ALERT MEMORANDUM

SDNY Decision Shows the PSLRA's Protections Remain Strong For Chinese Issuers

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Heightened federal scrutiny into Chinese issuers, as well as sustained private investor litigation against such companies, has led to commentary that the U.S. capital markets are becoming less attractive to Chinese companies. But a recent dismissal decision in *Barilli v. Sky Solar Holdings, Ltd.*, in the U.S. District Court for the Southern District of New York, highlights the continued significance of the heightened pleading standards of the Private Securities Litigation Reform Act ("PSLRA") and how they remain meaningful hurdles for plaintiffs suing Chinese (or other foreign) issuers, including the requirements that a plaintiff plead particularized facts identifying materially misleading statements in the offering documents and, for claims under the Securities Exchange Act of 1934, plead loss causation.

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In the *Sky Solar* decision, the court denied plaintiffs' motion for leave to amend their class action complaint against Sky Solar Holdings, Ltd., which arose from allegations that the company's former CEO had engaged in undisclosed related-party transactions and had defrauded investors in a predecessor company.[1] After previously granting the defendants' motion to dismiss plaintiff's earlier complaint, the court denied plaintiffs' motion for leave to amend as futile because (*i*) the allegations about the former CEO's wrongdoing, even if accepted as true, did not render other, general statements of his qualifications and background materially misleading and (*ii*) other alleged misstatements about the validity of the allegations against the former CEO did not cause investors any losses. The decision therefore reflects that, despite an increased focus on Chinese and other foreign issuers, the PSLRA continues to provide meaningful protection for these companies from unmeritorious private litigation.

[1] Cleary Gottlieb represented defendant Sky Solar in this case.

Recent Intensified Scrutiny of Chinese Issuers

For many years, Chinese issuers have been a focus of securities litigation in U.S. courts. However, several recent developments involving Chinese issuers have further heightened the attention placed on such companies by both private litigants and U.S. regulators.

One has been the scandal involving Luckin Coffee, Inc. ("Luckin"), which completed its $645.15 million IPO in May 2019, as well as a $666.54 million follow-on offering in January 2020. After a short-selling firm publicly alleged that Luckin had fabricated financial results, and that certain of its directors and officer had engaged in self-dealing, Luckin announced that investors should no longer rely on certain previous financial statements and earning releases. Private plaintiffs then filed putative securities class actions in the Southern and Eastern Districts of New York, the Ohio Court of Common Pleas, and New York Supreme Court.[2] In addition to alleging that Luckin's financial statements themselves were misleading, these plaintiffs challenged a number of other statements, including general statements about the strength of Luckin's internal controls and the nature of the risks it faced.

Another important development has been the long-festering confrontation over U.S. regulators' access to Chinese companies' accounting audits—which has recently prompted action both from the exchanges themselves,[3] as well as from Congress.[4] On April 21, 2020, the SEC released a public statement emphasizing the significant risks posed by the Public Company Accounting Oversight Board's ("PCAOB") inability to inspect audit work papers in China. In addition, last month, the U.S. Senate passed the Holding Foreign Companies Accountable Act (S. 945), a bipartisan bill that would prohibit foreign companies from listing and trading their securities on any U.S. securities exchange or through any other method regulated by the SEC, including "over-the-counter" trading, if the PCAOB is unable to inspect the issuer's public accounting firm for three consecutive years.[5] The text and legislative history indicate that the bill is aimed at listed Chinese companies whose auditors are unable to comply with PCAOB inspection and investigation requirements.[6] The bill echoes recent criticism of Chinese companies' perceived opacity from the Trump administration, including a memorandum dated June 4, 2020, in which President Trump stated, "While China reaps advantages from American markets . . . the Chinese government has consistently prevented Chinese companies and companies with significant operations in China from abiding by the investor protections that apply to all companies listing on United States stock exchanges."

At the same time, there has been a growing recognition that such requirements may drive Chinese companies to list on non-U.S. exchanges, including in London

[2] The cases are *Cohen v. Luckin Coffee Inc., et al.*, No. 20-cv-1293 (S.D.N.Y.), *Sterckx v. Luckin Coffee Inc., et al.*, No. 20-cv-1677 (E.D.N.Y.), *Gopu, et al., v. Luckin Coffee Inc., et al.*, No. 20-1747 (E.D.N.Y.), *Bergenholtz v. Luckin Coffee Inc. et al.*, No. CV-20-932052 (Oh. Ct. Comm. Pleas), and *Kimson Chemical Inc. v. Luckin Coffee Inc., et al.*, No. 651939/2020 (N.Y. Sup. Ct.). Under a recent Supreme Court decision, class actions asserting claims under the Securities Act may be brought in either federal or state court. *See* https://www.clearygottlieb.com/-/media/files/alert-memos-2018/supreme-court-holds-that-securities-act-class-actions-may-be-brought-in-state-court.pdf.

