

Client Alert

September 6, 2013

Corruption Allegations in China Lead to a Shareholder Class Action in the U.S.

By Timothy W. Blakely, Stacey M. Sprenkel and Caitlin Sinclair Blythe

The filing of a shareholder class action has become routine following a drop in stock price after the revelation of adverse news about a company. Allegations of corruption at a public company are proving to be no different, as the recently filed putative shareholder class action against oil and gas company PetroChina Company Ltd. (“PetroChina”) demonstrates.

THE CHINESE GOVERNMENT INITIATES A CORRUPTION INVESTIGATION

Evidencing the Chinese government’s continued campaign against graft, on August 27, 2013, the Communist Party’s Central Commission for Discipline Inspection reportedly disclosed its investigation into the alleged “severe disciplinary violations” of a deputy general manager of China National Petroleum Corporation (“CNPC”), PetroChina’s controlling shareholder.¹ In China, a “severe disciplinary violation” is considered to be a euphemistic term for corruption.² That same day, PetroChina filed a Form 6-K with the U.S. Securities and Exchange Commission (“SEC”), announcing that three PetroChina senior executives were under investigation by “relevant PRC authorities.”³ PetroChina stated that all three had resigned, effective immediately, from their respective positions “due to personal reasons.”⁴ The three executives include a vice president of both PetroChina and CNPC; an executive director, vice president and head of PetroChina’s Changqing oil field; and a chief geologist.⁵

Three days later, Hong Kong’s newspaper South China Morning Post reported that “[t]op Communist Party leaders” had agreed to initiate a corruption investigation into the conduct of a former CNPC senior manager, who also was a former member of the Politburo Standing Committee and a purported ally of Bo Xilai (whose own trial for corruption only recently concluded after very public hearings and intense public interest).⁶ And as of September 1, 2013, the Central Commission for Discipline Inspection appears to have extended its investigation to include the former chairman of PetroChina and CNPC,⁷ resulting in his removal on September 2, 2013 as head of the State-Owned Assets Supervision and Administration Commission (“SASAC”), a commission charged with

¹ Gordon G. Chang, *Will China Political Infighting Trigger SEC Probe of PetroChina?*, Forbes, Sept. 1, 2013, <http://www.forbes.com/sites/gordonchang/2013/09/01/will-china-political-infighting-trigger-sec-probe-of-petrochina/>.

² *Id.* See also Wayne Ma & Yvonne Lee, *China Extends Graft Probes to PetroChina*, The Wall Street Journal, Aug. 27, 2013, <http://online.wsj.com/article/SB10001424127887324591204579038404275544012.html>.

³ PetroChina Co., Ltd., Announcement and Resumption of Trading (Form 6-K) (August 27, 2013).

⁴ *Id.*

⁵ Ma & Lee, *supra* note 2. See also Eric Ng, *Three More CNPC Officials Under Investigation*, South China Morning Post, Aug. 29, 2013, <http://www.scmp.com/news/china/article/1299860/china-investigates-more-top-petrochina-execs-over-corruption>.

⁶ Zhou Yongkang, *Former Security Tsar Linked to Bo Xilai, Faces Corruption Probe*, South China Morning Post, Aug. 30, 2013, <http://www.scmp.com/news/china/article/1300525/zhou-yongkang-former-security-tsar-linked-bo-xilai-faces-corruption-probe?page=all>.

⁷ Chang, *supra* note 1.

Client Alert

oversight of China's state-owned companies.⁸

There is speculation in the global press that the Chinese investigation may trigger the interest of U.S. regulatory authorities.⁹ PetroChina's controlling shareholder, CNPC, is a state-owned entity. Thus, U.S. regulators would view the relevant executives as "foreign officials" under the Foreign Corrupt Practices Act ("FCPA"). And at the same time, those same "foreign officials" are executives of an "issuer" subject to jurisdiction under the FCPA because PetroChina's American Depository Shares ("ADSs") trade on the New York Stock Exchange.

