

## Legal Analysis of Luckin Coffee's Financial Fraud

Jiani Huang<sup>1, a, \*</sup>, Xueqin Li<sup>1, b</sup>, Xinru Chen<sup>2, c</sup>

<sup>1</sup>Law School, Shanxi University of Finance and Economics, Taiyuan030006, China

<sup>2</sup>Faculty of Economics, Shanxi University of Finance and Economics, Taiyuan030006, China

<sup>a</sup>d15536827527@163.com, <sup>b</sup>346188259@qq.com, <sup>c</sup>1392434536@qq.com

\*Corresponding author

**Keywords:** Luckin Coffee; New Securities Law; D&O Insurance; Group Lawsuit

**Abstract:** the night of April 2, 2020, Luckin Coffee released an internal investigation report on "fake 2.2 billion yuan transactions" after the investigation, admitting that Jian Liu, the company's chief operating officer and director, and his employees engaged in improper behaviors, including falsifying transaction data, starting from the second quarter of 2019. According to the data, Luckin's main business revenue in the first three quarters of 2019 was 2.929 billion yuan, while the fraud scale of 2.2 billion yuan was close to its total revenue in the three quarters. As a result, Luckin coffee's U.S. stock price fell more than 20 percent, wiping out more than \$30 billion in market value. This incident has aroused the discussion from all walks of life.

### 1. Introduction

Luckin Coffee is China's new retail specialty coffee operator, known as a "cost effective" conscientious enterprise, founded in 2017 by Zhiya Qian. The chain's coffee brand is just 20 months old, ready to be listed on the Nasdaq Stock Exchange in May 2019, and raised an additional \$1.13 billion in January 2020 through fixed-issue and convertible bonds. On April 2nd, LK. US sent to the Securities and Exchange Commission's announcement shows that, the COO Jian Liu and related employees engaged in improper behaviors including fabricating transactions from the second quarter of 2019, initially estimating that the amount of fabricated transactions amounted to 2.2 billion yuan from Q2 to Q4 in 2019, during which expenses were also substantially inflated. From the perspective of law, this paper analyzes the effect of the extraterritorial application of China's New Securities Law in Luckin case, application of D&O Insurance, the liabilities faced, the subject of liability and the enlightenment to China. Because the incident comes at a time when New Securities Law are being introduced, it could become a landmark event.

### 2. The Effect of Extraterritorial Application of China's New Securities Law

China's New Securities Law officially took effect on March 1, 2020. When the Luckin incident happened, a hot topic was whether China's New Securities Law could be applied to the Luckin incident and the issue of accountability. Article 2, paragraph 4, of the New Securities Law clearly states that "securities issuance and trading activities outside the territory of the People's Republic of China that disrupt the market order within the territory of the People's Republic of China and harm the legitimate rights and interests of domestic investors shall be dealt with and investigated for legal responsibility in accordance with the relevant provisions of this law." This article can also be regarded as the "long-arm jurisdiction" of the securities law for overseas law enforcement. With the enhancement of China's economic strength, the crackdown on economic crimes is getting stronger and stronger, and the pursuit of overseas fugitives is becoming more and more severe. Therefore, there is a view that although Luckin is registered in the Cayman islands and listed on Nasdaq in the United States, Luckin's IPO includes the participation of domestic investment institutions in the secondary placement, and for domestic investors whose legitimate interests are damaged, so the

"long-arm jurisdiction" can be used to hold Luckin accountable. The view was also expressed that the meaning of "long-arm jurisdiction" should be appropriately curtailed. If the broad understanding, disturb the domestic market order and damage the legitimate rights and interests of investors, its extension can be very large. The Securities Law protects the investors in the process of "public offering" and maintains the market order in China. For those pure red chip enterprises whose main assets are in China and the issuing subject is abroad, such as Luckin, although it has the joint point of Chinese assets, it lacks the close contact point in the sense of securities supervision, so it is not suitable to apply the "long-arm jurisdiction" of the New Securities Law in the case of Luckin.

