THE REVIEW OF
BANKING & FINANCIAL SERVICES
A PERIODIC REVIEW OF SPECIAL LEGAL DEVELOPMENTS AFFECTING LENDING AND OTHER FINANCIAL INSTITUTIONS

Vol. 34 No. 7 July 2018

GLOBALIZATION AS AN ADVANTAGE IN RESOLVING CROSS-BORDER FRAUD LITIGATION

The authors outline steps plaintiffs may take to put pressure on deep-pocket foreign defendants to settle with defrauded investors. They discuss: gaining control over the defendant entity; obtaining documents and information; contempt orders and Interpol; negative publicity; and involuntary bankruptcy.

By Katherine R. Catanese and Carly S. Krupnick *

Globalization, and the increase in cross-border transactions, raises several challenges to practitioners seeking to pursue litigation fraud claims that touch multiple countries. Professionals, however, may use aspects of globalization as an advantage and employ certain strategic, non-traditional approaches in extraterritorial litigation – especially actions involving fraud and deep-pocket defendants. Traditionally, cross-border fraud litigation includes tracing the deep-pocket defendant's assets and filing enforcement actions, potentially in many jurisdictions, to recover those assets. These approaches, however, are often costly and frustrating. Alternatives to the traditional approaches may help resolve these cross-border fraud cases more quickly and efficiently. This article focuses on finding the right pressure points deployed against deep-pocket defendants in cross-border fraud cases and using those pressure points to procure a resolution, often in conjunction with, and in addition to, the more traditional litigation approaches. The strategies described below may not work in isolation – layering multiple methods is sometimes more effective to procuring a settlement with the deep-pocket defendant.

* *KATHERINE R. CATANESE is a senior counsel at Foley & Lardner LLP focusing her practice on cross-border bankruptcies involving fraud. CARLY S. KRUPNICK is an associate in Foley & Lardner LLP's bankruptcy and business reorganization practice group. Their e-mail addresses are kcatanese@foley.com and krupnick@foley.com.*

CONTROL

In cross-border litigation, gaining control over the defendant entity in its various global locations can provide a huge strategic advantage. When the defendant company has several foreign subsidiaries and a parent entity in the United States, many States' laws allow for the appointment of a receiver if the defendant U.S. company violates a court order.[1] For example, if a group of investors has requested the company's books and records, which most State laws allow investors to do,[2] and the company has refused to provide the books and records or has ignored the request altogether, the investors can petition the court for a turnover of the books and records, and when the company fails to comply, the investors can request that a receiver be appointed over the company.

[1] *See, e.g.,* 8 Del. C. § 322.

[2] *See, e.g.,* 8 Del. C. § 220(b); IL ST CH 805 § 105/107.75; KS ST 17-6510; NY BSC § 624.

RSCR Publications LLC Published 12 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $650 per year in U.S., Canada, and Mexico; $695 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call (937) 387-0473 or visit our website at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@gmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail sarah.s.himmelfarb@gmail.com. To submit a manuscript for publication contact Ms. Himmelfarb. ISSN: 1051-1741.

The scenario has arisen in the Chinese reverse-merger[3] context, where a company operating in China has formed a U.S. parent to raise money in the U.S. The parent promises investors that it will trade on the New York stock exchange, only to "go dark" in the U.S., ignoring investor inquiries and potentially leaving its investors without recourse. Here, the investors can file a books-and-records action in the State court where the parent company is organized.[4] When the company fails to respond, the court can appoint a receiver with very broad powers, which can include the power to reconstitute the board, obtain books and records including financial information, and bring litigation.[5]

The Chinese reverse-merger example discussed above involved a typical WOFE (wholly owned foreign enterprise) structure, which commonly involves a U.S. parent, with a Caribbean subsidiary, a Hong Kong subsidiary, and a Chinese subsidiary (which usually is the operating entity holding the assets). Through the receivership order, the receiver is empowered to take control over the wholly owned subsidiaries. The goal is not necessarily to operate these subsidiaries or even to monetize the subsidiaries in some way (although this can be one goal). Instead, through control of these entities, the receiver can pressure those deep-pocket defendants running the operations to procure a resolution, or, at the least, open the lines of communication between the parties (*i.e.* force parties to the negotiating table). The receiver may also use this control to contact customers and vendors at the operations level, and re-route payments and shipments, or seize bank accounts for the foreign subsidiaries.

