

ANTIFRAUD

Dismissal of Securities Fraud Case Against China-Based Company Once Again Reversed on Appeal

Second Circuit revives claims against CNEP for second time while vindicating former director's "noisy" exit



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The U.S. Court of Appeals for the Second Circuit recently revived parts of a long-running shareholder class action litigation—originally filed in 2010—in which oil production and exploration company China Northeast Petroleum Holdings Limited (“CNEP” or the “Company”) stands accused of fraud that led to a collapse of its stock price. This is the second time that the Second Circuit has reversed the trial court’s dismissal of securities fraud claims against CNEP, having overturned the trial court’s prior dismissal of the complaint on loss causation grounds in August 2012.¹ The shareholder class action, which is only one of many legal pro-

¹ For a discussion of the prior ruling, see “China-based Company’s Victory in Securities Fraud Case Reversed on Appeal,” Morrison & Foerster Client Alert (August 7, 2012), available at <http://media.mofo.com/files/Uploads/Images/120807-China-Securities-Fraud.pdf>.

ceedings to spin out of the fraud allegations against CNEP, is illustrative of the scope and duration of legal actions that publicly listed companies in the United States (especially foreign companies) with internal control deficiencies should be prepared to defend.

In reversing the trial court’s dismissal of securities fraud claims against CNEP and two executives, the Second Circuit’s latest decision provides helpful reminders regarding key securities fraud pleading issues, including the knowledge (scienter) that a complaint must allege to survive a motion to dismiss. Notably, however, the Second Circuit affirmed the trial court’s dismissal of claims against the former chairman of the audit committee, illustrating that diligent efforts to discharge and document oversight responsibilities can help mitigate the risk posed by potential claims of securities fraud.

Case History.

In April 2010, CNEP made the first of a series of disclosures regarding material weaknesses in its internal controls, revealing that it had been misstating net in-

come and the value of its oil reserves.² Shortly thereafter, CNEP disclosed preliminary findings of a forensic audit suggesting that unauthorized cash transfers had occurred between the Company and the personal bank accounts of the then-Chief Executive Officer, Wang Hongjun, and Wang's mother, Ju Guizhi, who was at the time a director of the Company.³ In June 2010, several investor groups commenced a class action lawsuit alleging that the CNEP and its senior leadership had inflated the amount of oil reserves, overstated earnings, and engaged in embezzlement. Parallel developments to the shareholder litigation included a "noisy" resignation⁴ by the chair of the audit committee following the Company's refusal to further investigate these matters, and enforcement actions by the U.S. Securities and Exchange Commission (SEC) and the U.S. Department of Justice (DOJ).⁵

In October 2011, the district court in the Southern District of New York dismissed the securities fraud

² <https://www.sec.gov/Archives/edgar/data/787251/000121465910001127/f4191048ka2.htm>.

³ https://www.sec.gov/Archives/edgar/data/787251/000121465910001535/ex99_1.htm.

⁴ In July 2010, the chairman of the audit committee wrote a letter to his fellow directors strongly urging them to authorize an internal investigation into the accuracy of the Company's financial statements and whether payments made by the Company may have violated the Foreign Corrupt Practices Act (FCPA). In denying his request, the chairman of the board reasoned that, among other things, such an investigation "could last as long as a full year and cost the Company as much as several millions of dollars" and ended his letter by noting that "the course of action you recommend that the Board pursue seems at odds with the prudent discharge of duties to the shareholders." The audit committee chairman then resigned, citing their "differing views on this critical question." (The letters between the former audit committee chairman and the CNEP board are available at <http://www.sec.gov/Archives/edgar/data/787251/000121465910002181/0001214659-10-002181-index.htm>).

