have in place a well-designed D&O insurance program that has been specifically engineered to address the possibility of securities litigation in the U.S. A well-designed insurance program would have appropriate limits of liability, carefully negotiated terms and conditions designed to ensure protection for U.S. securities claims, and a program structure that provides the broadest scope of protection and separate limits reserved for individuals, particularly outside directors.

Unfortunately, due to the publicity surrounding the financial scandals involving some U.S.-listed Chinese companies, the insurance marketplace for all U.S.-listed Chinese companies has become challenging. The D&O insurers have become quite reluctant to take on these risks, and are demanding a significant premium to provide insurance. Many U.S.-listed Chinese companies are finding that they must now pay $50,000 to $60,000 or more for each $1 million of insurance coverage. The need for expertise from brokers and counsel has never been greater.

Conclusion

In light of the complex insurance needs of U.S.-listed Chinese companies and the challenging insurance marketplace, it is more important than ever that Chinese companies engage knowledgeable and skilled insurance advisors in connection with their D&O insurance placement. It is particularly important that the companies' advisors be well-versed in the U.S. securities litigation risks and in the ways the policy terms must be negotiated to address those risks. Without proper counsel, these companies and their directors and officers could find that their D&O insurance actually provides very little financial protection in the event of a U.S. securities class action lawsuit.

Here are some questions that the directors and senior management of all U.S.-listed Chinese companies should be asking about their D&O insurance program:

1. Are the limits of liability on our insurance program appropriate to a company of our size and will the limits of liability provide adequate protection for not only the company but its individual directors, in the event of a U.S. securities lawsuit?

2. Are the terms and conditions in our insurance program engineered to ensure that the policy will respond and provide financial protection in the event of a U.S. securities lawsuit?

3. Are defense costs and expenses that are likely to be incurred in connection with a lawsuit, investigation or enforcement action clearly covered, or are there exclusions, such as the "unlawful gain" or "personal profit" exclusions, that may preclude coverage?

4. Is our insurance program structured to provide the broadest scope of insurance protection for our company's outside directors, and have we considered independent director liability insurance or other such products for our outside directors?

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