DOCUMENTS AND INFORMATION

Knowledge is power,[6] and, in almost all cases involving fraud, key pieces of information exist that, if uncovered, will allow for the ultimate exertion of pressure over the defendant to procure a settlement or, if not, be utilized to buttress a fraud claim based on litigation. In one such Chinese reverse-merger case, after the court appointed a receiver, the receiver obtained an *ex parte* order to raid the residence of the CFO of the company in the United States and the company's investor relations firm.[7] Through the raid, the receiver obtained the CFO's cell phone with messages showing that the company planned to depress its stock in order to buy it back at a distressed price and take the company private, a key piece of evidence demonstrating fraud.[8] With this information in hand, the receiver sued in China, and the Chinese court ruled that the suing investors could not only collect from the parent company, but definitively owned and controlled it.[9]

[3] In a reverse-merger transaction, the existing public "shell company," a publicly reporting company with few or no operations, acquires a private operating company – usually one that is seeking access to funding in the U.S. capital markets. *S.E.C. Investor Bulletin* 2011-123 (June 9, 2011), *available at* https://www.sec.gov/investor/alerts/reversemergers.pdf. Typically, the shareholders of the private operating company exchange their shares for a large majority of the shares of the public company. Although the public shell company survives the merger, the private operating company's shareholders gain a controlling interest in the voting power and outstanding shares of stock of the public shell company. Also typically, the private operating company's management takes over the board of directors and management of the public shell company. The assets and business operations of the post-merger surviving public company are primarily, if not solely, those of the former private operating company. *Id.*

[4] *In re Southern China Livestock, Inc.*, No. 8851-VCN (Del. Ch. 2013) ("*SCLI*").

[5] The Court may also order "put" rights for the U.S. investor and issue an order valuing the investor's shares. Teri Buhl, *Chinese Reverse-Merger Investor Succeeds in Asset Hunt, Foiling Alleged "Go Dark" Buyout Scheme,* GROWTH CAPITALIST (May 16, 2013). In *SCLI*, the court granted the appointment of a receiver pursuant to 8 Del. C. § 322, a put option of plaintiffs' shares in *SCLI* at fair market value; and an award of attorney's fees and costs based on *SCLI* failure to comply with the court's prior order granting default judgment, which required *SCLI* to turnover its books and records by a date certain. *SCLI, supra* note 4 (Del. Ch. Jan. 17, 2014) ["Order Granting Plaintiffs' Motion for Contempt"].

[6] Francis Bacon, *Meditationes Sacrae* (1597).

[7] Kaja Whitehouse, *China Chicanery,* NEW YORK POST (April 19, 2013) https://nypost.com/2013/04/19/china-chicanery/.

[8] Buhl *supra* note 4.

[9] Matt Chiappardi, *Hope for Investors Burned By Companies that 'Go Dark',* LAW 360 (April 25, 2016), https://www.law360.com/articles/787843.

Additionally, some of the most revealing information gathered in a case can come from informants, including disgruntled employees or others close to the defendant. Often these are people who have been involved with the company for many years and can assist in locating assets or uncovering pressure points that can be used to reach a resolution (or to support a cause of action).[10]

Finally, putting pressure on those that assisted the company (and may still assist the company), not just the deep-pocket defendant and his or her company, can also be a valuable tool to assist in uncovering evidence in support of a fraud claim and/or to prosecute additional targets. For example, it may sometimes be difficult to enforce a subpoena against a defendant in a foreign jurisdiction, but locating U.S. vendors, accountants, auditors, public relations companies, banks, and others that may be involved with the company, assuming there is a reasonable and legal justification to do so, can provide leverage to the receiver or the plaintiff, often leading to valuable information to support prosecution and/or settlement of fraud-based claims. This is true, not just for the primary purpose of gathering information on the defendant from the third party, but also because the subpoena informs the third party that there is pending litigation against the defendant. For third parties still involved with the defendant company, this may be the leverage needed to force the defendant to discuss settlement rather than have the third party disclose potentially damaging information about the defendant in response to the subpoena.