⁵ In November 2012, the SEC filed a complaint against CNEP and the Company's top officials alleging that they diverted offering proceeds to the personal accounts of corporate insiders and engaged in related fraudulent and deceptive conduct. (See <https://www.sec.gov/litigation/complaints/2012/com22552.pdf>.) A few months later, the DOJ indicted CNEP CEO Wang Hongjun and Chao Jiang, CNEP's Vice President of Corporate Finance. Both were Chinese citizens residing in California and New York, respectively, and were charged with one count of conspiracy to commit wire and securities fraud and four counts of securities fraud. (See <http://www.justice.gov/opa/pr/former-corporate-officers-china-based-oil-and-gas-company-charged-fraud-and-false-statements>.) The DOJ case against Jiang resulted in a mistrial in April 2014, and he subsequently pleaded guilty to a lesser offense of criminal failure to institute adequate internal controls. Jiang was sentenced to three years of probation in December 2014. Jiang settled the SEC charges against him in July 2015, consenting to a final judgment enjoining future securities law violations. Wang did not appear in the criminal action and reportedly remains at large in China.

class action lawsuit.⁶ The court held that, as a matter of law, the lead plaintiff had not suffered economic loss because it had missed its opportunity to sell its shares at a profit when CNEP's share price rose above the purchase price on twelve different days during the two months after the alleged fraud had been revealed. On appeal, the Second Circuit reversed, vacating the district court decision and remanding the case to the trial court for further proceedings. In doing so, 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."⁷

In August 2013, following remand and after several months of mediated negotiations, CNEP agreed to a settlement of \$2.5 million representing approximately 5% of the damages the plaintiff class allegedly suffered. That settlement fell apart in April 2014 when CNEP told the trial court it would be unable to perform its obligations under the settlement agreement. The trial court then proceeded to rule on motions to dismiss the complaint filed by CNEP and the individual defendants, including Wang, Ju, and the former chair of the audit committee. The trial court dismissed the complaint against all defendants, finding that the complaint failed to adequately allege scienter against any of them. The lead plaintiff once again appealed the dismissals to the Second Circuit.

Most Recent Holdings.

On August 28, 2015, the Second Circuit issued a Summary Order (the "Order") disposing of the appeal. In the Order, the Second Circuit vacated the district court's dismissal of the Section 10(b) of the Securities Exchange Act and Rule 10b-5 claims against CNEP and Wang. The Second Circuit concluded that the complaint sufficiently pleaded Wang's scienter with allegations of his motive and opportunity to commit fraud. The Order relied on the complaint's allegations that, as CNEP's CEO, "Wang signed all of the relevant SEC filings attesting to the company's internal controls, while allegedly simultaneously looting China North's treasury and engaging in unauthorized transfers of company funds."⁸ Given Wang's position as CEO, the Second Circuit held that his scienter could be imputed to the Company. Accordingly, the Second Circuit vacated the district court's dismissal of the fraud claims against both CNEP and Wang.

The Second Circuit affirmed the dismissal of fraud claims against Ju because there was no allegation that she reviewed or signed CNEP's allegedly false SEC filings "and thus no basis to conclude that she made a material misrepresentation" as required for liability under Section 10(b). Because it revived the claims against

⁶ *In re China Ne. Petroleum Holdings Ltd. Secs. Litig.*, 819 F. Supp. 2d 351, 352 (S.D.N.Y. 2011).

⁷ *Acticon AG, et al., v. China Ne. Petroleum Holdings Ltd.*, 11-4544 (2d Cir. Aug. 1, 2012).

⁸ Slip Op. at 2.

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CNEP, however, the Second Circuit also revived the claims against both Wang and Ju under Section 20(a) of the Securities Exchange Act, which provides that individual executives, as control persons, are secondarily liable for their company's violations.⁹ The Second Circuit reasoned that as CNEP's CEO, Wang "may be liable as an individual who controlled China North and played a culpable role in its fraud" and "[s]imilarly, that as a director of China North and an alleged participant in the unauthorized transfers, Ju may also be liable as a 'controlling person' under Section 20(a)."¹⁰ The Second Circuit left the trial court to rule on the sufficiency of the complaint's controlling person allegations on remand.