DAYS LATER, A PUTATIVE SHAREHOLDER CLASS ACTION FOLLOWS

Just days after the announcement of the PRC corruption investigation, on September 4, 2013, a putative shareholder class action was filed against PetroChina and four of its current and former officers in the Southern District of New York. The complaint alleges violations of the Securities Exchange Act of 1934 and SEC regulations.

The crux of the complaint is that the purported corruption-related activities of PetroChina's senior executives render false and misleading several of PetroChina's public statements regarding the executives' compliance with U.S. securities laws and with PetroChina's ethical and corporate governance codes. These are precisely the types of allegations one would expect following disclosure of corruption-related issues, i.e. allegations that the company and its directors and officers made false and misleading statements or omissions by failing properly to disclose the corruption issues, or by affirmatively stating that it was in compliance with securities laws and company codes of conduct.¹⁰

PetroChina is not the first PRC-based company with stock listed on a U.S. exchange to face a shareholder class action alleging failure to disclose corruption, further evidencing that Chinese companies have been, and remain, on the radar screen of the U.S. securities plaintiffs' bar.¹¹

⁸ Michael Forsythe, *China State-Assets Head Removed as Graft Inquiry Gains Pace*, Bloomberg, Sept. 3, 2013, <http://www.bloomberg.com/news/2013-09-03/china-s-sasac-backs-jiang-probe-as-vows-to-support-xi-policies.html>.

⁹ See, e.g., Chang, *supra* note 1 (suggesting Chinese authorities' corruption probe may trigger parallel probes by the SEC and Department of Justice); Tom Han Shih, *US Market Watchdog Likely to Ratchet Up Pressure on PetroChina*, South China Morning Post, Sept. 4, 2013, <http://www.scmp.com/business/commodities/article/1302851/us-market-watchdog-likely-ratchet-pressure-petrochina?login=1>.

¹⁰ See, e.g., *In re Syncor Int'l Corp. Sec. Litig.*, 239 F. App'x 318, 320 (9th Cir. 2007); *City of Pontiac Gen. Emps. Ret. Sys.*, No. 5:12-cv-05162 (W.D. Ark. Feb. 20, 2013); *In re SciClone Pharms. Sec. Litig.*, No. 5:10-cv-03584 (N.D. Cal. Dec. 1, 2010); *Johnson v. Siemens AG*, No. 1:09-cv-05310 (E.D.N.Y. Mar. 31, 2011); *Deccan Value Advisers Fund L.P. v. Panalpina World Transport (Holding) Ltd.*, No. 5:09-cv-00080 (S.D. Tex. Sept. 3, 2010); *In re Willbros Grp., Inc. Sec. Litig.*, No. 4:05-cv-01778 (S.D. Tex. Feb. 15, 2007); *In re InVision Techs. Sec. Litig.*, No. 3:04-cv-03181 (N.D. Cal. Aug. 31, 2006); *In re Immucor, Inc. Sec. Litig.*, No. 1:05-cv-02276 (N.D. Ga. Sept. 26, 2007); *In re Nature's Sunshine Prods. Sec. Litig.*, No. 2:06-cv-00267 (D. Utah Feb. 10, 2010); *In re FARO Tech., Inc. Sec. Litig.*, No. 6:05-cv-01810 (M.D. Fla. Oct. 3, 2008); *McBride v. Titan Corp.*, No. 3:04-cv-00676 (S.D. Cal. Dec. 20, 2005); *In re Syncor Int'l Corp. Sec. Litig.*, No. 2:02-cv-08560 (C.D. Cal. Dec. 3, 2008).