CONTEMPT AND INTERPOL

In many cross-border fraud cases, the deep-pocket defendant is comfortably sitting in a foreign jurisdiction, convinced that he is untouchable. However, many deep-pocket defendants travel internationally, which can be used to the receiver's or plaintiff's advantage as a pressure point to compel a resolution. In difficult jurisdictions like China, obtaining a contempt order for non-compliance with a U.S. court order means virtually nothing to a Chinese defendant. But, if that U.S. contempt order can be lodged with INTERPOL, the international criminal police organization, travel by that deep-pocket defendant to an INTERPOL governing country has now been made considerably more difficult because now, should that defendant try to travel, he may be detained by INTERPOL until the contempt is purged. Once the contempt order is entered and an arrest warrant is issued, the warrant can be submitted to the National Crime Information Center and/or INTERPOL. Again, as with all of these techniques, the goal may ultimately not be to detain the defendant and force him to pay the outstanding judgement or sanction, but to exert pressure to force the deep-pocket defendant to the settlement table.

PRESS RELEASES AND WEBSITES

For certain defendants in foreign jurisdictions, reputation is paramount – negative publicity can devastate them. This is especially true now that anyone with access to Google can discover information about anyone and anything. As long as truthfully reported, using the internet to publicize orders and/or decisions in fraud litigation entered against the cross-border defendant through press releases, including, for example, the mechanisms referenced above, i.e. like appointment of a receiver and issuance of a contempt order, may be a powerful tool that can expose the defendant. In certain cultures, reputational harm can be a huge blemish and cause business relations to deteriorate quickly – not to mention the potential impact on the defendant's creditworthiness and ability to attract investors.[11] Although potentially risky because of concerns about defamation and related laws and regulations, creation of a website to detail the poor business practices of the company and its controlling members should be explored and carefully examined for its potential effectiveness.

AN INVOLUNTARY BANKRUPTCY

Although also risky because of the possibility of sanctions if used improperly, used appropriately, the commencement of an involuntary bankruptcy may serve as a tool to resolve a difficult case. In *In re Stillwater Asset Backed Offshore Fund Ltd.*,[12] the investors of a Cayman offshore investment fund and several related U.S. onshore funds had grown increasingly frustrated

[10] The obvious caveats should be noted – these informants may have ulterior motives and should never be the sole source of information used before making a strategic decision in litigation.

[11] Alexandra Stevenson and Matthew Goldstein, *Bounty Hunter Tracks Chinese Companies that Dupe Investors,* NEW YORK TIMES (March 15, 2016) https://www.nytimes.com/2016/03/16/business/dealbook/bounty-hunter-tracks-chinese-companies-that-dupe-investors.html (noting that the news release was only made in the United States as PRNewswire refused to publish the notice in China due to "heightened political sensitivity concerning Chinese investment interests").

[12] 2013 Bankr. LEXIS 226 (Bankr. S.D.N.Y. Jan. 17, 2013) (denying Cayman offshore fund's motion to dismiss an involuntary petition filed under U.S. bankruptcy laws).

with the asset manager's refusals to provide information about their investments or repay their obligations. After the 2008 financial crisis, investors in these funds redeemed their remaining investments, but the fund did not issue them a proper redemption, leaving them as creditors of the fund. The manager failed to provide information concerning the purported redemption, the rights of these creditors to the underlying assets, and the status of the underlying investment assets. After filing numerous lawsuits in the U.S., these investors remained without answers or payment.[13]

Thereafter, a group of investors/creditors filed an involuntary bankruptcy in the United States Bankruptcy Court for the Southern District of New York. The bankruptcy effectively provided a process to resolve claims brought under the various lawsuits in one consolidated forum, and allowed for swift discovery of documents and information that the investors could not obtain in the lawsuits they had filed. Ultimately, the involuntary bankruptcy led to a global settlement that allowed the investors/creditors to create and participate in a liquidating trust that held the assets of the U.S. and Cayman funds. The global settlement created an oversight committee, made up of investors/creditors, to control and liquidate the remaining assets, wind down the funds, and provide the best insight into what happened with the funds – a result not readily attainable through application of a more traditional litigation strategy.[14]

CONCLUSION

Litigation involving international, cross-border defendants that engage in fraud are difficult cases to resolve. By employing creative, non-traditional methods that go far beyond asset-tracing and customary litigation, however, litigators have access to various tools that may put pressure on these defendants to facilitate a settlement and/or assist in obtaining discovery necessary to support a judgment. These different approaches may be far more efficient and effective than a scorched earth litigation approach in cases involving cross-border elements. Using globalization as an ally rather than a roadblock can be an effective method to resolve litigation that otherwise seems hopeless. While any one of these methods may not be effective by itself, when used in combination, they can work as powerful tools to procure a settlement or other resolution where more traditional litigation techniques have proven ineffective. ■

[13] *Id.*

[14] *Id.* (Order Approving Global Settlement, April 4, 2014) [D.E. #138].