[3] Echo Wang, *Exclusive: Nasdaq to tighten listing rules, restricting Chinese IPOs – sources*, Reuters (May 18, 2020 8:31 PM), https://www.reuters.com/article/us-nasdaq-china-listings-exclusive/exclusive-nasdaq-to-tighten-listing-rules-restricting-chinese-ipos-sources-idUSKBN22V01Q.

[4] Kellie Mejdrich, *Luckin Coffee, China's answer to Starbucks, faces Nasdaq delisting*, Politico (May 19, 2020 1:31 PM), https://www.politico.com/news/2020/05/19/luckin-coffee-china-starbucks-nasdaq-268119.

[5] S. 945, 116th Cong. (2020), https://www.congress.gov/116/bills/s945/BILLS-116s945es.pdf.

[6] S. 2519, 116th Cong. (2020), https://www.congress.gov/116/crec/2020/05/20/CREC-2020-05-20-pt1-PgS2519.pdf.

and Hong Kong.[7] Hong Kong, in particular, recently updated its requirements to allow the listing of more tech and biotech companies, and commenters have stated that further restrictions may further erode the attractiveness of a U.S. listing.[8]

Background of the *Sky Solar* Decision

The *Sky Solar* decision, however, is an important reminder that, with respect to private securities class action litigation, there are significant threshold requirements for cases to proceed. Even with the current heightened scrutiny on Chinese companies, the PSLRA's heightened pleading standards continue to provide meaningful protections to Chinese issuers facing allegations of wrongdoing by their executives in civil lawsuits.

The *Sky Solar* case arose out of allegations that Sky Solar's CEO, founder, and largest shareholder, Weili Su, had engaged in a series of fraudulent, related-party transactions, and that this misconduct rendered materially misleading certain statements in the company's offering documents. After conducting a U.S. IPO in November 2014, Sky Solar disclosed in its 2016 Form 20-F that a former managing director had transferred, with no consideration, approximately $800,000 of a $4.2 million fee to a company owned by Su. On June 6, 2017, the company announced that an internal investigation had revealed additional transactions and fund transfers with entities controlled by Su, none of which had been approved by Sky Solar's board or the audit committee. The same announcement stated that Su would resign his directorship and management positions at both Sky Solar and its subsidiaries.

Shortly thereafter, investors filed a putative class action against Sky Solar, certain of its directors and officers, and the underwriters of its IPO, alleging claims under both the Securities Act of 1933 and the Securities Exchange Act of 1934. After subsequent amendments, plaintiffs' complaint asserted ten categories of alleged misrepresentations that—like the complaints in *Luckin*—challenged general statements about (*i*) Su's experience in the solar sector and business acumen; (*ii*) Sky Solar's internal controls; and (*iii*) the company's access to future financing.

On May 23, 2019, the court granted in full defendants' motion to dismiss that amended complaint.[9] With respect to plaintiffs' arguments that Sky Solar had omitted Su's history of allegedly failed businesses in the solar sector, as well as certain suspect transactions, the court relied on *Fries v. N. Oil & Gas, Inc.*, 285 F. Supp. 3d 706 (S.D.N.Y. 2018) and *In re Xinhua Fin. Media, Ltd. Sec. Litig.*, No. 07-cv-3994, 2009 WL 464934 (S.D.N.Y. Feb. 25, 2009) to hold that "general positive statements about Su's professional history and management abilities, such as statements that he was a 'successful businessman,' are at most non-actionable puffery," and that the omission of Su's past misconduct did not contradict the specific disclosures that Su was essential for Sky Solar's strategic planning or that he was essential to the company's success. With respect to plaintiffs' allegations about the company's internal controls, the court found that Sky Solar had disclosed merely that it had implemented internal controls and, further, had affirmatively warned investors of weaknesses therein. Finally, with respect to disclosures about Sky Solar's access to financing, the court found that Sky Solar likewise disclosed the terms of past financing, and that the disclosures about obtaining future financing were forward-looking, appropriately qualified, and, in any case, constituted puffery. Plaintiffs subsequently moved for reconsideration of this decision, which was denied.

