Published on *The National Law Review* https://natlawreview.com

The $180 Million Chinese Coffee Case for Attempting to Manage Earnings

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Last week, on December 16, 2020, Chinese-based coffee chain Luckin Coffee Inc. (“Luckin”) agreed to a $180 million settlement with the United States Securities and Exchange Commission (“SEC”). Luckin’s American Depositary Shares traded on the Nasdaq until July 13, 2020. The settlement stems from allegations that Luckin defrauded investors by materially misstating revenues, expenses, and net operating losses. The SEC’s complaint alleges that these fraudulent accounting actions were taken in an attempt by Luckin to increase profitability and meet earnings estimates.

The case is a reminder of risks associated with investing in U.S. listed companies with Chinese operations, which the SEC flagged in a June 2011 bulletin and a December 2018 cautionary public statement. The case follows a number of SEC enforcement proceedings brought in 2011-2012 featuring trading halts or delistings of at least 50 companies in those years.

According to the SEC, “from at least April 2019 through January 2020, Luckin intentionally fabricated more than $300 million in retail sales by using related parties to create false sales transactions through three separate purchasing schemes.” The Complaint further alleges, “Luckin employees attempted to conceal the fraud by inflating the company’s expenses by more than $190 million, creating a fake operations database, and altering accounting and bank records to reflect the false sales.” The Complaint goes on to allege that Luckin raised more than $864 million from investors from April 2019 through January 2020.

In the press release, Stephanie Avakian, Director of the SEC’s Division of Enforcement, stated, “[p]ublic issuers who access our markets, regardless of where they are located, must not provide false or misleading information to investors… While there are challenges in our ability to effectively hold foreign issuers and their officers and directors accountable to the same extent as U.S. issuers and persons, we will continue to use all our available resources to protect investors when foreign issuers violate the federal securities laws.”

The SEC Complaint includes charges for violations of anti-fraud, reporting, books and records, and internal control provisions of the federal securities laws. The anti-fraud provisions include scienter-based charges. The settlement includes a $180 million penalty. The SEC noted that such payment may be offset by certain payments made by Luckin to its security holders, subject to approval by Chinese authorities.

There are a few takeaways from the matter. First, the SEC continues to pursue accounting fraud cases, with a particular focus on earnings management. Second, the SEC will exercise its expansive jurisdictional footprint to investigate and charge foreign entities when appropriate and feasible. Moreover, the SEC charged Luckin with scienter-based fraud charges, unlike the trend towards non-scienter based charges under Chair Clayton. Finally, the SEC did not charge any individuals, possibly reflecting difficulties in pursuing an investigation in a notoriously uncooperative jurisdiction.

National Law Review, Volume X, Number 358