The author is inclined to the second point of view, "long-arm jurisdiction" is not appropriate and necessary to expand the explanation. As a kind of public power, securities regulation should be based on maintaining the order of China's public market and protecting the interests of China's public investors. In other words, if only a few private equity investors are involved, it may be advisable not to initiate "long-arm jurisdiction". The reprimand by the China securities regulatory commission (CSRC) immediately after the Luckin incident means that regulators will not stand idly by, but whether the "long-arm jurisdiction" will eventually be initiated is not a purely legal issue. It will also depend on the value judgment and policy choices of regulators.

### **3. Application of D&O Insurance**

Luckin Coffee is said to have bought a corresponding liability insurance policy before going public in the US. In response, Ping An insurance company of China, which underwrote the insurance, said it had received the claim application filed by the insured and was in the process of further processing.

#### **3.1 The Concept of D&O Insurance**

D&O insurance is the civil liability insurance jointly purchased by the company or the company and the directors and senior management personnel, which is compensated by the insurer. When a director or officer is held personally liable for an allegation of negligence or misconduct, the insurer shall indemnify and reimburse the director or officer for any legal expenses incurred in defending the director or officer's liability. Director liability insurance is a kind of liability insurance for company executives, which only protects the negligence of executives and does not include malicious information disclosure. However, the contents of directors' liability insurance of each company are not the same, which needs to be treated according to the specific contents of the insurance contract signed. [1]

#### **3.2 The Definition of "Misconduct" in the D&O Insurance**

Whether Luckin event can get the compensation of insurance needs to further determine the factual behavior of financial fraud of Luckin event. According to relevant personages of Anda insurance department, it is one of the key factors to trigger the liability insurance policy to determine the nature of "misconduct" such as breach of disclosure obligation, duty of loyalty and diligence. "Improper behavior" has subjectively "intentionally" and "fault" cent, and what insurance gives safeguard is "liability of honest operators for compensation", namely negligent act. Only when a reasonable duty of care has been fulfilled in the operation but the negligence still causes damage to the person can be included in the insurance liability. However, the compensation liability and the loss of the policyholder caused by "intentional" and "criminal acts" do not belong to the insurance compensation mechanism.

Therefore, the author believes that whether Luckin can apply the director's liability insurance should first determine the contents of the signed contract of director's liability insurance, and then identify the executives' behaviors of financial fraud of Luckin respectively, so as to determine whether there are "improper behaviors". But Luckin's case is complicated, especially since it will require the intervention of securities regulators and legal authorities.

#### **4. Luckin's Liability under U.S. Law**

The Luckin scandal could trigger an investigation by the U.S. Securities and Exchange Commission, which in conjunction with the justice department could open a criminal investigation into the company and the individuals responsible, and group lawsuit and sky-high fines could wipe out the company.

##### **4.1 Administrative and Criminal Liability under the Sarbanes-oxley Act**

Sarbanes-oxley Act, also known as SOX Act, is a regulatory regulation established by the U.S. legislature based on the corporate and securities supervision problems exposed in the bankruptcy of Enron Corporation Limited, WorldCom Corporation and other financial fraud events. It greatly increases the illegal cost of financial fraud of listed companies. Clearly, the United States is deeply disgusted by the financial fraud of listed companies. Luckin could face both administrative and criminal penalties under the Sarbanes-oxley Act on legal liability. Specifically, intentional securities fraud is punishable by up to 25 years in prison and fines of up to \$5 million and \$25 million for individuals and companies that commit fraud; Willful destruction or falsification of documents to prevent, impede, or influence a federal investigation is considered a serious crime and is punishable by a fine or 20 years in prison, or a combination thereof; The company's chief executive and chief financial officer must swear on the legality and fairness of financial reports filed with the securities and exchange commission, and those who violate this rule will be fined under \$500,000 or sentenced to five years in prison.[2]

Therefore, it is known that if the fraud is true, first of all, the company is bound to be subject to the administrative enforcement by the U.S. securities and exchange commission, which is likely to receive sky-high fines. It is also not ruled out that the company will be delisted from the exchange. Criminal liability under the Sarbanes Oxley Act is only one of several, including the possibility of up to 25 years in prison for intentional securities fraud.

##### **4.2 Civil Liability: Group Lawsuit in the United States**

The characteristics of the group lawsuit is not required does not allow every investor to sue, but choose one or several large losses of investors to class-action lawsuit on behalf of all investors, this is called the chief of the plaintiff, the case is integrated into a case, the trial results are applicable to all investors, is one of the ways to investors to seek relief. On February 13, 2020, a class action lawsuit was filed against Luckin in the court of the southern district of New York, accusing Luckin of releasing materially false or misleading information and failing to disclose adverse information, in violation of the securities act of 1934 in the United States. On April 2, Luckin revealed financial fraud, which led to a new wave of class action.