After the dismissal of their complaint, plaintiffs filed a motion to amend seeking leave to file a further amended complaint. The main additions in that

[7] Evelyn Cheng, *Chinese companies still hope for New York IPOs — despite recent fraud, scandals and coronavirus*, CNBC (Apr. 14, 2020 11:09 PM), https://www.cnbc.com/2020/04/15/chinese-companies-hope-for-new-york-ipos-despite-fraud-coronavirus.html.

[8] Evie Liu, *Fewer Chinese Companies Are Going Public in the U.S. – What to Expect Next*, Barrons (July 5, 2019), https://www.barrons.com/articles/china-companies-us-ipo-51562211149.

[9] *Barilli v. Sky Solar Holdings, Ltd.*, 389 F. Supp. 3d 232 (S.D.N.Y. 2019) ("*Sky Solar I*").

proposed amended complaint concerned an arbitration proceeding filed against Su, alleging that he breached a 2010 agreement with shareholders in Sky Solar's predecessor company. In particular, the arbitration alleged that Su violated the shareholders' right to participate in any IPO conducted by the predecessor company by instead conducting an IPO through a new subsidiary company. Su neither submitted any documentary evidence in opposition to the arbitration, nor appeared for the arbitration hearing. Eventually, on May 25, 2018, a Hong Kong arbitral tribunal decided that Su had breached the agreement. Specifically, the tribunal concluded that Su's purported justification for the share swap was not "credible or convincing," and that Su viewed Sky Solar's predecessor company "as his own private property, which he could deal with as he saw fit." After Su moved to set aside an injunction ordered by the tribunal, the tribunal confirmed the injunction and noted that Su "regards truth to be fluid and flexible, to be bended and stretched to fit such case as he sees necessary and convenient to present for his own immediate purpose," concluding that he was "a totally unreliable witness."

The proposed amended complaint in the Sky Solar action alleged that these findings by the tribunal provided further support for their claim that the company's general statements about Su's professional history and management abilities were misleading. Plaintiffs further alleged that the ultimate arbitral award rendered false the statement in the company's prospectus that it believed the claims asserted in the arbitration were "without merit" and "may be attempting to extort economic benefits."

Sky Solar Decision

On June 1, 2020, the court denied plaintiffs' motion for leave to amend in its entirety.[10] With respect to plaintiffs' challenges to Sky Solar's statement that it believed the arbitration claims were without merit, the court dismissed plaintiffs' claims under the Securities Act and the Exchange Act for separate reasons. In particular, the court held that plaintiffs' proposed claims under the Securities Act were barred by the applicable three-year statute of repose because the proposed amendments were first made more than three years after the company's IPO. The court further held that, while plaintiffs adequately alleged that Su believed the arbitration was meritorious for the purposes of their Exchange Act claims, they failed to adequately plead loss causation because they did not allege that the tribunal's decision caused the share price of Sky Solar's ADSs to drop. Critically, the court also rejected plaintiffs' attempts to shoehorn their new arbitration-related allegations into the broader category of losses caused by "the public revelation of Su's character," finding that plaintiffs had "describe[d] the fraudulent statement too broadly."

With respect to plaintiffs' attempts to revive their claims based on misstatements about Su's experience, Sky Solar's internal controls, and access to financing—which had been dismissed in the 2019 decision—by citing the arbitration, the court again found that the proposed amended complaint did not state a claim. Specifically, the court held that the tribunal's finding that Su had breached the shareholder agreement did not bear on whether Su used improper business tactics when running Sky Solar's predecessor company, and did not suggest that Su would not be essential to Sky Solar's success going forward. Likewise, the arbitral tribunal's findings neither altered the total mix of information available to shareholders about the company's internal controls, nor rendered material the "vague and optimistic" forward-looking statements about financing.

Implications Following Future Listings

The denial of leave to amend in *Sky Solar II*, as well as the previous dismissal of plaintiffs' complaint in *Sky Solar I*, demonstrates that, while the current U.S. alarmist rhetoric surrounding foreign issuers (and Chinese issuers in particular) may create new uncertainty for those issuers about the risks of participating in the U.S. capital markets, the securities

[10] *Barilli v. Sky Solar Holdings, Ltd.*, No. 17-cv-4572, 2020 WL 2848179 (S.D.N.Y. June 1, 2020) ("*Sky Solar II*").

laws have not changed. They continue to provide the same strong protections against unmeritorious private litigation. Meritless cases, including those that depend on attenuated connections between alleged misconduct by an executive and the issuer's generalized disclosures, will still be dismissed.

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