

Client Alert.

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China-based Company's Victory in Securities Fraud Case Reversed on Appeal

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On August 1, 2012, the Court of Appeals for the Second Circuit revived a putative securities fraud class action lawsuit against China North East Petroleum Holdings Ltd. ("NEP"), a China-based crude oil production company whose stock was traded on the New York Stock Exchange.¹ Reversing the trial court, which had dismissed the case, the Court of Appeals held that the recovery of NEP's stock price to a level above the price paid by the plaintiff did not necessarily preclude the plaintiff from proving that it had suffered an economic loss as a result of the alleged fraud.

THE UNDERLYING CASE

Last October, in the midst of a wave of U.S. securities fraud lawsuits filed against China-based companies that began in 2010, NEP achieved a significant victory when a federal District Court in New York dismissed a complaint alleging that the company had committed fraud. The complaint accused NEP of misleading investors by significantly overstating its reported earnings and oil reserves. The complaint also alleged that, contrary to NEP's representations, its internal controls were inadequate and permitted the company's CEO and his mother to improperly transfer money out of company accounts. According to the complaint, the alleged fraud was revealed when NEP withdrew its financial statements for 2008 and 2009, followed by announcements that the company's internal controls were deficient, that it was facing delisting of its stock from the New York Stock Exchange, and that it had misvalued certain oil and gas properties. NEP's stock price fell sharply in the days following each of these disclosures. Days after the end of the purported class period, however, NEP's stock price had somewhat rebounded and was higher than the average purchase price that the lead plaintiff, Acticon AG, had paid for its shares.

NEP moved to dismiss the complaint on various grounds. During oral argument on the motion, the District Court did not address the defendants' key arguments. Instead, the court expressed concern about whether Acticon could show loss causation because, after the alleged fraud had been revealed, Acticon could have sold its shares for a higher price than it paid for them. After ordering supplemental briefing, the District Court held that, as a matter of law, Acticon did not suffer an economic loss because Acticon missed its opportunity to sell its NEP shares at a profit when the price of NEP stock rose above the purchase price on twelve different days during the two months after the alleged fraud had been revealed.² Finding that this precluded Acticon from proving that it had suffered an economic loss, the District Court dismissed the complaint.

¹ Acticon AG, et al., v. China North East Petroleum Holdings Ltd., 11-4544 (2d Cir. Aug. 1, 2012).

² In re China Ne. Petroleum Holdings Ltd. Secs. Litig., 819 F. Supp. 2d 351, 352 (S.D.N.Y. 2011).

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THE APPEAL

Acticon quickly appealed the order dismissing the complaint, arguing that the District Court had misapplied the law. Last week, the Second Circuit agreed, vacating the ruling and remanding the case to the District Court for further proceedings. In overruling the District Court, the Second Circuit held that:

*At this stage in the litigation, we do not know whether the price rebounds represent the market's reaction to the disclosure of the alleged fraud or whether they represent unrelated gains. We thus do not know whether it is proper to offset the price recovery against Acticon's losses in determining Acticon's economic loss. Accordingly, the recovery does not negate the inference that Acticon has suffered an economic loss.*³

The Second Circuit explained that “[i]f we credit an unrelated gain against the plaintiff's recovery for the inflated purchase price, he has not been brought to the same position as a plaintiff who was not defrauded because he does not have the opportunity to profit (or suffer losses) from ‘a second investment decision unrelated to his initial decision to purchase the stock.’”⁴ Therefore, the Second Circuit was unwilling, at the pleading stage of litigation, to rule that a stock price recovery to a price above that paid by the plaintiff would *necessarily* prevent the plaintiff from showing that it had suffered an economic loss from the alleged fraud.

Notably, the Second Circuit declined to consider the defendants' other arguments for dismissal, instead preferring that the District Court rule on those arguments in the first instance.

NOW WHAT?

While the Second Circuit's ruling gave the plaintiff's claims new life, it remains to be seen whether those claims will survive the defendants' motion to dismiss, let alone make it past other contentious stages of a securities class action. On remand, the District Court will now have to determine whether the complaint can proceed in the face of defendants' numerous remaining arguments for dismissal—which the District Court did not consider given its narrow ruling on the sole issue of economic loss. As NPE's lawyer stated in reaction to the Second Circuit's opinion: “The district court had raised the issue on its own, and all of our defenses and theories remain intact.”⁵

The plaintiff's lawyers are calling the Second Circuit's ruling a “significant victory” that will permit investors who were allegedly defrauded to “have their day in court.”⁶ Only time will tell, however, whether the District Court will agree—or whether it will again dismiss the complaint on the alternative grounds urged by the defendants.

Both the District Court's and Court of Appeals, opinions are significant because they highlight the strict legal and pleading requirements that plaintiffs must overcome to pursue securities fraud claims—even claims raising serious allegations of fraud such as those involving Chinese reverse-merger companies. And for these defendants, the strict pleading standards governing federal securities fraud claims, along with technical legal defenses such as loss causation, may prove to be powerful (and effective) tools in combatting allegations of fraud.

³ Acticon, 11-4544, at *12 (emphasis added).

⁴ Id. (quoting *Harris v. Am. Inv. Co.*, 523 F.2d 220, 228 (8th Cir. 1975), cert. denied, 423 U.S. 1054 (1976)).

⁵ Jonathan Stempel, *Stock Price Rebound No Bar to Fraud Damages* – US Court, Reuters.com (Aug. 1, 2012).

⁶ Pomerantz Press Release, *Pomerantz Achieves Significant Victory for Shareholders Before Second Circuit Court of Appeals* (Aug. 1, 2012), available at <http://www.globenewswire.com/newsroom/news.html?d=10000580>.

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