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Hope For Investors Burned By Companies That 'Go Dark'

By **Matt Chiappardi**

Law360, Wilmington (April 25, 2016, 9:46 PM ET) -- When a foreign company incorporates in the U.S. and then "goes dark," investors are often left with no place to turn. Enter Anderson Kill PC's David Graff.

Using a method pioneered by the reviled corporate raiders of the 1980s, Graff says he's so far been able to shake loose millions of dollars for investors left at a dead end when a foreign company that sets up shop in the United States — perhaps to raise capital in an initial public offering or a debt offering — simply stops reporting to securities regulators, sometimes for years.

When companies go dark, the silence and stagnation can cause the value of their stocks to drop precipitously, leaving investors, many of whom tend to be Main Street traders, holding the bag without ever having intended to bear the risk of company behavior that's illegal under U.S. Securities and Exchange Commission rules.

It's a phenomenon that began accelerating in the 2000s — roughly 200 companies "went dark" in 2003 alone, according to a 2004 report from the University of Pennsylvania's Wharton School of Business — and has been roundly criticized by investors who've lost millions by sinking money into foreign markets believed to be white hot at the time.

And while companies from many shores engage in the practice, finding recourse can be particularly difficult if the company that goes dark is based in China, where the responsible parties tend to be far beyond the normal reach of U.S. judicial power. In such situations, investors can suddenly find themselves thrust into the middle of a sticky financial and geopolitical situation.

"This is the two biggest markets in the world gone awry," Graff told Law360. "These [investors] end up in international battles when all they were really looking to do is day trade."

Even if a judge in a U.S. court were to issue an order to, say, seize a particular company's assets, there's no direct mechanism to compel compliance in China. And further, Graff says, regulators are essentially standing on the sidelines while these companies flout SEC reporting rules.

"It's a huge problem, and nobody from the regulatory standpoint seems to be doing anything to stop it," he said.

The SEC declined to comment.

But where traditional channels have left investors out in the cold, Graff says he’s borrowed a page that corporate raiders used in their 1980s heyday: gain control of a company and use that power to enact decisions generally at odds with management’s wishes.

Instead of greenmailing a takeover to effectively line a raider’s pockets, here, Graff says, he uses judicial means to allow investors to extract their shares at a fair value.

“The process is a new take on the old guard of corporate takeover plays prevalent in the 1980s,” he said. “Whereas there the raiders bought up the equity to effectuate potential changes in control to unlock the value of the enterprise and receive the enterprise's strategic value on their shares when sold, or greenmail management for the same end, here, we use the court system to accomplish the same end — turning a distressed losing position into a winning control play.”

The method has so far been used successfully in several cases, including Delaware Chancery Court lawsuits against companies like Southern China Livestock Inc., Yinlips Technology Inc. and ZST Digital Networks Inc., as well as other proceedings in Nevada and New York against NIVS Intellimedia Technology Inc., Pacific Net and Shengtai Pharmaceutical Inc.

ZST was one of the first tests of the method. In that case, launched in 2012, the suing shareholder lodged what in Delaware is known as a "220 action," a lawsuit to demand inspection of a company’s books and records under Section 220 of the Delaware General Corporation Law.

When ZST didn’t comply, Graff didn't seek a simple fine, which probably wouldn’t be paid, or revocation of a company charter, which would ultimately be counterproductive. Instead, he pushed for a special purpose receiver over the Delaware subsidiary within the court’s reach.

The Chancery Court granted his request — likely the first time a receiver was appointed over a solvent Delaware corporation, he said — and the receiver, with broad powers, set in motion a chain of events that has been followed in similar cases since.

When a company like ZST fails to comply with the court’s 220 order, it can then be hit with a contempt order, sanctions and fee shifting, and a receiver can be appointed with a mandate to collect the judgment.

For example, a receiver might attack the value of insider shares to force a settlement from principals. Or it could use the voting power of the Delaware subsidiary's shares to force out the current board and elect new “friendly” directors.

From there the quasi takeover can reach through a web of international units, with the friendly board ousting and replacing directors in a subsidiary in, for example, the British Virgin Islands, and ultimately the target company’s parent — say, in Hong Kong.

Once the receiver has indirectly seized control of the parent in Hong Kong, it can direct the subsidiary in mainland China to perform all manner of remedies, from selling assets to seizing bank accounts — and all of this would fall under the protection of the internal affairs doctrine, which defers to the rules of a company’s home jurisdiction.

Because China respects the doctrine, the target businesses in this scenario would be run under Hong Kong rules, and directives from the parent to raise money for the U.S. investors would be enforced by

Chinese courts, Graff said.

“Ultimately, the proceeds of these actions are for the sole benefit of the investor left at loose ends in the United States,” Graff said.

In the case of ZST, the method was so successful that the Chinese court ruled the suing investors could not only collect from the company, but definitively own and control it, Graff said, and similar results have been achieved in other cases.

In one case, against Nutfruit Group Ltd., adjudicated in Nevada and New York, negotiations are even underway for the firm’s chairman to buy back his company from the suing investors.

Graff won’t reveal a precise figure for the amount of money he’s recovered for investors because many of the resolutions are achieved by settlements with varying degrees of confidentiality, but he says it is so far measurable in the millions.

“This rarely ends with a judgment or something stamped by the court,” he said.

Graff adds that while the strategy was developed to deal with an equity holder in a company that has its principal operations and assets in China, the methodology can be, and has been, used for other international and domestic firms, and can work for secured or unsecured judgment creditors.

“When a shareholder invests in a company, it expects to receive a return commensurate with the fair value of its holdings,” Graff said. “When we are able to get that shareholder that which it expected and deserved in the first place, and at times perhaps even more, it’s beyond gratifying.”

--Editing by Mark Lebetkin and Kat Laskowski.