With regard to CNEP's other directors and officers, plaintiffs attempted to show scienter through these defendants' conscious misbehavior or recklessness. The panel held that "a plaintiff relying solely on the defendant's alleged conscious misbehavior or recklessness . . . must show conscious recklessness – i.e., a state of mind approximating actual intent, and not merely a heightened form of negligence."¹¹ Such conduct must "at the least" be "highly unreasonable and . . . represent[] an extreme departure from the standards of ordinary care to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it."¹² The Order concluded that the complaint did not meet this pleading standard because failure to identify defects in the Company's internal controls does not constitute reckless conduct sufficient for Section 10(b) liability.

Finally, in what can be interpreted as a strong vindication of efforts by directors to discharge their duties from a corporate governance perspective and not have those efforts count against them in subsequent litigation, the Second Circuit affirmed the dismissal of the claims against the audit committee chairman who, as described above, made a "noisy exit" in response to the Company's refusal to further investigate issues raised by a forensic audit. In dismissing the claims, the district court held that the former audit committee chairman's behavior as alleged in the complaint "not only fails to establish scienter but actually exonerates him from any allegations of wrongdoing." The district court concluded that "the most logical inference that can be made based on the facts alleged in the Complaint is that [the chairman] was acting in good faith to try to discover and correct any prior misstatements by China North." The Second Circuit agreed, holding that any inference that the chairman acted with scienter is "further weakened by allegations describing his affirmative efforts to uncover fraud by China North."¹³

To What End?

Although the case has been revived and remanded to the trial court, it is unclear whether the case will pro-

ceed in any meaningful way against CNEP. A prior mediated settlement already has fallen apart, CNEP was unrepresented and did not appear in the appeal, and CNEP's counsel of record before the district court has sought leave to withdraw from representing CNEP and its officers and directors.¹⁴ It is doubtful that a default judgment against CNEP and/or Wang would advance the cause of CNEP investors, as U.S. court judgments cannot be directly recognized and enforced in mainland China where assets (if any) of CNEP and Wang are likely to be found. Other investors have turned their attention to CNEP's former audit firm to seek recourse, filing a securities fraud complaint¹⁵ against the firm and two audit partners on the heels of the SEC's administrative censure of them for improper professional conduct in connection with their audit of CNEP.¹⁶ These travails are a stern reminder of the difficulties that many investors have faced in seeking recompense following allegations of fraud against China-based companies and individuals over the past few years.

Regardless, the Second Circuit's affirmation of the dismissal against CNEP's former audit committee chairman should offer some solace to officers and directors who may be concerned that oversighting and documenting their fiduciary duties of oversight could be held against them in any future shareholder litigation. As the district court held—and the appellate court affirmed—courts must consider, when evaluating claims of wrongdoing, not only the inferences urged by plaintiffs from the alleged facts, but also plausible competing inferences. Accordingly, a "noisy exit" can demonstrate in the right circumstances that a director or officer affirmatively acted in good faith to discover and correct wrongdoing, which would weaken any claim that the officer or director had acted improperly with intent to defraud shareholders.

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⁹ 15 U.S.C. § 78t(a). To establish a prima facie case of control person liability, a plaintiff must show (1) a primary violation by the controlled person, (2) control of the primary violator by the defendant, and (3) that the defendant was, in some meaningful sense, a culpable participant in the controlled person's fraud.

¹⁰ Slip Op. at 3.

¹¹ *Id.*

¹² *Id.*

¹³ Slip Op. at 3.

¹⁴ Default also has been entered against CNEP and Wang in the SEC's civil federal court proceeding against the company.

¹⁵ See *Wong v. Baker Tilly Hong Kong Limited, Ross, and Kwok*, No. CV-14-09959 (C.D. Cal.).

¹⁶ See Cease and Desist Order dated December 17, 2014, available at <https://www.sec.gov/litigation/admin/2014/34-73862.pdf>.

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