###### **4.2.1 The Core of American Group Lawsuits is "Express Withdrawal".**

"Express withdrawal" means that the investor of the plaintiff does not clearly indicate the withdrawal from the class action, it automatically becomes a member of the plaintiff. Investors are often willing to join the plaintiffs out of a "free ride" mentality, where they can enjoy settlements or victories without paying a penny. Thousands of investors have filed claims against Luckin that could lead to its bankruptcy.[3]

###### **4.2.2 The Important Initiator of Group Lawsuits in the United States is the Group of Lawyers**

America's "fees for winning a lawsuit" system encourages a group of lawyers active in the securities market who specialise in representing investors in litigation. These lawyers pay daily attention to the information disclosure of public companies and the market performance of their stocks. Once there are any suspicious points in the information disclosure documents of the listed

company or abnormal fluctuations in the stock price, professional investigation will be carried out. If any violation is found, a class action will be immediately organized.

#### **4.2.3 American Group Lawsuits often End in Settlements**

Investors hope to get compensation as soon as possible, lawyers hope to get lawyer fees as soon as possible, and listed companies hope to get rid of the negative impact brought by class action as soon as possible. Under multiple driving forces, class action is often settled by means of settlement. Luckin's suit is likely to avoid a substantive trial after paying substantial damages. Class-action damages can range from 20% to 50% of an investor's loss. It is worth emphasizing that only the investor protection agency can bring the "Chinese type of class action" stipulated in the New Securities Law of China, which is quite different from the lawyers as the main promoter of class action in the American market.

#### **5. Who is the Subject of Responsibility?**

The company is a legal person. Although it has an independent personality, its ownership is separated from the business right, forming a set of operating mechanism, and there are different levels of principal-agent relations. The vertical principal-agent relationship includes shareholders, the board of directors and the management. The management, led by the CEO, also has layers of authorization with the subordinate departments. Luckin suddenly "show its own scandal" and several different entities emerged, including a special committee of independent directors, the company's board of directors that handled the investigation reports, and COO Liu Jian, who was accused of leading the fraud. Lawrence Rosen, founder of Rosen Law, says that in addition to Luckin, he will name Zhiya Qian who is Luckin's CEO and Reinout Hendrik Schake who is chief financial officer as co-defendants. So the CEO, CFO and COO may all be to blame.

#### **6. The Influence of Luckin Case on China's New Securities Law**

A highlight of China's New Securities Law is to change the "audit system" to "registration system", and at the same time to increase the intensity of information disclosure and investor protection, greatly raising the cost of illegal market entities. For example, the fixed penalty for fraudulent issuance and letter approval can be up to 20 million yuan or 10 million yuan. The New Securities Law establishes a Chinese-style class action of "express withdrawal and implied accession", which can bankrupt the companies and persons liable. After the Luckin incident, the registration system that China is beginning to implement needs to be more cautious. The back-end legal liability for violation of laws must be very strict. The issuer must also attach great importance to securities compliance and strictly follow the principle of legality and good faith to avoid the recurrence of Luckin incident.

#### **7. Conclusion**

Throughout history, the chase for capital and the breeding of evil have been repeated all over the world. Some act as ordinary investors, some as manipulators, and some as counterfeiters. However, if these stories did not happen, there would be no institutional innovation and constant improvement in regulation. Any capital market develops in the interlaced game of light and darkness. If the fraud Luckin contributed anything, it is to provide another case of past experience for the capital market, but also to all listed companies sounded the alarm: law-abiding, integrity is the foundation of the enterprise, and the loss of integrity will be condemned by the market and the law.

#### **References**

[1] Tianzheng Lu. A Study on Directors' Liability Insurance and its Influence on Corporate Governance[D]. Guangxi University, 2019.

- [2] Peng Wang.A Case Study on Financial Fraud of KMJC Company[D]. Anhui University,2019.
- [3] Haizhou Pi.Luckin's Survival is a Miracle[J].Financial Investment Report,2020