¹¹ See Amended Consolidated Complaint at 29-35, *In re China Valves Tech. Sec. Litig.*, No. 1:11-cv-00796 (S.D.N.Y. Sept. 26, 2012) (alleging, for example, that FCPA violations may artificially inflate revenue and expose company or acquirer to substantial penalties and liability). By way of background, defendants moved to dismiss lead plaintiff's original Consolidated Complaint, which had alleged violations of sections 11, 12(a)(2), and 15 of the Securities Act of 1933 and sections 10(b) and 20(a) of the Securities Exchange Act of 1934, where lead plaintiff's claims relied in part on alleged failures to disclose purported FCPA violations. On September 12, 2012, the district court granted defendants' motions, but permitted lead plaintiff leave to amend the Consolidated Complaint (the Amended Consolidated Complaint was filed on September 26, 2012). See Memorandum Opinion at 20-21, 25, *In re China Valves Tech. Sec. Litig.*, No. 1:11-cv-00796 (S.D.N.Y. Sept. 12, 2012). Defendants subsequently moved to dismiss the Amended Consolidated Complaint, but as of the date of this publication, the district court has not yet ruled on defendants' motion.

Client Alert

CHINA'S CAMPAIGN AGAINST CORRUPTION CONTINUES

The anticorruption investigation into PetroChina has been widely characterized as an example of President Xi Jinping's "campaign" against public corruption.¹² It also is particularly notable that China is targeting corruption involving a major state-owned entity and high-level officials—seemingly reinforcing China's promise to target both "tigers" and "flies" in its anti-graft campaign.

THE HIGH COST OF CORRUPTION FOR PUBLIC COMPANIES

The events over the past two weeks, culminating in the PetroChina class action lawsuit, serve as a stark reminder to public companies of the many risks and broad exposure to liability posed by corruption, especially in challenging markets like China. As China's campaign against corruption continues and as governments around the world step up enforcement of anti-bribery laws, the risk of facing law enforcement and regulatory scrutiny for corrupt activities is higher than ever before. And, as the PetroChina lawsuit demonstrates, the potential liability extends beyond regulatory scrutiny. For public companies, shareholders also will seek to hold companies and their executives accountable for shareholder losses as a result of alleged corruption and its fallout. The costs of defending government investigations, litigating shareholder class action lawsuits, and the possible sanctions, fines and damages that could follow are significant—yet vastly understate the cost of corruption, which includes the severe reputational damage that a company can suffer as allegations of wrongdoing play out in the press around the world.

CONTACT

Morrison & Foerster's FCPA + Anti-Corruption Task Force:

Paul T. Friedman
San Francisco
(415) 268-7444
pfriedman@mofo.com

Timothy W. Blakely
Hong Kong
+ 852 2585 0870
tblakely@mofo.com

Randall J. Fons
Denver
(303) 592-2257
rfons@mofo.com

Adam S. Hoffinger
Washington, D.C.
(202) 887-6924
ahoffinger@mofo.com

James E. Hough
Tokyo
81332146752
jhough@mofo.com

Daniel P. Levison
Singapore
+65 6922 2041
dlevison@mofo.com

Carl H. Loewenson, Jr.
New York
(212) 468-8128
cloewenson@mofo.com

Kevin Roberts
London
+ 020 7920 4160
kroberts@mofo.com

Robert A. Salerno
Washington, D.C.
(202) 887-6930
rsalerno@mofo.com

Ruti Smithline
New York
(212) 336-4086
rsmithline@mofo.com

Stacey M. Sprenkel
San Francisco
(415) 268- 6040
ssprenkel@mofo.com

Rick Vacura
Northern Virginia
(703) 760-7764
rvacura@mofo.com

Sherry Yin
Beijing
+ 86 10 5909 3566
syin@mofo.com

¹² See, e.g., Wayne Ma, *China National Petroleum Corp. Executive is Investigated*, The Wall Street Journal, Aug. 26, 2013, <http://online.wsj.com/article/SB10001424127887323906804579036452335428802.html>; Jeremy Page, Wayne Ma & Brian Spegele, *China Probes Former Oil Company Head*, The Wall Street Journal, Sept. 1, 2013, <http://online.wsj.com/article/SB10001424127887324886704579048173818547000.html>.

Client Alert

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer's* A-List for 10 straight years, and *Fortune* named us one of the “100 Best Companies to Work For.” Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.